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TEFRA: Purchase and Sale of a Corporate Business

Martin D. Ginsburg

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I. CAST OF CHARACTERS

T  Target corporation, the stock or assets of which will be purchased. In some cases, as stated, assets of T (including stock of a T subsidiary) will be used to redeem outstanding T shares.

A  The dominant shareholder (or shareholder group) owning stock of T. While A may be an individual, a partnership, a corporation, or a group of individuals, unless otherwise stated it is assumed A is a single individual. If no reference is made to any other T shareholder, assume all of the outstanding stock of T is owned by A.

K  Minority shareholder of T. Unless otherwise stated, assume K is not related to A and owns 10% of the outstanding stock of T.

H, W  When reference is made to these letters they represent, ordinarily, subsidiary corporations of T, wholly-owned by T unless otherwise specified. At times, when specifically stated, H and W are divisions of T. In all cases, H operates a hotel business with substantially appreciated assets but little in the way of depreciation or investment credit recapture, and W operates a widget business with substantially appreciated assets and large potential depreciation and investment credit recapture.

P  Large corporation unrelated to A which, directly or through a subsidiary, will purchase assets or stock of T. Unless otherwise stated, assume P is a public corporation.

S  Subsidiary of P. Unless otherwise stated, assume S is wholly-owned by P and is newly organized.

V  A corporation with substantial assets and operating history. P owns most but not all of the outstanding stock of V; the exact stock ownership in V will be stated when V appears on the stage.

B  When P is not a public corporation, and in some cases when it is, B is the domi-
nant shareholder (or shareholder group) owning stock of P. B may be an individual, a partnership, a group of individuals, or (rarely) a corporation. If no reference is made to any other P shareholder, assume all of the outstanding stock of P is owned by B, and that B is either a single individual or a partnership of individuals.

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II. HOW IT ALL CAME ABOUT

It is probably fair to say that, in a major way, the subchapter C amendments enacted by TEFRA were fathered by The Wall Street Journal. Over the two or three years preceding the legislation, one could hardly pick up that informative publication without reading of yet another proposed hostile takeover or friendly acquisition of T or a T subsidiary designed to achieve truly marvelous savings in corporate tax. Some of these plans undoubtedly worked, others seemed a bit problematic, still others appeared questionable indeed. But, good schemes or bad, the overall impression conveyed was of a nation overwhelmed by a spreading rash of enormous corporate acquisitions motivated and financed in significant part by extraordinary tax avoidance.

Action begets reaction. On May 6, 1982 Representative "Pete" Stark, Chairman of the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, introduced H.R. 6295 denominated the Corporate Takeover Tax Act of 1982. After a House Subcommittee Hearing on May 24, Senator Danforth on June 29 introduced S. 2687, a revised version of the Stark bill. The Senate Finance Committee, after adopting S. 2687 as part of the Deficit Reduction Package without benefit of public hearing, on July 15 (with Mr. Danforth in the chair) held that hearing. The public session before the Finance Committee, as well as the not-so public markup of the Stark bill in the House Subcommittee, yielded changes and clarifications that were incorporated by the Conference Committee in its Report and in the final version of the legislation that was enacted as part of the Tax Equity Responsibility Act of 1982 (H.R. 4961).

The Conference Committee produced the final text of TEFRA on August 17. May 6 to August 17 is rather a short time in which to formulate a well-considered legislative package to revise, in a careful and sensible way, some of our more important and intricate rules governing the taxation of corporations and their shareholders. Not surprisingly, the legislative package has more than its fair share of problems and uncertainties, some perceived in the course of the legislative process and others newly emerging, and much is needed in the way
of clarification or correction through regulations and perhaps some technical amendments.

That legislation was needed seems beyond debate. That the legislation was specifically a reaction to perceived abuses was useful in a practical way—had there not been a widespread perception of tax abuse almost certainly there would have been no subchapter C amendments in 1982—but unfortunate in a more general way. Because the legislative package was largely targeted to specific abuses and quickly crafted, there was limited opportunity for reasoned participation by the private sector or for any careful consideration of a variety of tax issues affected by the proposed changes. Subchapter C cries out for reform but the task is not ideally undertaken in haste. Because the rules of subchapter C are, and after TEFRA remain, inordinately complex and confusing, and in application unduly advantage the well-advised while unfairly disadvantaging those who are not, sensible reform is best accomplished through the sort of careful, cooperative process that brought forth The Installment Sales Revision Act of 1980. But, while the tax fraternity did much to initiate and assist in the formulation of that salutory legislation, few practitioners, busy constructing the extraordinary transactions that attracted the 1982 amendments to subchapter C, took time out to urge sensible revision of pertinent Code provisions. The outcome, a less than fully satisfactory statutory scheme, ought to have been predictable.

