1983

Recent Developments Affecting Multiple Corporations: Sections 304, 306, and 338

James P. Holden

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I. *Section 304—Background*

This paper reviews some of the recent changes made in the Internal Revenue Code respecting the taxation of corporate distributions and adjustments. Also noted are various pending technical corrections to those changes.

A. *Overlap of Sections 304 and 351*

Section 304(a)(1) provides that where "one or more persons"("A") (i) possess 50 percent or greater control in each of two corporations, and (ii) transfer stock in one corporation (the "issuing corporation" ("X")) to the other corporation (the "acquiring corporation" ("Y")) in exchange for property, then, the transaction is treated as a redemption distribution from Y to A.

To determine whether this deemed redemption qualifies for capital gain treatment, the section 302(b) tests are applied with respect to A's stock interest in X. However, if the section 302(b) tests are not met, Y's payment to A constitutes a 301 distribution. Prior to enactment of the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248 ("TEFRA"), the determination of the extent to which this distribution was taxable as a dividend was made with regard to the earnings and profits ("E&P") of Y.

Section 351 states that (i) where A transfers property to a corporation in exchange for stock or securities of the corporation and (ii) immediately after the transfer, A controls (80 percent or more) the corporation, then no gain shall be recognized on the transfer. However, to the extent A receives property other than stock or securities of the corporation ("boot"), section 351(b) provides for the recognition of capital gain.

Before enactment of TEFRA, it was possible for a transaction to meet the requirements of both sections 304 and 351. For example, assume that A owns all the stock of X and Y corporations. A transfers the X stock to Y for additional Y shares and cash. This transaction was described in section 351 because A controlled Y after the transfer. Under section 351, A's exchange of X stock for Y stock would have been tax-free, and A would have recognized capital gain on the cash received.

However, this transaction was also described in section 304 because A controlled both X and Y. The transaction, characterized as a redemption, did not satisfy the section 302(b) tests because A's control of X and Y was unaffected by the transaction. Thus, under section 304, the cash would have been taxable as a dividend to the extent of Y's E&P.

Prior to TEFRA, courts were divided on the question regarding which section controlled. Compare *Commissioner* v. *Stickney* 399 F.2d 828 (6th Cir. 1968) (section 304 controls) with *R. A. Coates Trust* v. *Commissioner,* 480 F.2d 468 (9th Cir. 1973) (section 351 controls).

B. *Pre-TEFRA Holding Company Bailout Technique*

Prior to the TEFRA amendments, a bailout of E&P at capital gains rates was made possible by the overlap of sections 304 and 351. The technique typically involved use of a holding company. For example, assume that A owns all the stock of X, an operating company with \$1 million of E&P. A borrows \$1 million from a bank and pledges his X stock as collateral. After waiting a reasonable time, A creates Y and transfers his X stock to Y in exchange for Y stock. Y assumes A's obligation intending to make debt service with tax-free intercorporate dividends received from X. The bank releases A from liability. A has effectively removed \$1 million from corporate solution. Since X has sufficient E&P, this withdrawal should be taxable as a dividend. However, under pre-TEFRA law, it might not have been for the following reasons.

If section 351 controlled, the assumption of liability by Y generally would have been tax-free under section 357(a). Even if section 357(b) (not a bona fide business purpose) or (c) (liability in excess of basis) applied to tax all or some part of the assumption, any gain recognized would have been capital gain.

On the other hand, if section 304 controlled, Y's assumption of the liability would constitute a distribution of property to A, *see Maher* v. *Commissioner,* 469 F.2d 225 (8th Cir. 1972), and that distribution would be taxed as a section 301 distribution because A's interest in X was unaffected by the transaction. However, even characterized as a section 301 distribution, the assumption still might not have been taxable as a dividend. This is because dividend treatment depended upon Y's E&P, and Y, as a newly-formed corporation, would have no E&P. Thus, even if section 304 applied, A could treat the assumption as a tax-free basis return or at worst as capital gain.

II. *Section 304 Under TEFRA*

TEFRA made the following changes in order to remove the bailout potential described above.

A. *Section 304 Overrides Section 351*

Section 304(b)(3)(A), enacted by TEFRA, provides that section 304 takes precedence over the provisions of "part III" of subchapter C, *i.e.*, sections 351 through section 368, in transactions described in both section 304 and the part III provisions.

