1994

Section 338(h)(10)

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SECTION 338(h)(10)

by

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Washington, D.C.

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I. Basic Facts

A. Corporation T is engaged in a manufacturing business. T's tax basis balance sheet as of the close of December 31, 1993 is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Accounts payable $3,000,000</td>
</tr>
<tr>
<td>Investment securities</td>
<td>Mortgages payable $4,000,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>Notes payable $11,000,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>Total liabilities $20,000,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>Shareholder's equity $7,000,000</td>
</tr>
<tr>
<td>less depreciation</td>
<td>Total liabilities and shareholder's equity $27,000,000</td>
</tr>
<tr>
<td>Patents</td>
<td></td>
</tr>
<tr>
<td>Licenses</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td></td>
</tr>
<tr>
<td>less depreciation</td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td></td>
</tr>
</tbody>
</table>

$1,000,000 $3,000,000 $11,000,000 $20,000,000 $7,000,000 $27,000,000

B. All of the stock of T is owned by corporation S. S's tax basis in its T stock is $7 million. S and T are members of an affiliated group of corporations which file a Federal consolidated income tax return on a calendar year basis. As of the close of 1993, the group had a non Section 382 limited net operating loss carryover of $40 million, of which $10 million is attributable to T.

1. The existence of both a net operating loss attributable to T, as well as the identity of S's basis in the T stock and T's net basis in its assets may have been caused by several factors, including the distribution of appreciated property from T to S.

C. Alternatively, T is an S corporation wholly owned by one or more individuals (A). A's basis in the T stock is $7 million.
D. S (or A) desires to dispose of its manufacturing operations. For various nontax reasons (e.g., liability exposure, nontransferable assets), the disposition must take the form of a sale of T stock.

E. Corporation P is interested in acquiring T.

1. P has valued the assets of T based on an acquisition of the T assets -- i.e., assuming a revaluation of asset basis -- as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Investment securities</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Patents</td>
<td>10,000,000</td>
</tr>
<tr>
<td>Licenses</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Land</td>
<td>12,000,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Customer relationships</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>5,000,000</td>
</tr>
</tbody>
</table>

Total: $63,000,000

2. If, however, the form of acquisition were a stock purchase, P would expect to retain T's historic asset basis, i.e., a regular Section 338 election would not make economic sense. In the absence of tax benefit resulting from basis revaluation, P has estimated the value of T's assets to be as set forth below. In theory, this value is the "stepped up" fair market value set forth above, less the present discounted value of the tax benefit resulting from the step up, taking into account the anticipated retention period, depreciation lives, etc.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Investment securities</td>
<td>4,500,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>2,650,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Patents</td>
<td>9,000,000</td>
</tr>
<tr>
<td>Licenses</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Land</td>
<td>8,500,000</td>
</tr>
<tr>
<td>Buildings</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Customer relationships</td>
<td>3,350,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>4,000,000</td>
</tr>
</tbody>
</table>

Total: $56,000,000
3. a. Thus, in the absence of any other factors, P should be willing to pay approximately $36 million for the stock of T ($56 million asset value less $20 million liabilities), and $43 million for the T assets ($63 million less $20 million liabilities).

b. In addition, P is concerned about the potential for product liability litigation, and would demand a reduction of approximately $3 million to cover that potential exposure.

II. Deciding Whether a Section 338(h)(10) Election Makes Sense (For the sake of simplicity, the effect of the corporate alternative minimum tax is ignored in the following discussion.)

A. Results in the Absence of the Election

1. To S

a. If S sells the T stock for $33 million ($36 million less $3 million reserved for contingent liabilities), S will recognize a gain of $26 million ($33 million less $7 million basis).

b. By reason of the anti-circularity rule of Reg. §1.1502-11(b), S could not use T's NOL carryover to offset that gain.

c. The NOLs of other S group members would be available (assuming not otherwise limited by the separate return year limitation -- or SRLY -- rules of Reg. §1.1502-21(c) and 22(c)), leaving the S group with no immediate Federal tax payable, but with remaining NOL carryover reduced to $4 million ($30 million-$26 million gain).

d. Thus, S has $33 million in cash and $4 million remaining NOL carryover.

2. To P

a. As noted above, the P group will succeed to T's historic asset basis, leaving the group with tax exposure if the assets are disposed of at full fair market value. That exposure, however, has already been reflected in the price.

b. In addition, the P group will succeed to T's $10 million NOL carryover, subject, however to various limitations including:

(1) Section 382;
(2) The SRLY rules; and

(3) Section 384.

B. Results If Election Made

1. To S
   a. If P pays the full $40 million it presumably would pay in an asset sale ($43 million less $3 million reserved for contingent liabilities), as explained more fully below, T will recognize a gain of $33 million on a deemed sale of its assets. This amount is generally derived from P's purchase price ($40 million) plus T's liabilities assumed ($20 million), less T's asset basis ($27 million). This gain is recognized while T is a member of the S group, and may be offset by T's share of the consolidated NOL ($33 million income x $10 million T NOL/40 consolidated NOL or $8.25 million) reducing the T gain to $24.75 million.
   b. The remaining T gain may be offset by the remaining non SRLY NOLs of the S group ($31.75 million), leaving the group with a remaining carryover of $7 million.
   c. To summarize, the S group has $40 million in cash and $7 million remaining NOL.

2. To P
   a. As explained more fully below, T's basis in its assets will be revalued to reflect P's $60 million purchase price.
   b. T's NOL will be eliminated by the election. On the other hand, T has $33 million more in asset basis, the recovery of which is not limited by Section 382, 384 or the SRLY rules.

(1) In fact, if T were to generate an NOL in the P group, that NOL could be carried back to earlier taxable years of the P group. See PLR 8742006 (July 1, 1987); see also P.L.R. 8802006 (September 30, 1987).