With all which, perhaps the most surprising thing about the new law is how good much of it turns out to be. Credit largely goes to those on the congressional staffs and in the Treasury Department who, in the midst of dealing with the many concerns presented by TEFRA, devoted much time to rationalizing, insofar as the political process allowed, the changes in subchapter C under which we will be living for some time to come.

III. REDEMPTIONS AND PARTIAL LIQUIDATIONS: BEFORE TEFRA

The changes made by TEFRA in sections 302, 311, 336, and 346 of the Code, although interrelated, were reactive to two quite different corporate acquisition schemes. One, a redemption gimmick, depending upon the facts of the particular case appeared highly problematic, likely to succeed in attracting major tax savings, or somewhere in between. The other, a partial liquidation plan keyed to provisions of the consolidated return regulations of extreme generosity, without doubt achieved the wonderful tax results it was intended to achieve. To understand what Congress did in TEFRA, and what the Treasury is likely to do in forthcoming regulations including revisions to the consolidated return regulations, we do well to begin by examining prior law in the context of the acquisition plans that attracted Mr. Stark’s attention.
A. Redemption Schemes: Mobil-Esmark and All That

We deal here with a plan which, if successful, in practical effect allowed A (a parent public corporation) to sell all of the stock of T, its subsidiary, to P corporation (or P's subsidiary S) without any recognition of gain by A on the transfer, and to place the cash proceeds in the hands of A's shareholders at capital gain rather than dividend tax rates.

*The Mobil-Esmark Transaction.* In June, 1980 the directors of Esmark, Inc. ("A") decided to dispose of its subsidiary, Vickers Energy Corp. ("T") which, in turn, owned the stock of several corporations including TransOcean Oil, Inc. The various units of Vickers were offered for sale to the highest bidder. After negotiating with Esmark, Mobil Oil Corp. ("S"), a subsidiary of Mobil Corp. ("P"), made a winning bid of approximately $740 million for TransOcean. Under the terms of a definitive agreement executed August 21, 1980, S agreed to make a tender offer for up to approximately 12 million of A's 22 million shares for $715 million in cash. S's shares in A were then to be redeemed in exchange for stock of T, whose only asset would then be the stock of TransOcean. Under the agreement, S agreed to acquire all of the stock of T and was required to redeem all tendered A shares in exchange for up to 97.5% of the stock of T. In the event S failed to acquire enough A shares to exchange for the maximum amount of T stock, S had the option (which it indicated it would exercise) to purchase the balance for cash. S was to acquire the remaining 2.5% of T stock in exchange for other consideration to be paid to A. The agreement also provided that S had the option to purchase 97.5% of the T shares from A for cash in the event that the tender offer was terminated or S declined to pay for tendered shares. S, in a tender offer extended September 2, 1980, in fact acquired the full number of A shares sought. At a single closing, S purchased the tendered A shares and promptly exchanged the shares for the stock of T.


*The Dome-Conoco Transaction.* In May, 1981 a subsidiary ("S") of Dome ("P"), a Canadian corporation, made a tender offer to acquire at least 13% of the outstanding shares of Conoco ("A"), reserving to itself the right to acquire slightly above 20%. The announced purpose of the tender offer was to place Dome in a position to redeem its Conoco stock for the 52.9% interest which Conoco held in Hudson's Bay Oil & Gas Co. ("T"), another Canadian company. Officers of Dome and Conoco had met to discuss the proposed tender offer and redemption, but Conoco officials had refused to go along with the proposal and initially sought to block the tender offer by court action. The tender offer and redemption transaction was, however, successfully consummated.

There were a number of other transactions of this sort. In some, as
in Mobil-Esmark, P's acquisition of T was the sole object of the exercise and A was a willing participant. In other cases, P was a Black Knight acquiring a substantial block of A shares with the intention of taking over control of A itself. When the takeover failed, due normally to the intervention of a White Knight, A was able to negotiate a redemption of the shares held by P delivering in exchange stock of T. Dome-Conoco exemplifies something of a middle case; P purchased A shares for the purpose of exchanging those shares for the stock of T and ultimately succeeded in that endeavor despite A's initial refusal to cooperate.

B. Redemptions: The Tax Law Before TEFRA

Before TEFRA as after, section 311(a) states that, except as elsewhere provided in that section (and other exceptions not here relevant), no gain or loss shall be recognized to a corporation on a distribution of property with respect to its stock. Before TEFRA as after, section 311(d)(1) announces the key exception: A corporation distributing appreciated property to a shareholder in a redemption to which section 311 applies will recognize gain as if the distributing corporation had sold the property at fair market value. But not always.