Under this new rule, section 351 continues to apply to the extent that A receives Y stock for X stock. *See* TEFRA Conference Report, H.R. Rep. No. 760, 97th Cong. 2nd Sess., 542 (1982) ("Conference Report"). However, the receipt by A of any other property, including Y securities, in exchange for X stock is now tested under section 304. Y securities are included because section 317 defines securities as "property" within the meaning of section 304(a)(1).

The Tax Reform Act of 1983, H.R. 4170 ("1983 TRA") would change section 304(b)(3)(A) to provide that section 304 supercedes only section 351 (and related provisions of section 357 and 358) but not the remaining provisions of part III. Thus, where a transaction is described in both section 304 and the reorganization provisions, the latter may continue to operate.

B. *Exception for Acquisition Indebtedness*

Section 304(b)(3)(B)(i) provides an exception to the rule that sections 304 overrides section 351 in cases where the distribution of "property" is in the form of Y's assumption of indebtedness which A incurred to purchase the transferred X stock ("acquisition debt exception."). This exception also applies where Y receives the X stock subject to a liability and where an acquisition debt is extended, renewed, or refinanced. *See* section 304(b)(3)(B)(ii).

The Conference Report at 542 explains that the acquisition debt exception was included because the "assumption of such [acquisition] debt is an alternative to a debt-financed direct acquisition by the acquiring company." This view—that a transaction involving Y's assumption of purchase money debt on the transferred stock is equivalent to a direct debt-financed purchase by Y—apparently reflects the theory of Revenue Ruling 80-240, 1980-2 C.B. 116. In that ruling, a shareholder who sought to acquire control of a bank through a holding company was required by business exigencies to purchase that stock directly and then transfer it to a holding company subject to the purchase money indebtedness. The Service held that section 304 was inapplicable, viewing the shareholder as merely a conduit whose transitory ownership of the stock and whose obligation on the debt should be ignored.

However, the acquisition debt exception in the new statute is too broad and fails to consider the bailout opportunities that exist when stock is purchased from a related person. For example, assume that A is the son of B and that B owns all of the stock of X, which has E&P. A purchases the X stock from his father B, paying $1 million in funds borrowed from a bank. After waiting a reasonable time, A forms Y and transfers the X stock to Y. Y assumes A's purchase money debt.

This transaction is essentially equivalent to a direct sale of X from B to Y because, in either case, B effectively removes $1 million from corporate solution without diluting the A-B family group's ownership of X and Y. Under this circumstance, dividend treatment should apply.

If B were to sell X directly to Y, dividend treatment would result under the rationale of *United States* v. *Davis,* 397 U.S. 301 (1970), holding that a meaningful reduction in stock ownership is required to qualify under section 302(b)(1) and that section 318 attribution applies to determine whether a meaningful reduction has occurred. Since B, through A, owns all of the X stock before and after the transaction, the *Davis* criteria are not satisfied and the distribution to B should be taxed as a dividend (to the extent of Y's E&P).

However, under these facts, dividend treatment would not apply because the acquisition debt exception would render section 304 inapplicable.

The 1983 TRA would remedy this problem by amending section 304(b)(3)(B)(i) to restrict the acquisition debt exception to situations where A purchases X stock "from a person none of whose stock is attributable to the transferor".

As enacted in TEFRA, the acquisition debt exception is too broad in another respect because it applies even if A owns less than 80 percent of Y, *i.e.,* where there is no section 304/section 351 overlap. This means that where A owns between 50 and 80 percent of Y, Y's assumption of A's purchase money indebtedness on the X stock, even though not described in section 351, would be exempted also from the rules of section 304.

To change this result, the 1983 TRA would further amend section 304(b)(3)(B)(i) to provide that the acquisition debt exception is not available where A owns between 50 and 80 percent of Y.

C. *Aggregation of E&P*

Section 304(b)(2)(A) aggregates the E&P of X and Y to determine whether a distribution to A is taxable as a dividend. The amendment considers that the property paid by Y to A has been first "distributed by the issuing corporation (X) to the acquiring corporation (Y) and then immediately thereafter distributed (to A) by the acquiring corporation."

This deemed distribution from X to Y occurs only for purposes of determining the E&P of Y that is available to make the distribution from Y to A a dividend. The Conference Report at 543 states that the deemed distribution is "solely for the purpose of determining the extent to which the amount distributed is treated as a dividend to (the shareholders) and does not, for example, constitute a distribution of personal holding company income to the acquiring corporation."

Section 304(b)(2)(A) changes the pre-TEFRA rule that Y's E&P, alone, determines dividend equivalency. As stated, this rule was a major element of the holding company bailout problem because even if section 304 applied over section 351, Y's E&P might have been insufficient to compel dividend treatment.