C. Summary

1. If no Section 338(h)(10) election is made, the S group has $33 million in cash and a remaining NOL carryover of $4 million. The P group has a limited-use T NOL of $10 million.
2. If a Section 338(h)(10) election is made, the S group has up to $40 million in cash and $7 million of remaining NOL carryover. The P group has no NOL for T but has an increase in asset basis of $33 million, the recovery of which is not restricted by the NOL limitations.

a. These figures presume that P would pay S the full value of the basis increase. In fact, P may be willing to pay considerably less, keeping a substantial portion for itself. On these numbers, however, there is substantial room for negotiation.

3. Thus, a Section 338(h)(10) election appears to make sense. This result obtains because:

a. Net inside basis is identical to outside basis.

b. There is a substantial spread between basis and fair market value.

c. The increased basis could generally be assigned to assets whose disposition or depreciation would result in a relatively rapid recovery;

d. T has an NOL for which the Section 338(h)(10) election provides full benefit, and which would be limited in the absence of that election; and

e. S owns and sells 100% of T.

4. The application of the variables in Paragraph 3. above obviously affect the utility of the election in any individual case.

a. Thus, when T has been acquired relatively recently by P, a Section 338(h)(10) election probably would not make sense since outside basis is likely to be higher than inside basis.

(1) The loss disallowance regulations (Reg. §1.1502-20), however, increase the importance of the Section 338(h)(10) election, since the election would permit deduction for loss recognized on T's deemed sale of its assets, whereas the deduction for a loss recognized on the actual sale of stock may be denied.

b. Also, new Section 197, added as part of the Revenue Reconciliation Act of 1993, is highly significant in this context. Thus, the 15-year amortization therein provided generally for all acquired intangibles
(including goodwill) will tend to make the Section 338(h)(10) election comparatively more attractive.

c. Another important factor is P's ability to realize the benefit provided by the basis step up. If the acquisition is highly leveraged, the interest deductions could render the recovery of the basis increase significantly less valuable. While any NOLs of T could be carried back to prior years of the P group, the carryback is available, of course, only if the P group has a tax history. If P is newly formed (as in the typical LBO), the ability to carry back NOLs is not relevant.

d. An additional negative factor is the existence of SRLY losses in S. If such losses exist, they would be available to offset S's gain on the sale of its T stock but not T's gain on the deemed (h)(10) sale of its assets. Similarly, to the extent that S has net capital losses, these would be available to offset S's gain on the sale of the T stock, but not any ordinary income recognized by T on the deemed sale of its assets.

III. Eligibility

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

1. A member of an affiliated group of corporations which files a consolidated return;

2. A member of an affiliated group which files separate returns; or

3. An S corporation.

Reg. §1.338(h)(10)-1(a), (c).

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

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

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

b. A selling affiliate is defined as a domestic corporation (not a member of a selling group) from which P purchases the T stock. Reg. §1.338(h)(10)-1(c)(4).

2. Conceptionally, a Section 338 election cannot apply to a parent since, if it did, the inclusive deemed sale tax liability would be, economically, P's responsibility.

C. Similarly, T must be a member of the group on the acquisition date. Regs. §1.338(h)(10)-1(c)(3), (c)(4). Specifically, in the case of a nonconsolidated subsidiary, the regulations require P to purchase from the selling corporation, on the acquisition date, an amount of T stock that satisfies the requirements of Section 1504(a)(2). Reg. §1.338(h)(10)-1(c)(4).

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

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

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

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

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

1. Qualified Stock Purchase
   a. Definition

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

   b. Twelve-month acquisition period

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

   c. Acquisition date

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

   d. Aggregation rule

   All stock purchases made by members of the P group are aggregated
in determining whether a qualified stock purchase has occurred.
Section 338(h)(5),(8); Reg. §1.338-1(d)(7).

      (1) The P group is defined to include P and other members of its
      affiliated group within the meaning of Section 1504(a). In
determining whether the requirements of Section 1504(a) are
satisfied, the exceptions to affiliation provided in Section
1504(b) are not taken into account. Section 338(h)(5).

2. Purchase defined
   a. General

   To count as part of a qualified stock purchase, T stock must be
acquired by “purchase.” A “purchase” is any acquisition of stock
with the following exceptions.
b. Carryover basis acquisitions

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

(1) For example, T stock acquired by P in a transaction to which Section 304(a)(1) applies, and which is treated as a distribution to which Section 301 applies, is not acquired by "purchase." In such a Section 304(a)(1) transaction, P is treated as having received the acquired stock as a contribution to capital. Accordingly, under Section 362(a), P's basis is determined by reference to the transferor's. See Reg. §1.338-2(b)(2)(ii), Example 1.

c. Nonrecognition transactions

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

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

(2) An acquisition of T stock directly from T (and not a T shareholder) for cash arguably may be considered a purchase although, pursuant to Sections 118 and 1032(a), neither P nor T would recognize gain. LTR 8823102 (03/16/88). But cf., Section 338(h)(7)(A) (prior to its repeal by the Tax Reform Act of 1986).

d. Related party acquisitions

A purchase also does not include an acquisition from a person whose stock ownership would be attributed to P under the attribution rules of Section 318(a) (other than the option attribution rule of Section 318(a)(4)). Section 338(h)(3)(A)(iii).

(1) Related corporation exception

However, a purchase, otherwise qualifying, will not be disqualified by the related party rules if the acquisition is from a corporation at least 50% of whose stock was purchased by P. Section 338(h)(3)(C).
(2) **Running of 12-month acquisition period**

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

3. **Combination purchase and redemption**

   a. **General**

      (1) The requirements for a qualified stock purchase may be satisfied through a combination of stock purchases by P and redemptions by T. Reg. §1.338-2(b)(5).

   b. **Computation**

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

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

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

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

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

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

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

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

a. **General**

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

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

b. **Example**

   T owns 80% of T1. On January 1, 1994, P purchases 80% of T and makes a Section 338 election. By reason of that election, new T is treated as having purchased the assets of old T, including the stock of T1. That deemed purchase of T1 stock by new T is considered a purchase for Section 338 purposes by a member of the P group on January 1, 1994. Thus, a Section 338 election may be made for T1. This result occurs even though, economically, P has purchased only 64% (80% x 80%) of T1. T1's deemed sale of its assets occurs on January 1, 1994, immediately after the deemed sale of T's assets.

c. Accordingly, when T has subsidiaries for which a Section 338 election is made, the same economic gain could be taxed twice: once upon the deemed sale by stock, and a second time on the
subsidiary's deemed sale of its assets. In general, the regulations eliminate the stock gain in this context. See Reg. §1.338-3(c).

d. See generally VI.D., infra.