1. The basis for the claimed nonrecognition of gain by A on its redemption distribution of T stock was old (pre-TEFRA) section 311(d)(2)(B). It provided that no gain would be recognized by the distributing corporation when the distribution consisted of stock (or an obligation) of a corporation—

"(i) which is engaged in at least one trade or business,
(ii) which has not received property constituting a substantial part of its assets from the distributing corporation, in a transaction to which section 351 applied or as a contribution to capital, within the five-year period ending on the date of the distribution, and
(iii) at least 50 percent in value of the outstanding stock of which is owned by the distributing corporation at any time within the 9-year period ending one year before the date of distribution."


2. There was also an exception to the gain recognition rule for a distribution in complete redemption of all of the stock of a shareholder owning at least 10% of the distributing corporation's stock, but the redeemed shareholder must have held such stock (actual ownership as distinguished from ownership by attribution) for the full year preceding the distribution. Old section 311(d)(2)(A). This exception did not apply to the Mobil-Esmark transaction, or others like it, since the holding period of P or S in the A stock redeemed was measured in hours or weeks, not years.

3. In Mobil-Esmark and similar arrangements, the essential issue was whether the transaction qualified as a genuine redemption of A stock from P (or S), a redemption falling within the ambit of old
section 311(d)(2)(B), or whether the transaction would be treated as sale by A of the T stock to P (or S) for cash, and a redemption distribution of the cash proceeds by A to its tendering shareholders. If the transaction were so viewed, A would recognize gain on the deemed sale of its T shares to P (or S), and each tendering shareholder under pre-TEFRA law would recognize capital gain (or loss) or dividend income depending upon the applicability vel non of paragraphs (1), (2), or (3) of section 302(b).

4. In this regard, consider Idol v. Commissioner, 38 T.C. 444 (1962), aff’d, 319 F.2d 647 (8th Cir. 1963). The taxpayer acquired sole control of a corporation. He then sold part of his stock to a third party who was interested in acquiring a trucking franchise held by the corporation. Under a pre-arranged plan, the corporation then “redeemed” this third party’s stock in exchange for the trucking franchise.

a. The Tax Court held that the corporation recognized gain on the transfer of the franchise, which in reality constituted a sale of assets.

i. It is clear that the third party intended only to acquire certain assets of the corporation and had no desire to invest in the corporation.

ii. No business reasons were shown for the corporation to redeem the stock. The purpose of the corporation was to transfer assets.

iii. The taxpayer did not intend to part with any interest in the corporation, since he remained its sole shareholder after the dust settled.

5. Similar reasoning applied in Rev. Rul. 80-221, 1980-2 C.B. 107. Here, corporation X owned a vacant parcel of appreciated land. An unrelated corporation, Y, offered to purchase the land at its fair market value. In order to avoid recognition of gain on X’s transfer of the land, the following transaction was devised. Y purchased from X, for an amount equal to the fair market value of the land, a single share of nonvoting preferred stock of X. The share was redeemable by transfer of title in land to Y, and callable by X 14 months after issuance. The share was redeemed by X in exchange for a deed to the land 13 months after issuance.

a. The exception to the general rule of § 311(d) provided by § 311(d)(2)(A) for a distribution in complete redemption of a 10% shareholder was facially applicable.

b. The Service ruled that this exception did not apply since the form of the transaction “was chosen solely for the purpose of attempting . . . to avoid the tax on the gain that otherwise would have been recognized to X.” The two steps of the transaction (stock purchase followed by redemption distribution) “were part of a prearranged integrated plan and may not be considered independently of each other for federal income tax purposes.”

i. Y had no interest in acquiring ownership in X.

ii. Y wanted only to purchase land, and X wanted to sell land.
iii. Y's "stock" interest in X was transitory "and was not intended to represent a normal shareholder interest."

6. Compare the above two authorities to *Standard Linen Service, Inc.*, 33 T.C. 1 (1959), *acq.*, 1960-2 C.B. 7. In this case, a corporation conducted a laundry business and a separate linen supply business. Because of certain operating problems, a purchaser for the corporation's stock was sought. A potential purchaser was interested in acquiring only the linen supply assets, and did not wish to make a stock purchase. After negotiations, it was agreed that the purchaser would purchase almost 75% of the corporation's outstanding stock for an amount based on the fair market value of the linen supply assets, and that this stock would immediately be surrendered to the corporation in exchange for the linen supply assets. Held: transaction was a partial liquidation and not a sale of assets.

   a. The motive underlying the transaction was the desire of some (but not all) shareholders to sell stock in the corporation.
   b. There was no evidence that the corporation had considered a sale of assets.
   c. Tax savings to the corporation were not the sole motivation for the form of the transaction, since the shareholders wanted to sell stock.
   d. The facts and formalities were consistent with a partial liquidation: outstanding stock was significantly reduced, linen supply business was eliminated, redeemed shares were retired, articles were amended to reflect capital reduction and partial liquidation.
   e. The *Idol* court distinguished *Standard Linen* in that, in *Idol*, the parties had contemplated a sale of corporate assets, there was no showing that the shareholder desired to part with equity interest, and tax considerations alone shaped the form of the transaction.