Under section 304(b)(2)(A), however, to the extent of the deemed distribution from X to Y, all of the available E&P of X is "pushed-up" to Y. This is true whether or not that full amount is needed, *i.e.*, whether or not Y's E&P, alone, would have been sufficient to cause dividend treatment.

This drain of E&P away from X creates other unanticipated new problems. It permits X to make a subsequent tax-free distribution (of what would otherwise be a dividend) to noncorporate shareholders. Also, if X is a controlled foreign corporation, the draining of its E&P may eliminate a section 1248 taint on its stock.

The 1983 TRA would eliminate these problems by limiting the drain on X's E&P to the amount required to overcome any insufficiency in Y's E&P. Proposed section 304(b)(2)(A) states that the property distribution to A is deemed to be made "(i) by the acquiring corporation (Y) to the extent of its earnings and profits, and (ii) then by the issuing corporation (X)."

D. *Issues Relating to Control*

Section 304(c)(2)(A), added by TEFRA, provides that where A controls X and transfers X stock to Y in exchange for Y stock, the Y stock received is taken into account to determine whether A controls Y. Prior to TEFRA, the Service had adopted the ruling position that section 304 could not apply where A transferred X stock to a newly-formed Y. This conclusion was based on Treas. Reg. § 1.304-2(a), which provides that A must control X and Y "before" the transfer to satisfy the common control requirement. Since Y was not in existence and, thus, not controlled before the transfer, the control requirement was not met. *See* Ltr. Ruls. 8007042 and 7933076. Section 304(c)(2)(A) overturns this surprisingly liberal position.

Section 304(c)(2)(B), added by TEFRA, provides that where two or more persons control X and transfer X stock to Y, which they control after the transfer, then to determine whether X and Y are commonly controlled corporations, each of the transferors is considered to control each of the corporations.

This provision changes the pre-TEFRA rule that only those transferors who receive property subject to section 304, *i.e.* property other than Y stock, are counted in the determination of common control. For example, assume unrelated A and B each own 50 percent of X. A transfers his X stock to newly-formed Y for 60 percent of the Y stock. B transfers his X stock to Y for 40 percent of the Y stock and Y securities. Section 304 would not apply to A because he received only Y stock.

However, under the new law, section 304 will apply to B's receipt of Y securities because under section 304(c)(2)(B), B is deemed to be in control of Y. Prior to TEFRA, section 304 would not have applied to B since he alone did not control Y and since A could not be counted to determine control. Thus, section 304(c)(2)(B) insures that section 304 may not be avoided by manipulating the transfer of property among control group members.

The 1983 TRA proposes also to remedy a longstanding technical problem relating to the constructive ownership rules under section 304(c)(3) applicable to determine control. Section 304(c)(3) states that sections 318(a)(2)(C) (attribution from corporations to shareholders) and 318(a)(3)(C) (attribution from shareholders to corporations) apply to determine control under section 304 without regard to the usual 50 percent threshold ownership requirements. This means that corporation-to-shareholder and shareholder-to-corporation attribution applies regardless of the level of share ownership. For example, assume that individual A owns 50 percent of M corporation and 100 shares of publicly-held N corporation. M owns 100 percent of X corporation. N owns 100 percent of Y corporation. M sells the X stock to Y. Under section 304(c)(3), the sale is governed by 304 because N is deemed to own all stock owned by A, including A's 50 percent interest in M as well as 50 percent of M's 100 percent of the X stock. Hence, N is deemed to be in common control of X and Y.

To prevent this result, the 1983 TRA contains a *de minimis* rule. Section 304(c)(3) would be amended to provide that shareholder-to-corporation and corporation-to-shareholder attribution is inapplicable to determine common control under section 304 if the shareholder owns 5 percent or less of the corporation.

II. *Section 306*

A. *Pre-TEFRA Bailout Potential*

Prior to TEFRA, section 306 did not apply to stock issued in a section 351 exchange. This rule permitted a bailout of E&P at capital gain rates through use of a holding company. For example, assume that individual A owns all of the stock of X corporation which has significant E&P. A transfers the X stock to newly-formed Y corporation in exchange for Y common and preferred stock. A later sells the preferred stock for cash. Like the cash received by A in the section 351/section 304 overlap, the preferred stock represented a form of bailout. It was possible because neither section 304 nor 306 applied to the preferred stock issued in the section 351 transaction.