6. Effect of post-acquisition events

a. Liquidation of T into P

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

b. Tax-free liquidation or merger of P

Similarly, if P is merged into another corporation in a tax-free reorganization, or liquidated into its parent under Section 332, the acquiring corporation will succeed to P's ability to make the Section 338 election. Reg. §1.338-2(c)(2).

c. Downstream merger of P into T

(1) In general, Section 338 must be elected by a corporation, not individual purchasers of T. Frequently, however, individuals will form a corporation (P) to purchase the T stock. In addition, for business reasons (for example, the requirement of P's lender to attach the lien to assets of T) it may be necessary to combine P and T. As noted in III.D.6.a., supra. If T liquidates into P, a Section 338 election may be made for T. However, that liquidation requires a transfer of T's assets, which Section 338 was enacted to avoid. What if P merges downstream into T?

(2) The regulations allow the election, provided P is considered for tax purposes to purchase the T stock. (Reg. §1.338-2(b)(1)). Accordingly, if the existence of P is ignored as transitory (see Rev. Rul. 73-427, supra), the implication is that the election will not be allowed since the acquisition will be treated as made by the individual shareholders of P. The regulations further provide that facts which indicate that P does not purchase the T stock include that P merges into T, liquidates, or disposes of the T stock following the QSP.
(3) Private letter rulings suggest that the IRS disregards P in this context. See LTRs 8546110, 8542020, and 8539056. In each ruling, a corporation (P) was formed to acquire the T stock. In each, P borrowed funds, acquired T, and subsequently merged into T, with the debt secured by T's assets. In each, the IRS disregarded P and treated the transaction as a redemption by T of its own stock, to the extent of the borrowed funds and a purchase by P's shareholders, and to the extent of the equity contributed to P. Because in each case P was owned by a corporation, a Section 338 election was still available. If, however, P were owned by individuals, the implication is that a Section 338 election could not be made.

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

7. **Going Public**

   a. The Service has recognized that Section 338(h)(10) may be utilized in a going public transaction. See PLR 9142013 (July 17, 1991). In this ruling, simplified, S transferred the T stock to a Newco (N), at which time it had a binding commitment to sell 51% of the N stock to an underwriter (who in turn, would sell that stock to the public pursuant to a firm commitment underwriting.) The Service ruled that the binding commitment caused Section 351 not to apply to N's acquisition of the T stock. It further held that, since S owned less than 50% of N at the conclusion of the transaction, the stock owned by S would not be attributed to N under Section 318, and therefore the unrelated party requirement of Section 338(h)(3)(A)(iii) was not violated. As a result, N's acquisition of the T stock was a qualified stock purchase entitling N and S to join in a Section 338(h)(10) election.

8. **Retaining an interest**

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

   **Example (1):** Corporation T has an agreed upon value, based on a Section 338(h)(10) election, of $100X. Its sole shareholder, Corporation S desires to retain a preferred stock interest with a value of $10X. A and S form P to which are contributed, respectively $90X in cash and T stock with a value
of $10X. A receives all of the P common and S the P preferred. Thereafter, P purchases the remaining T stock from S for $90X.

Notwithstanding that P has supplied funds for 90 percent of the T stock, and S will recognize gain on the receipt of those funds, it is very possible that the IRS would contend that, as to S and A, the overall transaction is one to which Section 351 applies. In other words, S may be treated as having transferred all of its T stock to P for P preferred stock and cash, and S and A may be regarded as a group of transferors who are in control of P immediately after the transaction. Thus, S's receipt of cash may be regarded as boot under Section 351(b), with the result that, as described above, P will not have accomplished a qualified stock purchase of T by reason of Section 338(h)(3)(A)(i) (basis determined in part by reference to transferor's) and (h)(3)(A)(ii) (stock acquired in Section 351 exchange). See III.D.2.b., c., supra.

This problem may be easily solved.

**Example (2):** The facts are the same as in Example (1) except that, after the acquisition, but as part of the plan, P merges downstream into T. In the merger, A's stock of Newco is exchanged for all of the common stock of T, and S's stock of Newco is exchanged for preferred stock of T described in Section 1504(a)(4). The transaction should be treated in part as a purchase by A of the T common from S (see Rev. Rul. 73-427, 1973-2 C.B. 301), and in part as an exchange by S of common stock for preferred stock in a recapitalization (see Rev. Rul. 78-250, 1978-1 C.B. 83.) If A is a corporation, the transaction should qualify as a qualified stock purchase. Although the regulations do not expressly so provide, the requirements for a qualified stock purchase should be satisfied through a combination purchase and recapitalization of stock for non stock. See Reg. §1.338-2(b)(5); III.D.3., supra.

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

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

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

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

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

Is there a way to make this work?

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

In this structure, however, there is some risk that Newco 1 will be deemed to have made a "gain recognition election," and will thereby be taxed on the gain in the 10% of T that it holds. Since Newco 1 will have acquired that stock in a Section 351 exchange, it represents "nonrecently purchased stock" as to Newco 1. Since Newco 1 and Newco 2 are members of the purchasing group, arguably the deemed gain recognition election rule of Regs. §1.338(h)(10)-1(e)(4) applies. See paragraph VI.A.3.c. infra. On the other hand, since the S group will have been taxed on 100% of the gain, and S indirectly retains an interest in T, the additional level of tax liability may be viewed as inappropriate in this context.
Example (7): As an alternative, instead of receiving stock, S could receive options, convertible debentures, or similar instruments in the acquisition vehicle. Provided that these do not rise to the level of "stock," Section 351 would not apply to the acquisition. At the same time, however, S will have retained an interest in future growth of T.