C. Partial Liquidation Transactions: Prior Law and Practice

At least the more extreme of the redemption schemes, typified by Mobil-Esmark, were controversial and may well end up in court. The partial liquidation scheme was very much a horse of another color. Prior to TEFRA it was not at all controversial. Statutory law, the consolidated return regulations, and administrative practice through the IRS private ruling process combined to confirm wonderfully favorable tax consequences. In common parlance the partial liquidation scheme has become associated with the acquisition of Marathon Oil Company by United States Steel Corporation, but in fact partial liquidation acquisition arrangements were carried out by a host of well-advised corporations large and not-so-large. A review of the following pre-TEFRA Private Letter Rulings will convey a sense of the quantity and quality of tax planning.

LTRs 8220067, 8216023, 8213060, 8204064, 8147046, 8141099, 8042140.

1. Under pre-TEFRA section 346(a)(2), a distribution could qualify
as a partial liquidation if it resulted in a substantial contraction of the distributing corporation's business activity. Old section 346(b) specified that a distribution would be treated as meeting the requirements of section 346(a)(2) if it consisted of the assets, or the proceeds of a sale of the assets, of one of two or more five-year active businesses (essentially as described in section 355). The statute required that the distribution be in redemption of stock, but the Internal Revenue Service ruled that no actual redemption would be required when the distribution was pro rata.


The statute also required adoption of a plan of partial liquidation and the completion of distributions within the taxable year succeeding the year in which the plan was adopted. It was the position of the Service that a distribution of the stock of a subsidiary corporation, or of the proceeds of sale of that stock, could not qualify as a partial liquidation, but section 346 could apply to a distribution in kind of the subsidiary's assets (following a liquidation of the subsidiary into the parent corporation qualifying under sections 332 and 381) or to a distribution of the proceeds of sale of those assets.

Rev. Rul. 79-184, 1979-1 C.B. 143.

Not surprisingly, over the years a variety of arcane permissions, limitations, and special rules developed in the administrative practice under old section 346. Many of them derived from the requirement of old section 346(a)(2) that the distribution not be essentially equivalent to a dividend. Significantly, the thrust of administrative practice was to view with concern distributions, particularly smaller distributions, that did not yield an important contraction in the corporation's business activity, and to view more kindly very substantial distributions producing an obvious and major contraction in business activity. For a useful, recent summary of the pre-TEFRA practice, and a challenging comparison of the partial liquidation and redemption techniques under prior law, see—Henderson, Federal Tax Techniques for Asset Redeployment Transactions, 37 Tax L. Rev. 325, 346-56 (1982).

2. Prior to TEFRA, section 336(a) applied to partial as well as complete liquidations, and specified that the distributing corporation, in general, would recognize no gain or loss. The exemptions were standard fare: Installment obligation gain was recognized under section 453B, investment credit recapture tax was imposed under section 47, depreciation recapture income was recognized under sections 1245 and 1250, if and when applicable section 336(b) required recognition of the LIFO recapture amount, and so forth. The shareholder recipient of a distribution in partial liquidation recognized capital gain or loss under pre-TEFRA section 331(a)(2), and in the shareholder's hands the
basis of the distributed property was fair market value as provided in old section 334(a).

But when the distributee shareholder was itself a domestic corporation in control of the distributing domestic subsidiary—"control" for this purpose is the ownership of stock possessing at least 80% of the voting power of all classes of stock entitled to vote and at least 80% of each class of nonvoting stock excluding nonvoting stock which is limited and preferred as to dividends—and a consolidated return was filed, all of these statutory provisions were overridden by the consolidated return regulations. And that was where the game was played for fun and profit.

3. Assume T corporation has outstanding 100 shares of voting common stock and is worth in total 1,000. T for many years has conducted a small business worth 100 and a large business worth 900. The inventory (FIFO) of the large business has an adjusted basis of 300 and a current value of 500. The equipment of the large business has an adjusted basis of 100, originally was purchased for 200, and has a current value of 400. If the equipment were sold investment credit recapture tax would be 20. P corporation is the common parent of an affiliated group of corporations filing a consolidated return. In 1981 P purchases the 100 outstanding shares of T paying 1,000. One week later T distributes to P, in redemption of 90 shares, all of the assets of the large business. T is included in P's 1981 consolidated return for a period that includes the date of the partial liquidation distribution.