B. *TEFRA Changes*

New section 306(c)(3) provides that "section 306 stock" includes stock other than common stock (*i.e.*, preferred stock) acquired in a section 351 transaction if "the receipt of money (in lieu of the stock) would have been treated as a dividend to any extent." The section further states that "rules similar to the rules of section 304(b)(2) shall apply for purposes of this section." These provisions mean that to the extent that a hypothetical distribution of money would have been taxable as a dividend under section 304 (with E&P aggregated under section 304(b)(2)), any preferred stock distributed instead constitutes section 306 stock.

New section 306(c), however, does not fully foreclose the bailout potential available through use of a newly-formed holding company. While it accomplishes the classification of the preferred as section 306 stock, it leaves open opportunities for capital gain treatment on the eventual disposition of the stock.

For example, assume that A owns all of the stock of X which has significant E&P. A transfers the X stock to newly-formed Y for Y common and preferred stock. The Y preferred is section 306 stock in A's hands. However, before Y generates significant E&P, A causes Y to redeem the preferred. Even though section 306(a) provides for dividend treatment on the redemption of the Y preferred to the extent of Y's E&P, dividend treatment is avoided because Y has no E&P. Thus, the bailout potential continues.

The 1983 TRA would remedy this problem by amending section 304(c)(3). The amendment would provide that "rules similar to those under section 304(b)(2)" apply to a subsequent disposition of preferred stock (*e.g.*, in a redemption) as well as to the initial receipt of the preferred. This means that the E&P of X and Y would be aggregated at the time of the subsequent disposition to determine whether the amount received is taxable as ordinary income.

Section 306(c)(4) provides attribution rules, similar to those under section 304(c)(3), which apply under section 306(c)(3). The 1983 TRA would amend section 306(c)(4) to provide that shareholder-to-corporation and corporation-to-shareholder attribution is inapplicable where a shareholder owns no more than 5 percent of a corporation's stock. This proposed amendment parallels the proposed change under section 304(c)(3).

IV. *Section 338—Background*

A. *Prior Law*

Before enactment of TEFRA, if a corporation ("P") purchased 80 percent or more of the stock of another corporation ("T") and liquidated T under section 334(b)(2), the following tax consequences ensued: P obtained a basis in the acquired T assets generally equal to P's cost basis in the T stock; T recognized no gain or loss (except for recapture items) by virtue of section 336; T could stay in existence for up to 5 years after the stock purchase and, if it filed a consolidated return with P for the pre-liquidation period, could combine its tax attributes with those of P during that period; complex adjustments to basis were required to reflect the effect of pre-liquidation operations of T; on eventual liquidation of T, recapture income generated could be offset on the consolidated return by losses of the other members of P's affiliated group; and on liquidation, the tax attributes of T disappeared.

In contrast, if P purchased T's assets directly, in a section 337 transaction, the tax consequences were as follows: P obtained a cost basis in the assets; T recognized no gain or loss on the sale but did recognize recapture income; T was required to completely liquidate within 12 months after adopting a plan of liquidation; as a consequence of the liquidation, T's tax attributes disappeared; and no opportunity existed to offset the recapture tax liability of T against losses of P.

B. *Reasons For Statutory Changes*

One of the principal features of prior law at which section 338 is aimed is the selectivity inherent in the section 334(b)(2) scheme—only assets of corporations actually liquidated were stepped up, and accordingly, only those assets were subject to recapture tax. Subsidiaries of T which were not liquidated were not subject to the recapture provisions.

In addition, prior law permitted P to purchase selected assets directly from T and also to purchase the stock of T without liquidating the corporation. Only those assets sold by T would generate recapture tax liability.

The TEFRA changes seek to restrict this opportunity for selectivity and to make more uniform the tax consequences between asset acquisitions effected directly through section 337 asset purchases and those effected indirectly through stock purchases. In addition, section 338 attempts to eliminate the need for complex asset basis adjustments required in a section 334(b)(2) liquidation. These adjustments, required in part to reflect business operations of the target corporation between the stock purchase and the subsequent liquidation, often led to artificial and incorrect asset bases. *See R. M. Smith, Inc.* v. *Commissioner,* 69 T.C. 317 (1977).

Section 338 also replaces the required liquidation with an election. As a result, state law asset transfer requirements and local transfer tax obligations are no longer applicable.

V. *Overview of Section 338*

A. *Operation of Section 338*

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 the target corporation ("T"). Within 75 days of the "acquisition date," *i.e.,* the date on which a "qualified stock purchase" of an 80 percent interest is complete, P must elect to have section 338 apply. (Under the 1983 TRA a section 338 election would be timely if made not later than 8 and ½ months after the month in which the acquisition date occurs.)