E. The IRS had ruled that P could not be an S corporation on the grounds that Section 1371(a)(2) provides that, for purposes of Subchapter C, an S corporation in its capacity as a shareholder is treated as an individual. PLR 8818049 (February 10, 1989). This position was reversed in PLR 9245046 (July 28, 1992). Thus, an S corporation can make a qualified stock purchase and join in an (h)(10) election.

1. Consequently, a variety of combinations involving C and S corporations are possible.
   a. As described above, a C corporation can purchase the stock of an S corporation and join in a Section 338(h)(10) election.
   b. Similarly, an S corporation can purchase the stock of a C corporation and join in a Section 338(h)(10) election, provided the C corporation is a member of a consolidated group or is a nonconsolidated 80% owned subsidiary.
   c. Further, an S corporation may purchase the stock of a second S corporation and join in a Section 338(h)(10) election.
   d. Where the S corporation is the purchaser, however, an issue arises concerning whether its ownership of the controlling amount of T stock jeopardizes the acquirer's S election. See Section 1361(b)(1), (b)(2)(A). The Internal Revenue Service has held, however, that S status will not terminate if the subsidiary promptly liquidates into the acquirer. See Rev. Rul. 73-496, 1973-2 C.B. 312. See generally, Eustice and Kuntz, Federal Income Taxation of S Corporations, §3.06[3] (Third Edition).

IV. Procedure

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

1. Since consent of the seller is necessary to make a Section 338(h)(10) election (which only makes sense since the seller is agreeing to bear the tax
liability), the buyer would be well advised to secure the seller's cooperation at an early stage, and make the election a subject of the stock purchase agreement.

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

1. Actually, for acquisitions to which the new regulations apply (generally acquisitions, on or after January 20, 1994), the election is made on Form 8023-A. Form 8023 apparently continues to apply to elections governed by the former Temporary Regulations.

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

1. If the election is not timely filed, relief under Treas. Regs. §1.9100-1 would be available, provided the standards for such relief are satisfied. See Rev. Proc. 92-85, 1992-2 C.B. 490; See e.g., PLRs 9410049 (December 16, 1993); 9321051 (February 25, 1993); 9310016 (December 11, 1992); 9004036 (October 31, 1989); 8948046 (September 7, 1989); 8909053 (December 7, 1988); 8851057 (September 26, 1988).

2. Prior to the amendment of the regulations, the election was filed with the District Director where P's return would be filed. While the final regulations do not specify where the election is to be filed, the instructions to the Form 8023-A provide that the election is to be filed with the Service Center where the return which includes the deemed sale gain is filed.

3. The prior regulations required certain additional information to be supplied (see Temp. Reg. §1.338-1T(e)(1)), and also required the election to be attached to the last return of old T and the first return of new T. (Temp. Reg. §1.338-1T(e)(2)). The instructions to the Form 8023-A similarly require that the form be attached to the last return of old T and the first return of new T.

a. Further, the instructions provide that, whether or not a Section 338 election is made for T, P must attached the Form 8023-A to its return for the year that includes the acquisition date. It is unclear what sanctions apply if the form is not attached to P's return, particularly in the case where no Section 338 election is made.

4. The instructions also provide that, if an election is made for more than one T, a schedule is to be attached showing, for each T, the information otherwise requested on the face of the form. In addition, the schedule must show the amount of the consideration paid for the T stock included in the qualified stock purchase, the liabilities of all Ts on the acquisition date, and
"other relevant items." The instructions make clear that tax liability on the deemed sale is not required in the case of a Section 338(h)(10) election.

5. In the case of an S corporation, the name, address, social security number, tax year, and Service Center where the prior return was filed must be provided for each shareholder who sells T stock in the qualified stock purchase. Similarly, each such shareholder must sign the form.

6. The instructions also provide that a schedule is to be attached identifying any assets to which the carryover basis result of the consistency rules applies. In addition, that schedule must show the consideration paid for each such asset, the basis for such asset as determined under the carryover basis rules, and the name of each corporation buying or selling the asset.

D. The 1990 Act clarified that the Section 338(h)(10) election was not subject to the information reporting rules of Section 1060 (Form 8594), but authorized separate reporting requirements specifically applicable to Section 338(h)(10) elections. See Section 338(h)(10)(C). While implementing regulations have not been issued, the instructions to the Form 8023-A require that the aggregate fair market value (by class) on the acquisition date of the Class II and Class III assets of the Target be supplied, and each intangible amortizable Class III asset be identified with its fair market value and useful life specified.

a. In light of the fact that it is anticipated that Section 197 intangibles will now be considered Class IV assets, it is questionable what intangibles will be covered by this instructions requirement. See V.B.4.a.(4)(a), infra.

V. Consequences of the Election

A. To Sellers

1. Returning to the example, assume that P purchases the T stock for $40 million on June 30, 1994 and a Section 338(h)(10) election is made. How are the results on the S side determined?

2. In the consolidated return context, T is treated as having sold all of its assets in a single transaction at the close of the acquisition date (June 30, 1994), and while a member of the selling consolidated group. Reg. §1.338(h)(10)-1(e)(1). Thus, gain or loss on that sale is realized and recognized under usual tax principles. If T has inventory, whether accounted for on a FIFO, LIFO, or other basis, all realized gain will be taxed as ordinary income. At the same time, realized losses will also be recognized, and will not be subject to Section 267 (See Reg. §1.338-3(b)(3)). The results of that deemed sale are reported in the seller's consolidated return for the period that includes the acquisition date.
a. If T is an S corporation or a nonconsolidated subsidiary the sale is deemed to occur while T is owned by the S corporation shareholders or by the selling parent. Reg. §1.338(h)(10)-1(e)(1).