If P had not filed a consolidated return that included T on the distribution date, T in 1981 would be required to pay 20 in investment credit recapture tax and to recognize 100 in depreciation recapture income. On the distribution P would not recognize gain, but only because P's 900 basis in the 90 shares equalled the net 900 value of all of the assets (and liabilities) of the distributed large business, and P would hold those assets at a basis equal to fair market value, presumably 900 plus the amount of accompany T liabilities.

The consolidated return rules work wonders—

a. T recognizes no investment credit recapture on the transfer of its section 38 property to P, another member of the affiliated group.
   Reg. § 1.1502-3(f)(2).

b. On the facts given P recognizes no gain on the distribution.
   Reg. § 1.1502-14(b)(1), (2)(i)

c. The distribution in partial liquidation triggers no immediate depreciation recapture income to T. On the facts given, P will hold the equipment at an initial basis of 400. As P depreciates that equipment each year, T will include in income an appropriate portion of the now deferred 100 of recapture income. Thus, if in 1981 P enjoys a depreciation deduction of 40, T will include 10 in income and the consolidated return will reflect a net deduction in the group of 30.
   Reg. §§ 1.1502-31(b)(2)(ii), -13(d), (f).
d. On the facts given, P will hold the distributed inventory at a basis of 500 and the excess of the value of that inventory above its basis in T's hands will go untaxed. If the partial liquidation distribution had been delayed so that the net value of the property, when distributed, was greater than the 900 purchase price paid by P for 90% of the T stock, P would not recognize gain on the distribution and, essentially, would hold the distributed assets at the same stepped-up basis P would have enjoyed had the distribution been made promptly after the stock purchase.

e. Contrast these extraordinary results, under the pre-TEFRA consolidated return regulations, with the results that would have obtained had P caused T promptly to liquidate under old section 334(b)(2). In that case, P would not recognize gain on the distribution and would hold the distributed assets at a basis derived from the 1,000 purchase price paid for the T stock. But T would have incurred investment credit recapture tax of 20 and depreciation recapture income of 100 would have been immediately recognized and included in the P consolidated return for 1981.

Reg. § 1.1502-14(c)(2).

Little wonder that P caused T to retain its small business and undergo a partial liquidation rather than a complete liquidation. But surely it is a greater wonder that the Treasury Department left standing this set of consolidated return regulations, and thereby invited congressional intervention, long after the partial liquidation scheme became a topic of popular conversation among tax lawyers in and out of Government. Had the Treasury, for example, amended the regulations to provide that every distribution within a consolidated group, other than a distribution in complete liquidation, will require carryover of asset basis, and further to provide that investment credit recapture would be triggered in any complete liquidation in which asset basis does not carry over (the key case is a section 331 liquidation within a consolidated group), the problem would have evaporated long ago.

IV. REDEMPTION AND PARTIAL LIQUIDATIONS: AFTER TEFRA

The notion, long embedded in sections 311(a) and 336 and (by extension) section 337, that a corporation does not recognize gain when its distributes appreciated property with respect to its shares, is familiarly known as the General Utilities doctrine. See General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). Over the years the doctrine has been eroded by depreciation and LIFO recapture and tax benefit recovery rules, and by the special section 311(d) provisions which, prior to TEFRA, applied only to stock redemptions that were not incident to a partial liquidation.

Reactive to Mobil-Esmark redemption schemes and U.S. Steel-Marathon partial liquidation plans, the TEFRA amendments, in general, propound a new taxing formula that more closely equates recog-
nition of gain to the distributing corporation and basis step-up to the distributed assets in the hands of the recipient shareholder. A key factor in the new equation is the corporate or non-corporate identity of the distributee shareholder. In an important but not all encompassing class of cases, appreciated property distributions to a corporate shareholder do not trigger gain to the distributing corporation, the recipient enjoying dividend treatment and suffering the disadvantage of carryover rather than stepped-up asset basis. When, on the other hand, the recipient is not a corporation, often the distributing corporation recognizes gain while the shareholder, also recognizing gain, takes the property at a fair market value basis. But the equation is for various reasons incomplete, and complexity and the attendant opportunities for blunder or special planning remain with us.

A. Partial Liquidations: In General

Sections 331 and 336 no longer apply to a partial liquidation, and section 346 no longer defines that term. To the contrary, new section 346(b) grants the Treasury authority to write regulations necessary to ensure that TEFRA's repeal of the historic favorable treatment of partial liquidations may not be circumvented "through the use of sections 355, 351, 337, or any other provision of law or regulations (including the consolidated return regulations)." New section 346(a) replaces old section 346(a)(1) and specifies that a distribution shall be treated as in complete liquidation of a corporation if it is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan.