If a qualifying purchase and election occur, T is treated as if it sold all of its assets in a single transaction governed by section 337. In this hypothetical sale, which takes place at the close of the acquisition date, T is both the seller and the purchaser. As the seller, T is characterized as "old T", a corporation whose existence for tax purposes terminates on the acquisition date. As the purchaser, T is "new T," a corporation whose existence for tax purposes begins on the day after the acquisition date.

The hypothetical selling price (and purchase price) of the T assets is equal to P's basis in the T stock "grossed up" to reflect the value of any T stock not held by P and adjusted appropriately for liabilities and other items. (Under the 1983 TRA, the hypothetical selling price would be the fair market value of T's assets; the hypothetical purchase price would be an amount equal to the fair market value of the T assets reduced by any unrealized appreciation in the T stock held by P as of the acquisition date).

B. *Consequences of the Sale*

As a result of the deemed section 337 sale, old T incurs all appropriate tax liabilities, its tax attributes disappear, and new T holds the assets at a stepped-up basis. However, minority shareholders of T 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.

C. *Liquidation of T*

Under section 338, there is no need to liquidate T to obtain basis step-up for assets. In fact, any liquidation of T will result in a carryover basis to P under section 334(b)(1). If a section 338 election has been made, the stepped-up basis carries over; if it has not, the historic T asset basis carries over. Section 338 conclusively abolishes the non-statutory rule of *Kimbell-Diamond Milling Co.* v. *Commissioner,* 14 T.C. 74 (1950), *affd.,* 187 F.2d 718 (5th Cir. 1951).

D. *Consistency Provisions*

In accordance with the legislative purpose to prevent P from selectively stepping up the basis of acquired assets, Section 338 contains a complex set of consistency rules. In general, these rules require that P (and its affiliates) must treat all acquisitions from T or T's affiliates consistently as either stock purchases or asset purchases.

VI. *Tax Aspects Affecting Consolidated Groups*

A. *Tax Liability Under Section 338—General Rule*

In general, any gain recognized on the hypothetical sale is taxable to old T, whose tax year ends on the day of the hypothetical sale. Conference Report, 537.

B. *Old T as Part of an Affiliated Group*

Where old T was a subsidiary in an affiliated group, section 338, as originally enacted, left unanswered the question whether gain or loss from the deemed sale was reportable as part of consolidated group income. Section 338(h)(8), added by section 306(a)(8)(A)(i) of the Technical Corrections Act of 1982, P.L. 97-448, ("1982 TCA"), provides that T is not a member of an affiliated group with respect to the deemed sale of assets.

Commentators have uniformly concluded that under section 338(h)(8), the acquisition date should be reported as a one-day separate return year for old T. However, under section 338(h)(8), it appears that only the gain or loss resulting from the section 338 deemed sale is reportable in the one-day separate return year. Thus, for all other purposes, T should remain part of the selling affiliated group on the acquisition date.

If old T has subsidiaries, the statute does not state, but leaves room for regulations to state, whether there can be a one-day consolidated return year for the old T group. The extent to which old T may use the corporate tax graduated rate structure to report its section 338 gain in the one-day separate return year is unresolved at this time.

C. *Alternative Election Where T is Subsidiary in Affiliated Group*

Section 338(h)(9), enacted by the 1982 TCA, provides an alternative election available where old T was a subsidiary in an affiliated group. If this election is made, T recognizes gain or loss as if it sold assets in a fully taxable single transaction, *i.e.*, one to which section 337 does not apply.

The countervailing advantage is that T is treated as a member of the selling consolidated group, with the result that losses of the group may offset any gain which T recognizes. Moreover, since the deemed asset transaction is taxable to T, section 338(h)(9) provides that those members of the old affiliated group who actually sell T stock to P do not recognize gain or loss on those sales. The transaction is thus taxed as if T had in fact sold its assets (section 337 would not apply because T's liquidation would occur under section 332) and had distributed the proceeds tax free to its parent in a section 332 liquidation. The election may be made under regulations prescribed by the Secretary (which have not yet been issued) and the General Explanation provides that a section 338(h)(9) election may not be made until regulations are issued. General Explanation, 135.

Presumably, the regulations will require the purchasing and selling corporations to make a joint election under section 338(h)(9). Otherwise, the purchasing corporation could make an election without advising the selling group.