3. Price at Which Assets Deemed Sold

a. **MADSP formula:** A formula must be used to determine selling price. Reg. §1.338(h)(10)-1(f). That formula determines fair market value by reference to the amount paid.

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

c. Thus, the (h)(10) formula determines a modified ADSP ("MADSP") and is as follows (Reg. §1.338(h)(10)-1(f)(2)):

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

\[G\] is the grossed up basis of recently purchased stock;

\[L\] is new T's liabilities as of the beginning of the day after the acquisition date (not including liabilities that were not liabilities of old T). Reg. §1.338(h)(10)-1(f)(3); §1.338(b)-1(f). T's tax liability resulting from the sale is not included, as this generally would not be considered a liability of new T. Reg. §1.338(h)(10)-1(g); and

\[X\] is other relevant items. These relevant items should include the adjustments required for events occurring subsequent to the acquisition date, e.g., receipt of contingent amounts, etc. Reg. §1.338(h)(10)-1(f)(5).

(1) The final regulations make clear that P's acquisition costs that are capitalized into its basis in the T stock are not taken into account in determining the seller's amount realized under the MADSP formula. See Reg. §1.338(h)(10)-1(f)(4)(i).

(2) Similarly, the regulations make clear that the selling group's (or selling shareholders') selling costs which are incurred in connection with the stock sale and which reduce the amount...
realized on that sale will reduce the amount realized under the formula. See Reg. §1.338(h)(10)-1(f)(4)(ii).

(3) In each case the regulations provide as an example brokerage commissions and similar costs incurred to purchase (or sell) the T stock.

d. In applying the formula, T first determines the MADSP and then allocates that aggregate amount among the assets according to fair market values, using the residual method of allocation. Reg. §1.338(h)(10)-1(f)(1).

a. The residual allocation method is described more fully in V.B.4., infra.

e. As applied to this case (disregarding S’s (or A’s) transaction costs), the aggregate deemed sales price of T’s assets would be the $40 million paid by P for the T stock (no gross up being necessary since P buys 100% of T), plus the $20 million liabilities for a total of $60 million. That $60 million would then be allocated among T’s assets, based on the basis allocation rules (disregarding for the sake of simplicity the assignment of Section 197 intangibles to Class IV), as follows:

<table>
<thead>
<tr>
<th>Class</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class I</td>
<td>Cash</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Class II</td>
<td>Securities</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Class III</td>
<td>Accounts receivable</td>
<td>5,000,000</td>
</tr>
<tr>
<td></td>
<td>Inventory</td>
<td>3,000,000</td>
</tr>
<tr>
<td></td>
<td>Machinery &amp; equipment</td>
<td>7,000,000</td>
</tr>
<tr>
<td></td>
<td>Patents</td>
<td>10,000,000</td>
</tr>
<tr>
<td></td>
<td>Licenses</td>
<td>3,000,000</td>
</tr>
<tr>
<td></td>
<td>Land</td>
<td>12,000,000</td>
</tr>
<tr>
<td></td>
<td>Building</td>
<td>8,000,000</td>
</tr>
<tr>
<td></td>
<td>Customer list</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Total Class III</td>
<td></td>
<td>$52,000,000</td>
</tr>
<tr>
<td>Total Classes I-III</td>
<td></td>
<td>$58,000,000</td>
</tr>
<tr>
<td>Residual, Class IV</td>
<td></td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

The allocated price is then compared to adjusted basis to determine the realized gain.
<table>
<thead>
<tr>
<th>Asset</th>
<th>Sales Price</th>
<th>Basis</th>
<th>Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
<td>$0</td>
</tr>
<tr>
<td>Securities</td>
<td>5,000,000</td>
<td>3,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>5,000,000</td>
<td>5,000,000</td>
<td>0</td>
</tr>
<tr>
<td>Inventory</td>
<td>3,000,000</td>
<td>2,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Machinery &amp; equipment</td>
<td>7,000,000</td>
<td>6,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Patents</td>
<td>10,000,000</td>
<td>1,000,000</td>
<td>9,000,000</td>
</tr>
<tr>
<td>Licenses</td>
<td>3,000,000</td>
<td>2,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Land</td>
<td>12,000,000</td>
<td>1,000,000</td>
<td>11,000,000</td>
</tr>
<tr>
<td>Building</td>
<td>8,000,000</td>
<td>6,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Customer list</td>
<td>4,000,000</td>
<td>0</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>2,000,000</td>
<td>0</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Total</td>
<td><strong>$60,000,000</strong></td>
<td><strong>$27,000,000</strong></td>
<td><strong>$33,000,000</strong></td>
</tr>
</tbody>
</table>

f. The $33,000,000 gain is considered to arise in the S group (or in T's final S return) from a sale by T of its assets occurring at the close of June 30, 1994. Reg. §1.338(h)(10)-1(e)(1).

4. **Section 481 Adjustments**

a. If T is including amounts in income under Section 481(a) by reason of a change in accounting method, it would seem that the Section 338(h)(10) election would trigger the remaining balance of the Section 481 adjustments. Thus, T, upon its deemed sale of assets likely would be considered to have ceased to engage in the trade or business to which the adjustment relates. Similarly, although (as set forth in V.A. 9 infra), in the consolidated return or nonconsolidated subsidiary context, after that sale, T is treated as having liquidated into its parent under Section 332, the cessation is not the result of that Section 381 transaction and thus likely would not bar the trigger.

5. **Estimated Taxes**

a. How should the transaction be treated for estimated tax purposes? In this regard, it is noted that Section 338(h)(13) provides that the tax attributable to the deemed sale under Section 338(a)(1) is not to be taken into account for purposes of the additions to tax provided by Section 6655 of the Code. Remember too that the sale is
considered to occur on the acquisition date, but the election may be made up to 8 1/2 months later. At least three alternatives are possible.