The notion of a partial liquidation is not, however, expunged from post-TEFRA law. The idea that a corporate-contracting distribution is distinguishable from a run of the mine dividend distribution remains firmly embedded in subchapter C.

The term partial liquidation is defined in new section 302(e). The language is slightly different—paragraph (3) offers us a new defined term, "qualified trade or business," remarkably similar to the new defined term "qualified business" in new section 311(e)(2)(B)(i)—but the substance appears to be basically unchanged from the definition contained in old section 346. And almost certainly it remains the position of the Service that a distribution of stock or securities of a subsidiary corporation will not qualify as a partial liquidation.


As earlier noted, when the partial liquidation was a creature of old section 346 the Internal Revenue Service did not require an actual redemption of shares when the distribution was pro rata. See item III C 1. TEFRA's repositioning the definition in section 302, a provision that deals with stock redemptions, might suggest a change.
But it is not so. The Conference Committee Report specifically confirms that under new section 302(e) an actual surrender of stock by the shareholders will not be required; indeed, the report makes it clear that an actual surrender of stock will not be required, when section 311(d) is implicated, even if the distribution in partial liquidation is not pro rata.


While the definition of a partial liquidation has not changed dramatically after TEFRA, the tax consequences of a distribution in partial liquidation have changed in significant ways.

B. Partial Liquidations: At the Shareholder Level

The tax consequences to the recipient of a distribution in partial liquidation primarily are determined by the identity of the recipient.

1. Noncorporate Shareholder

A distribution in partial liquidation, received by a shareholder who is not a corporation, is now governed by section 302(a). Whether or not the distribution is pro rata to all shareholders, under that section it is treated as a payment in exchange for stock and gives rise to capital gain (or loss) unless the collapsible corporation provision, section 341(a)(2)(B) as amended by TEFRA, applies to convert what would have been long-term capital gain into ordinary income.

New section 302(b)(4).

2. Corporate Shareholder

By its terms, new section 302(b)(4) does not apply to a distribution in partial liquidation if the recipient shareholder is a corporation.

a. If the distribution in partial liquidation is pro rata to all shareholders, the rules of sections 302(d) and 301 will apply. Thus, if the shareholder corporation and the distributing corporation are domestic, the basis of the appreciated property in the hands of the distributing corporation (increased by any gain recognized to it under, e.g., section 453B) measures the amount of the dividend and carries over as basis in the hands of the recipient corporation.

b. If the distribution in partial liquidation is not pro rata to all shareholders, tax consequences to the corporate recipient will be determined under the longstanding redemption rules of paragraphs (1), (2), and (3) of section 302(b). Thus, if the accompanying stock redemption either terminates the corporate shareholder’s interest in the distributor or is “substantially disproportionate,” section 302(a) will apply to require recognition of gain (or loss) by the shareholder corporation. In that circumstance, the distributed property in the hands of the shareholder corporation will have a basis equal to fair market value. If, however, none of the provisions of section 302(b) is applicable in the particular case, the intercorporate dividend rules described above will be in point.

c. Passthru Entity Shareholder
For purposes of determining under section 302(b)(4) whether stock is held by a shareholder who is not a corporation, any stock held by a partnership, estate, or trust will be treated as if it were actually held proportionately by its partners or beneficiaries. It is less than entirely clear how this rule will apply when, for example, a shareholder is a partnership and the rights of various corporate and noncorporate partners are determined under the partnership agreement in a complex way.

See new section 302(e)(5).

d. Subchapter S Corporation: Old Law

Assume an S corporation owns 10% of the distributing corporation and receives a pro rata partial liquidation distribution of appreciated property, basis (in the hands of the distributing corporation) 100 and value 1,000. Mr. C is the sole shareholder of the S corporation. What tax consequences under the tax law in force immediately after the enactment of TEFRA (i.e., before enactment of the Subchapter S Revision Act of 1982)?

i. Section 302(b)(4) does not qualify its negative reference to "a corporation." A subchapter S corporation is "a corporation." It would appear, therefore, that the S corporation will treat the distribution as a dividend and not as a payment in exchange for stock under section 302(a).

ii. TEFRA having provided nothing to the contrary, the distribution in partial liquidation is a "dividend" to the S corporation for purposes of the passive gross receipts limitation, section 1372(e)(5). In unfortunate circumstances, it could cause that corporation to lose its subchapter S qualification.

iii. Assuming subchapter S qualification is maintained, in computing taxable income under section 1373(d) the S corporation will not enjoy a section 243 dividends received deduction but, under section 301(b)(1)(B)(ii), the amount of the dividend income should be limited to 100. In the hands of the S corporation, the distributed property should retain its basis of 100 under section 301(d)(2). The relevance of this last will appear when we consider the tax consequences of the partial liquidation to the distributing corporation.