For transactions entered into between the enactment of TEFRA and the 1982 TCA, section 306(a)(8)(a)(ii) of the 1982 TCA provides that section 338(h)(8) and section 338(h)(9) will not apply if P establishes by clear and convincing evidence that the transaction was negotiated in contemplation that the target corporation would be treated as a member of the selling corporation's consolidated return group with respect to the deemed asset sale.

VII. *Consistency Rules*

A. *Background*

As stated, section 338 was enacted to deny taxpayers the opportunity to selectively step-up the basis of acquired assets (i) by liquidating T and not liquidating its affiliates, and (ii) by purchasing both assets and stock of T. To this end, the consistency provisions adopt an all or nothing approach. They require that, for a specified period of time before and after P purchases the T stock, P and its affiliates must treat all other acquisitions from T and its affiliates consistently with the treatment of T. Thus, all acquisitions must be treated either as asset acquisitions or as stock acquisitions.

B. *Statutory Definition*

1. *Consistency period.* The consistency period is the period during which all acquisition from T and its affiliates must be treated consistently. It is defined in section 338(h)(4)(A) as the one-year period before the beginning of the 12-month acquisition period, plus the acquisition period (up to and including the acquisition date), and extending through the one-year period beginning on the day after the acquisition date.

Example (1). P purchases all of T's stock on January 1, 1983. The consistency period begins on January 1, 1982 and ends on January 1, 1984.

Example (2). P purchases 50 percent of T's stock on January 1, 1983 and the remaining 50 percent on June 1, 1983. The consistency period begins on January 1, 1982 and extends through June 1, 1984.

In addition, section 338(h)(4)(B) provides that the consistency period may be extended to include any period "during which the Secretary determines that there was in effect a plan" to make other qualified stock purchases or asset purchases from T or a target affiliate.

2. *Target affiliate.* A corporation is a target affiliate of T if it and T were, at any time during the consistency period ending with the acquisition date, both members of an affiliated group having a common parent. Section 338(h)(6). Except as otherwise provided in regulations to be issued, the term target affiliate does not include "a foreign corporation, a DISC, a corporation described in section 934(b), or a corporation to which an election under section 936 applies." Section 338(h)(6)(B)(i).

In addition, stock held by a target affiliate in a foreign corporation or in a DISC or a corporation described in section 1248(e) is excluded from the operation of section 338. Section 338(h)(6)(B)(ii). These exceptions were enacted to avoid problems involved with interfacing the consistency rules and the foreign tax provisions of the Code.

However, stock of a foreign corporation, a DISC or a section 1248(e) corporation held directly by T is not excluded from operation of section 338. Thus, a section 338 election will trigger the application of section 1248(f) and section 995(c) as to T.

C. *Operation of Consistency Rules*

1. *In general.* Section 338 includes five provisions intended to enforce the consistency requirement. These relate to: (a) deemed purchases, (b) attribution of acquisitions, (c) binding elections, (d) deemed elections and (e) a grant of regulatory authority to the Service to do whatever is necessary to enforce the consistency requirement.

2. *Deemed purchases.* Under section 338(h)(3)(B), if P purchases stock in one corporation and as a result is treated as the owner of shares

in a third corporation under section 318(a), P is treated as having purchased the shares in the third corporation.

Example (1). T owns all the stock of X and Y; P purchases all the T stock. P is treated also as having purchased all of the X and Y stock. Each of the three acquisitions—the actual acquisition of T and the deemed acquisitions of X and Y—must be treated consistently. Presumably, the "purchase price" for the X and Y stock is determined by allocating the purchase price for the T stock to the X and Y stock as part of T's assets. General Explanation, 136.

Example (2). T owns all the stock of X and 80 percent of the stock of Y; P purchases 90 percent of the stock of T. P is treated as purchasing 90 percent of the stock of X and 72 percent of the stock of Y. P must treat the acquisitions of T and X consistently but not the acquisition of Y. This is true even though P, T, X and Y may file a consolidated return.

Under the 1983 TRA, this rule would be changed. P would be deemed to purchase all of the stock held by T as of the close of the acquisition date *i.e.,* without regard to section 318 attribution. This rule would alter the result in example 2 because P would be deemed to have purchased all of the X stock and 80 percent of the Y stock, *i.e.,* T's entire holding in X and Y. Thus, the consistency provisions would apply to T, X and Y.

3. *Attribution of acquisitions.* Section 338(h)(7) provides that, except as otherwise provided in regulations, any acquisition of stock or assets by any member of an affiliated group which includes a purchasing corporation is treated as if it were made by the purchasing corporation. An affiliated group for this purpose includes all corporations described in section 1504(a) (including those otherwise excluded under section 1504(b)). Section 338(h)(5).