(1) The election can be anticipated and estimated taxes paid as if the election were made. If the election is made, it is hard to fault this approach.

(2) Estimated taxes can be paid based on a sale of stock and Section 338(h)(13) relied upon as protection against penalty for any incremental tax caused by the election. In light of the retroactive nature of the election, this approach also seems reasonable.

(3) No estimated taxes may be paid at all and Section 338(h)(13) relied upon as protection against penalty. This result seems a little too good to be true.

b. It should be noted that there is no authority for (or against) any of the foregoing approaches.

6. **State Taxes**

What are the state tax consequences of the transaction?

a. Affected states will need to be surveyed to determine whether they would tax the transaction as a stock sale, or as an asset sale by T, and, if the latter, whether T or the selling shareholder(s) would bear the liability.

(1) If the state tax liability rests with T, and is payable after the transaction, P would be well advised to reduce the purchase price to reflect this assumed liability.

(2) Is the state tax liability deductible by T or the selling consolidated group? See PLR 8804024 (October 30, 1987).

7. **Installment Reporting**

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

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

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

(1) It is hoped that regulations will confirm that installment reporting is not made unavailable solely by reason of the constructive nature of the transaction.

d. It might be noted that the "open transaction" treatment of contingent payments provided by the Section 338 regulations (see Temp. Reg. §1.338(b)-3T(h)(1)(ii), (h)(2)(i) could be read to imply that installment reporting is not available.

e. Even assuming installment reporting is available, various limitations still apply. See Section 453(i) (recapture); 453(k)(2) (publicly traded property); 453(b)(2)(A), (l) (dealer dispositions); 453(b)(2)(B) (inventory), 453A(a)(1) (interest on deferred tax liability). An issue also arises as to how the various forms of consideration are allocated among the assets of old T.

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

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

b. Similarly, in the case of an S corporation, T's affiliation with P does not result in the termination of old T's S election. Id.

9. **Deemed Liquidation**

a. For purposes of Subtitle A of the Code, T is treated as if, after the deemed sale, and while owned by the selling consolidated group (or the nonconsolidated parent or the S shareholders), it distributed all of its assets in complete liquidation. Reg. §1.338(h)(10)-1(e)(2)(ii).
b. Where T is a member of a consolidated return group or a nonconsolidated subsidiary, that liquidation will be governed by Section 332. As a result, T's remaining NOL carryovers are inherited by its parent, as are T's E&P, as adjusted for the deemed sale.

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

i. Thus, in the foregoing example, T's $33 million gain will increase A's stock basis to $40 million, resulting in no further gain realized on the deemed liquidation.

10. **Effect on Consolidated Returns**

a. The characterization of the transaction as a deemed asset sale followed by a Section 332 liquidation should also apply for purposes of the consolidated return regulations.

b. Thus, if T is the owning member of property whose gain or loss was deferred by the selling member in an intercompany transaction, T's deemed sale will require a restoration of that gain or loss under Regs. §1.1502-13(f)(1).

c. As an additional benefit of the election, any deferred intercompany gain or loss recognized to T as the selling member continues to be deferred by the reason of the deemed Section 332 liquidation. The restoration of the balance of that deferred gain or loss will result under the usual consolidated return rules, applied as if there had been an actual Section 332 liquidation of T as of the close of the acquisition date.


B. **To P Group**

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

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

b. In addition, new T is not related to old T for purposes of Section 168, and may make independent Section 168 elections. Reg. §1.338-2(d)(1)(i).

(1) But see Reg. §1.338-2(d)(2) (new T treated as old T for certain employee benefit plan and mitigation purposes).

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

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

(2) It continues to be liable for old T's tax liabilities, including the liability from the deemed sale (Reg. §1.338-2(d)(4)(i)); and

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

2. It is the deemed purchase which gives rise to basis revaluation.

3. In general, the aggregate basis amount is the same as the aggregate deemed sales price (See Reg. §§1.338(h)(10)-1(e)(5); 1.338(b)-1(c)), and is as follows:

a. P's grossed up basis in recently purchased T stock:

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

b. Liabilities of new T:

(1) Liabilities of T which increase basis include its liabilities and the liabilities to which its assets are subject, as of the beginning of the day after the acquisition date. The tax liability resulting from the deemed sale is not included in basis if a Section 338(h)(10) election is made. Reg. §1.338(b)-1(f)(1).
(2) To be included in basis, an obligation must be a "bona fide liability" of T as of the beginning of the day after the acquisition date which would be includible in basis under "principles of tax law" that would apply if new T had acquired old T's assets and assumed its liabilities. Accordingly, if the amount of an old T obligation is contingent or speculative, such that it would not be included in basis under general tax principles, it is not includible in the basis of new T's assets as the beginning of the day after the acquisition date. Reg. §1.338(b)-1(f)(1), (2).

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

c. Other relevant items.

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

(2) IRS adjustments

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

4. That amount is allocated among new T's assets under the usual basis allocation rules. Reg. §1.338(h)(10)-1(e)(5), Temp. Reg. §1.338(b)-2T, -3T.

a. For purposes of the allocation, the regulations divide new T's assets into four classes, as follows:

(1) Class I assets

These are basically cash items. Thus, included are cash, demand deposits, and similar accounts in banks, S&L's and similar depository institutions. In addition, the IRS has

(a) This classification is narrower than the “cash or equivalent” category relevant under former Section 334(b)(2). See Rev. Rul. 66-290, 1966-2 C.B. 112.

(2) Class II assets

These are highly liquid, cash-like assets. Included are CD’s, U.S. government securities, readily marketable stock or securities (as defined in Treas. Reg. §1.351-1(c)(3)), and foreign currency. Here too, the IRS has authority to designate additional items in the I.R.B. Temp. Reg. §1.338(b)-2T(b)(2)(ii).