iv. If the S Corporation does, or does not, distribute to Mr. C an amount equal to its taxable income for the current year, he will be taxed on that income as a dividend. See section 1373. The amount taxable to Mr. C with respect to the distribution in partial liquidation will be limited to 100, the basis of the distributed property, rather than its 1,000 value. If the S corporation subsequently sells the property for 1,000, Mr. C will be taxed on the 900 gain but, if the property is a capital asset and the holding period requirement is satisfied, the gain will be long-term capital gain.

v. It is not clear that Congress intended these results.

e. S Corporation: New Law

The Subchapter S Revision Act of 1982 substantially revises the S corporation taxing regime. Among other things, the passive gross
receipts limitation and new tax penalty does not apply to an S corporation that has no accumulated earnings and profits (from a prior C corporation history) at the close of the taxable year, and no amount will be added to earnings and profits in any year in which the corporation is an S corporation. The S corporation does not compute "taxable income" and, instead, the direct item passthru (to the shareholders) concept of the partnership taxing rules generally applies:

"In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation."

New section 1366(c).

If this were all there were to it, the 1982 Act would offer the potential of significant tax avoidance. If an S corporation, when it is a shareholder in a C corporation, is treated as a corporation, receipt by the S corporation of a dividend in appreciated property would fall under section 301(b)(1)(B)(ii). Thus, if the basis of the distributed property were 100 and its value 1,000, the gross income to the S corporation would be limited to 100 and hence, under proposed section 1366(c), the gross income of the S corporation's shareholder also would be limited to 100. All of this would have direct relevance to partial liquidation distributions after TEFRA since, under new section 302(b)(4), the same advantage would accrue to a recipient S corporation and to its shareholders.

Sensibly, however, new law avoids the problem by providing that when an S corporation is a shareholder in a C corporation, the S corporation will be treated as an individual.

New section 1371(a)(2).

In practical effect, section 1371(a)(2) amends sections 301, 302(b)(4)(A), 311(d)(2)(A), and 311(e)(1)(A).

Query: What does it do to new section 304(b)(2)(A)?

Unfortunately, the addition of new section 1371(a)(2) does not resolve all problems in the partial liquidation area. Assume a C corporation owns less than 10 percent of the stock of T corporation, or owns more than 10 percent but has held less than 5 years, and a pro rata distribution of appreciated property is made by T in partial liquidation. Section 311(d)(2)(A) applies. If, subsequently, the corporate shareholder elects to become an S corporation, waits a respectable period of time, and then distributes to its shareholders the appreciated capital assets that were received from T in the partial liquidation distribution, under amended subchapter S the S corporation will recognize capital gain on that distribution and the capital gain will flow through to the shareholders. They will receive the property at a basis equal to fair market value. In the result, the "qualified stock" requirements have been avoided at little tax cost.

Query: Can Treasury craft a regulation under section 346(b) to deal with this one? See the discussion below in IV B 3.
3. *Personal Holding Company Income*

Ordinarily, a dividend received qualifies as personal holding company income. A pro rata distribution in partial liquidation is treated, in the case of a corporate shareholder, as a dividend under new law. With one exception: A dividend to which section 302(b)(4) would apply if the corporate recipient were an individual is excluded from the definition of personal holding company income.

New section 543(a)(1)(C).

Under prior law, a distribution in partial liquidation was excluded from personal holding company income because it gave rise to capital gain (or to section 341(a) ordinary income). Presumably the new exception was inserted because it seemed too harsh to impose the personal holding company penalty tax when the recipient corporation's only sin is to receive a large distribution in partial liquidation that overwhelms its normal income from operations in the particular year.

It can well be argued that this is too great a kindness. Assume Mr. A owns (at a basis of 500) a significant percentage, but less than 80%, of the outstanding shares of T corporation. The shares owned by A are worth 1000 and he has held them less than five years. T conducts business through two equally valuable divisions, H and W. T proposes to distribute the assets of the H division to its shareholders who will organize a partnership to continue the H business. It is anticipated that at some future date the stock of T (then operating only the W business) will be sold.

To simplify the analysis, let us further assume that all of the shares of T not owned by A are owned by a substantial, unrelated corporation.

If A receives his pro rata share of the partial liquidation distribution, he will recognize a capital gain of approximately 250. In addition, under section 311(d)(1), discussed below, T will recognize gain on the distribution. If, however, appropriately in advance of the partial liquidation A transfers all of his T shares to newly organized Holding Corporation in exchange for all of its stock, on the subsequent distribution T will recognize no gain pursuant to new section 311(d)(2)(A), also discussed below, Holding Corporation will be treated as having received a dividend measured by the basis of the assets distributed to it (assume 100), will enjoy a section 243 deduction (85), and pay remarkably little tax (a maximum of 6.9). If the distribution in partial liquidation qualified as personal holding company income, the tax burden would be substantially increased and it is unlikely A would interpose Holding Corporation between T and himself.