Example (1). P owns all the stock of P-1; T owns all the stock of X and Y. P purchases the X stock and P-1 purchases the Y stock. P is treated as if it purchased the Y stock as well as the X stock so that the acquisitions of X and Y must be treated consistently.

Example (2). P purchases the X stock and P's shareholder, individual A, purchases the Y stock. A's purchase is not attributed to P since an individual is not part of an affiliated group that includes P.

Example (3). P owns all the stock of P-1. P and P-1 each purchase 50 percent of the stock of X. There is no qualified stock purchase and thus section 338 is not applicable because there is no single "purchasing" corporation.

The Conference Report states by footnote that section 338(h)(7) "will prevent transfers of target corporation stock within the purchasing corporation's affiliated group from disqualifying a section 338 election (*Chrome Plate, Inc.* v. *U.S.,* 614 F.2d 990 (5th Cir. 1980))." Under section 334(b)(2), the *Chrome Plate* rule had prevented a purchasing corporation from "dropping down" purchased stock to a subsidiary or "pushing up" the stock to a parent prior to the section 334(b)(2) liquidation.

4. *Binding elections.* If P makes a qualified stock purchase with respect to the stock of T and one or more of T's "target affiliates" during the consistency period (either actually or by means of the deemed purchase provision), P's treatment of the acquisition of T stock is binding on the acquisition(s) of T's affiliates.

Thus, if P makes a section 338 election for T, that election also applies to T's affiliates. Section 338(f)(1). Similarly, if P does not make an election with respect to T, no election may be made for any affiliates.

Example (1). T owns the stock of domestic corporations X and Y and foreign corporation F. P purchases all the stock of X and makes a section 338 election. Six months later, P purchases all the stock of T. Section 338(f)(1) requires P to apply section 338 to its acquisition of T stock and its deemed acquisition of Y stock since P, within the consistency period, previously, election section 338 for X. However, F is excluded as a target affiliate and section 338 is inapplicable to it.

Example (2). The facts are the same as above, except that P makes no section 338 election. Under section 338(f)(2), P may not elect section 338 for T (and Y) since it did not elect for X.

Example (3). The facts are the same as in (1), except that P purchases the T stock one year and one day after P elects section 338 treatment with respect to X. If the Service determines that P's purchase of T stock was deferred to avoid the consistency rules, it may extend the consistency period to include the T purchase. In this event, section 338 would apply to the purchase of T and the deemed purchase of Y because P had made a previous section 338 election for X. On the other hand, if the Service finds no consistency avoidance purpose, P is free to elect or not to elect section 338 for T and Y. In any event, T and Y must be treated consistently.

5. *Deemed elections.* A combination of stock and asset acquisitions may cause P to be deemed to have made a section 338 election. Subject to certain exceptions, P is treated as having made a section 338 election with regard to T if P makes a qualified stock purchase of T stock and, during the consistency period, P (or one of its affiliates) acquires any asset from T or a T affiliate. Section 338(e).

Example (1). T owns the stock of X and Y; P purchases the stock of X and the assets of Y. P must apply section 338 to X.

Example (2). T operates a business and, in addition, owns the stock of X and Y. T adopts a section 337 plan of liquidation and sells the business assets, together with the X and Y stock, to P. P must apply section 338 to X and Y.

Example (3). T owns the stock of X and X owns the stock of Y. P's affiliate, P-1, purchases an asset of Y. Nine months later P purchases the stock of T. P must apply section 338 to T, X and Y.

As noted above, certain exceptions are provided to the deemed election rule. These include asset acquisitions occurring under the following circumstances:

(1). The property P acquires is sold by T or a T affiliate in the ordinary course of business, *e.g.*, sale of inventory. Section 338(e)(2)(A). Sales of property which occur irregularly but nonetheless relate to the normal conduct of business qualify for this exception. The General Explanation at 138 offers as an example the "sale of used machinery that was employed in the seller's trade or business."

(2). The basis of the acquired asset in P's hands is determined in whole or part with reference to its basis in the hands of T or a T affiliate, *e.g.*, a post-acquisition dividend of property from T to P under section 301(d)(2)(B) or the post-acquisition liquidation of T under section 334(b)(1). Section 338(e)(2)(B). It is unclear whether this exception applies to a distribution of cash or a distribution of property with a basis in excess of the property's fair market value. For example, assume that P purchases the stock of T, issuing ten year notes to the former shareholders of T. P does not file a section 338 election. During the consistency period, in order to pay the notes, T distributes cash to P and P pays the former shareholders. Is P subject to the deemed election provision by virtue of the cash distribution from T to P?