(3) Class III assets

Class III assets are all assets of T other than those in Classes I, II, or IV. All such assets, whether tangible or intangible, and whether or not depreciable, depletable, or amortizable, are included. Temp. Reg. §1.338-2T(b)(2)(iii). Ordinarily, most of T’s assets will fall into Class III.

(4) Class IV assets

The Class IV or residual assets are defined as intangible assets in the nature of goodwill and going concern value. Temp. Reg. §1.338(b)-2T(b)(2)(iv).

(a) The legislative history to Section 197 indicates that the regulations are to be modified to treat all amortizable Section 197 intangibles as Class IV assets, effective for all acquisitions to which Section 197 applies. See H.R. Rep. No. 103-213, 103d Cong. 1st Sess. at 689 (1993). Although the regulations have yet to be so modified, it is believed that taxpayers can follow this clear direction of the legislative history.

b. Allocation of aggregate basis

(1) General—consecutive allocation

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

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

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

(2) Required residual method of allocation to goodwill

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

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

i) In the bargain case, whether the residual method will truly work to the taxpayer’s advantage will depend upon the valuation of T’s assets. In this regard, the regulations provide that “[i]n assigning fair market values to Class II or Class III assets, the fact that the target has assets in the nature of goodwill or going concern value (Class IV assets) must be taken into account.” Temp. Reg. §1.338(b)-2T(c)(1). Query the impact of this provision in light of Section 197.
and the assignment of intangibles generally to Class IV.

ii. Although this provision does not necessarily mean that the residual method cannot be used in a bargain case, it appears to give the IRS authority to challenge valuations of hard assets. If such valuations are successfully challenged, the basis assignment will be affected accordingly, and the basis of depreciable assets or inventory may be given a “haircut.”

5. As applied to this case (disregarding transaction costs), new T’s basis in its assets will be $60 million -- $40 million paid for the T stock (no gross-up being necessary since P purchases 100%) plus $20 million of T liabilities. The allocation of that basis is the same as described above.

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

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

C. T’s Several Tax Liability

Notwithstanding substantial arguments to the contrary, the regulations provide expressly that T remains severally liable for consolidated return tax liability (including the tax on the deemed sale) attributable to periods in which it was a member of the selling group. Reg. §1.1502-6(a). In other words, P buys into T's tax liability. Reg. §1.338(h)(10)-1(e)(5).
VI. Other Issues

A. T Shareholders Sell (or Own) Less Than 100% of T

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

2. For example, assume, as above, that S wants to retain 10% of T's pre-transaction value e.g., preferred stock with a value of $4 million. T, while in the S group, nonetheless recognizes gain as if 100% of its assets are sold for the MADSP. Reg. §1.338(h)(10)-1(g), Example (2). Thus, although S will receive only $36 million in proceeds (90% x $40 million), S recognizes gain on 100% of the appreciation ($33 million). Similarly, a nonconsolidated subsidiary will recognize gain on 100% of its assets.

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

   b. To some extent, this additional tax to S is a prepayment of S's liability, since S will receive a basis step up in its retained stock at no additional tax cost. S's new basis will be equal to its fair market value determined by reference to the MADSP formula. Reg. §1.338(h)(10)-1(e)(ii); -1(g), Example (2). Thus, as above, since, based on the MADSP, new T's net assets are worth $40 million, S's stock basis in T would be increased from $700,000 (10% x $7 million) to $4 million. This $3.3 million increase matches the additional gain recognized by T attributable to the retained 10% interest (10% x $33 million). This same result applies to stock of a nonconsolidated T which is retained by its parent.

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

3. In the case of a consolidated T or a nonconsolidated subsidiary, if the seller only owned 90% of T to begin with, there is a double tax on the remaining 10%. Thus, as above, T recognizes the full $33 million gain.

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

(1) In addition, the S group (or T where nonconsolidated) bears the minority’s share of the corporate level tax.

b. If the 10% is held by an S corporation shareholder who does not otherwise participate in the sale to P, it would seem that the results should be similar to those which result in the consolidated case. Thus, T will recognize the full 100% of its gain, which will flow through to all of the S corporation shareholders under Section 1366, and basis will be adjusted under Section 1367 (and perhaps Reg. §1.338(h)(10)-1(e)(2)(iii)). Although Reg. §1.338(h)(10)-1(e)(3)(iii) provides that a “minority shareholder” recognizes no gain or loss on retained shares (and basis and holding period remain unchanged), that provision apparently does not apply in the case of an S corporation. Thus, a “minority shareholder” is defined as a shareholder of old T other than S corporation shareholders. Reg. §1.338(h)(10)-1(e)(3)(i). S corporation shareholders, in turn, are defined as all of the S corporation shareholders, whether or not those shareholders sell their T stock to P. Reg. §1.338(h)(10)-1(c)(2).

c. If the 10% is held by P (or a member of the P group? See Reg. §§1.338(h)(10)-1(b)(2), 1.338-1(c)(7), the double tax occurs immediately, since P is deemed to have made a "gain recognition election" with respect to those shares. Reg. §1.338(h)(10)-1(e)(4); Reg. §1.338(h)(10)-1(g), Example (5). See generally Reg. §1.338(b)-1(e)(2).

B. S Is to Retain Certain T Assets

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

a. If clearly part of the overall transaction, it would seem that the distribution should be treated as part of T’s Section 332 liquidation into S. If so, T would recognize no gain on the distribution (Section 337(a)), and S would take a carryover basis in the property (Section 334(b)(1)).
In recent rulings (PLR 9137040 (June 17, 1991), PLR 9044063, (August 7, 1992), and PLR 8938036, (June 27, 1989)), the IRS concluded that the distribution was part of the Section 332 liquidation. 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.

Would the result be different if the distributed properties were dropped down by S to a controlled subsidiary after the stock sale? See PLR 9210041 (December 12, 1991), supplementing PLR 9137040.

C. What About Contingent Liabilities?

1. Recall that P held back $3 million for fear of product liability. What if its fears are realized, and T is forced to pay damages for acts occurring prior to the acquisition?

2. Assuming that this payment is made in discharge of an "old" T liability, new T will not be permitted a current deduction. However, distinguishing "old" T liabilities from "new" T liabilities is not so easy to do.

3. Instead, new T is awarded basis when the liability becomes "fixed and determinable." Temp. Regs. §1.338(b)-3T(c)(1). That increase is then allocated over new T's July 1, 1994 assets, generally based on their fair market values on that date. Temp. Regs. §1.338(b)-3T(d)(1). Since, in this case, new T was already in class IV, any additional basis will be allocated to goodwill.

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

4. That payment may also have consequences to S. Since the MADSP formula is used, under Temp. Regs. §1.338(b)-3T(h)(1) once the liability becomes fixed, a recomputation of the gain may be necessary, taking into account the additional amount as sale proceeds. Since the original allocation went into class IV, the additional proceeds would similarly be allocated to a sale of goodwill. S, as a preliminary matter, may have to report the income in the return for the taxable year in which the item becomes fixed. Temp. Regs. §1.338(b)-3T(h)(1), (3).
a. Does the same result apply to S corporation shareholders (A)?

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

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

b. However, a Technical Advice Memorandum (PLR 8741001 June 16, 1987) concluded that, in a regular Section 338 election, old target (which elected to use the ADSP formula under Section 338(h)(11)) both recognized gain on new target's assumption of certain contingent liabilities (warranty servicing costs) and was not allowed a deduction upon new target's payment of those liabilities.

c. PLR 8741001 was supplemented in PLR 9125001 (December 24, 1992) specifically to permit a deduction to old T. This supplemental TAM did not address the timing of that deduction.

6. Similar rules apply with respect to the payment of contingent purchase price. See Temp Reg. §1.338-3T.

D. What If T Has Subsidiaries?

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

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

b. If a Section 338 election is made for the lower tier subsidiary, no gain is recognized on the deemed sale of its stock. See Reg. §1.338(h)(10)-1(e)(2)(iv); Reg. §1.338-3(c)(2). Gain is recognized, however, if no Section 338 election is made for the subsidiary. See Reg. §1.338(h)(10)-1(e)(2)(v).
c. If a Section 338(h)(10) election is made for T, can a regular Section 338 election be made for a lower tier subsidiary? It appears so. It also appears that the regular Section 338 election eliminates the gain recognized in the S group on the deemed sale of stock of the lower tier subsidiary. See Reg. §1.338-3(c)(2), 1.338(h)(10)-1(e)(2)(v).

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

E. What If T Is Insolvent?

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

2. a. Literally, it would seem that there is no bar to making the election. Thus, the requisites for the election are that --

   (1) T be member of the seller's consolidation return group for the period that includes the acquisition date, or be affiliated with the selling corporation or an S corporation on that date. Reg. §1.338(h)(10)-1(d)(1), (b)(1), (c); and

   (2) P make a qualified stock purchase of T from the selling group, the controlling parent, or the S corporation shareholders. Reg. §1.338(h)(10)-1(d)(1).

b. Of these, the only issue relates to whether P has made a "qualified stock purchase." This latter term is defined under Section 338(d)(3) to include a transaction in which stock meeting the consolidated return affiliation tests of Section 1504(a)(2) is acquired by a corporation by "purchase" within a 12-month period. Since a "purchase" is defined under Section 338(h)(3) to include any acquisition of stock (with certain exceptions not herein pertinent), literally the acquisition of all of the stock of an insolvent corporation by a second corporation would be a qualified stock purchase. To reach a contrary conclusion, the IRS would have to contend that, because of T's insolvency, its former stock ceased to exist in a tax sense, and what "stock" there is is held by the creditors.

c. It would seem that the better answer is that the share certificates continue to represent "stock" in T. Thus, for example, insolvency
does not bar consolidated return filing, and a creditor in an insolvent corporation is not generally recognized as a "shareholder" under the Code. See e.g., Section 382(l)(5), Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942).

3. Viewed from the purchaser's perspective clearly the election should be permitted. Thus, upon the acquisition of stock, an election should be available to obtain a basis benefit for liabilities in the acquired corporation. This is especially true when the insolvent corporation is a subsidiary of a corporation whose stock is purchased and is subject to a Section 338(h)(10) election.

a. Example: P purchases the stock of T for $1,000,000. Among T's assets is stock of a subsidiary (TS) with gross assets of $100,000,000 and liabilities of $100,000,001. If a Section 338(h)(10) election is made for T, P should also be entitled to revalue the assets of TS to $100,000,000 (with any excess liabilities available for basis in other assets of T).

4. Assuming the election is valid, what are the consequences to S?

a. On the one hand, the regulations expressly provide that a Section 338(h)(10) election results in an asset sale by T followed by a distribution of assets in complete liquidation. Reg. §1.338(h)(10)-1(e)(1), (2)(ii).

b. Where T is a member of a selling group (or is a nonconsolidated subsidiary) one would expect that deemed liquidation to be governed by Section 332. An insolvent corporation, however, cannot be liquidated under Section 332. See Reg. §1.332-2(b). It might also be argued, however, that, after the deemed sale (and deemed assumption of liabilities), T is no longer insolvent in that it has no assets or liabilities.

c. As noted above, the consequences of qualification under Section 332 include the inheritance by S of T's excess NOL carryovers, and the elimination of T's excess loss account. Is this result appropriate in this context?

5. It is understood that some at the IRS believe that a Section 338(h)(10) election cannot be made for an insolvent corporation.

a. It is noted, however, that the revised regulations no longer expressly provide that T's deemed liquidation is one to which Section 332 applies. Is a possible reading that, in the case of an insolvent T, the deemed liquidation is governed by Section 331, with the
consequence that NOLs are not inherited and ELAs are restored? 
See Reg. §1.338(h)(10)-1(e)(2)(ii).