(3). The acquisition occurred before September 1, 1982. Section 338(e)(2)(e).

(4). To the extent provided in regulations, the property acquired is located outside the United States. Section 338(e)(2)(D).

(5). Any other type of acquisition to the extent permitted by regulations. Section 338(e)(2)(E).

(6). In addition to these statutory exceptions, the legislative history indicates that a *de minimis* exception may be provided by regulations (Conference Report, 540).

(7). The Conference Report further notes that stock in T's affiliate does not constitute an asset in the hands of T for purposes of section 338(e) (Conference Report, 538). This means that if P purchases X stock from T, the sale of the X stock is not treated as an asset sale by T. A contrary conclusion would automatically require section 338 treatment for P's acquisition of the X stock under section 338(e). However, as noted previously, if P purchases both the X stock and an asset of T, P is deemed to have made a section 338 election with respect to X.

Section 338(h)(7) discussed above does not appear to operate absent a "qualified stock purchase" by a member of the affiliated group. Thus, the deemed election rules would not apply to the following situation:

P owns all of the stock of P-1 and P-2. P-1 and P-2 each purchase 50 percent of the T stock, and P acquires some of the assets of T.

The 1983 TRA would replace existing section 338(h)(7) with a new section 338(h)(8) which would provide that for purposes of the consistency rules and, except as otherwise provided in regulations, "an affiliated group shall be treated as 1 corporation." This rule would change the result in the foregoing example because the purchases of T stock by P-1 and P-2 would be treated for purposes of the consistency provisions as a purchase by one corporation. Thus, P's purchase of assets would require the stock purchases by P-1 and P-2 to be treated as asset purchases.

However, the new provision may restore application of the *Chrome Plate* rule since it applies only for purposes of the consistency rules. Thus, presumably, it would not apply to impute purchases by P affiliates to P for purposes of satisfying the "purchase" requirement other than in the context of the consistency rules.

6. *Grant of regulatory authority.* Where the foregoing statutory provisions do not otherwise reach a transaction, the consistency requirement may nonetheless apply because section 338 contains a catchall provision of extreme breadth. This provision, section 338(i), reads as follows:

> "The Secretary shall prescribe such regulations as may be necessary to ensure that the purposes of this section to require consistency of treatment of stock and asset purchases with respect to a target corporation and its target affiliates (whether by treating all of them as stock purchases or as asset purchases) may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations)."

Until regulations are promulgated, the reach of this provision is uncertain. Its validity will remain in doubt until litigated.

A purchaser corporation may not affirmatively use the consistency provisions. For example, assume that P purchases the stock of T and does not make a timely section 338 election. Later, but within the consistency period, P decides that a section 338 election should have been made, and it therefore purchases an asset from T in order to force a deemed election. Does section 338(e) offer an opportunity to make a belated election where no timely election was made? The Conference Report, at 540, states that section 338(e) may not be used in this manner.

D. *Planning for Consistency Provisions*

Various planning techniques have been offered as means to avoid the consistency requirements. These principally involve structuring purchases by related parties so as not to fall within the consistency rules and issuing second classes of stock to prevent a qualified stock purchase.

Examples. Assume in each of the examples below that A, an individual, owns all the stock of P which owns all the stock of P-1. T owns all the stock of X and Y.

(1). P purchases the stock of X and makes a section 338 election. A purchases the stock of Y and does not (and cannot) make an election. Two years later, A transfers his Y stock to P. Since A is not includable in the purchasing group, his acquisition is not imputed to P, and thus the consistency requirement is inapplicable. However, it is possible that section 338(i) would cover this transaction.

(2). P-1 purchases the assets of X. A purchases the Y stock. Since A is not includable in the purchasing group, the consistency rules again do not apply.

(3). P-1 issues a class of nonvoting participating preferred stock to a third party which has a value equal to 25 percent of P-1's outstanding shares. P-1 purchases the X stock and makes an election. P purchases the Y stock and makes no election. The consistency rules should not apply because P-1 is not an affiliate of P and thus is not part of the purchasing group for purposes of the consistency rules. However, P-1 and X cannot file a consolidated return with P.

(4). X issues a class of nonvoting participating preferred to a third party which has a value equal to 25 percent of X's outstanding stock. P purchases the stock of T and makes a section 338 election. P has made a qualified stock purchase of T and Y but not of X. P must treat T and Y consistently but not X.