Holding Corporation now owns the T shares at the basis of 500 at which A held those shares. The distribution in partial liquidation, because it was treated as an intercorporate dividend, did not reduce stock basis. But it did reduce the value of those T shares, from 1000 down to 500. Thus, when the T shares subsequently are sold and assuming values remain unchanged, Holding Corporation will recognize no gain on its shift from T shares worth 500 to cash of 500. A tax
of 6.9 maximum on the totality of these transactions surely is rather low, and enactment of new section 543(a)(1)(C) appears startlingly generous.

Query: If A organized Holding Corporation and transferred to it his T shares in contemplation of the distribution from T, motivated at least in part by the failure of the T shares to meet the qualified stock definition, can (and will) the Treasury arm the Service to upset the plan by promulgating a nasty regulation under new section 346(b)? That provision reads:

"The Secretary shall prescribe such regulations as may be necessary to insure that the purposes of subsections (a) and (b) of section 222 of the Tax Equity and Fiscal Responsibility Act of 1982 (which repeal of special tax treatment for partial liquidations) may not be circumvented through the use of section 355, 351, 337, or any other provision of law or regulations (including the consolidated return regulations)."

Subsections (a) and (b) are the provisions of the Act that amend sections 331 and 336 to eliminate from them any reference to a partial liquidation. It would appear that if the tax plan is sufficiently transparent, a nasty regulation could be written to impose recognition of gain at the T level and, perhaps, capital gain treatment to A (rather than dividend income to Holding Corporation).

C. Other Redemptions: At the Shareholder Level

Other than in adding new paragraph (b)(4) and subsection (e), and adding as subparagraph (c)(2)(C) a liberalizing special rule for waiver of attribution by certain entities, TEFRA made no specific change in section 302. Thus, the familiar rules of paragraphs (1), (2), and (3) of section 302(b) continue to govern the tax treatment to shareholders (corporate or noncorporate) of stock redemptions. Note, however, that a distribution in partial liquidation that also terminates a shareholder’s interest in the corporation will be treated as a distribution in exchange for stock under section 302(a) whether or not the shareholder satisfies the special rules (e.g., no interest in the corporation as an officer, director, or employee) of section 302(c)(2).

Conference Report 530.

D. At the Distributing Corporation Level.

After TERFA as before, overriding the General Utilities doctrine section 311(d)(1) states as a basic rule that if a corporation distributes appreciated property (other than a debt obligation of the distributing corporation) to a shareholder in a redemption to which subpart A (i.e., section 302) applies of part or all of the shareholder’s stock in the corporation, the distributing corporation will recognize gain as if the property had been sold by it at the time of the distribution.
The regulations under section 311(d)(1) state that the recognition rule applies only when there is an actual redemption of stock (or when an acquisition of stock by a corporation is treated under section 304 as a distribution in redemption of the stock of either the acquiring or issuing corporation), announce the recognition rule does not apply to a distribution in partial liquidation, and by inversion inform us that if there is an actual redemption the recognition rule can apply to the distributing corporation whether the shareholder receives capital gain or dividend treatment. The first two of these three pronouncements will require revision in light of the TEFRA amendments.

Reg. § 1.311-2(a)(2).

It has been the position of the Internal Revenue Service, and no doubt remains so, that if in a transaction governed by section 311(d)(1) the corporation distributes depreciable property in redemption of shares held by a related person (within the meaning of section 1239 and measured immediately before the redemption), the gain recognized by the distributing corporation will be treated as ordinary income under section 1239 to the extent such gain is not otherwise treated as ordinary income under the depreciation recapture provisions.


Before TEFRA and after, section 311(d)(2) sets out a series of exceptions to the recognition rule of section 311(d)(1). Three of those exceptions, contained in subparagraphs (D), (E), (F), remain unchanged. Four others were repealed by TEFRA and three new exceptions substituted.

1. Exceptions Eliminated by TEFRA

Under prior law a corporation distributing appreciated property did not recognize gain (other than recapture income and other than as provided in subsections (b) and (c) of section 311 and in section 453B) if the distribution was in complete redemption of all of the stock of a shareholder who, at all times within the 12-month period ending on the date of distribution, owned at least 10% in value of the outstanding stock of the corporation, provided the redemption qualified under section 302(b)(3) determined without the application of section 302(c)(2)(A)(ii). Under this exception, it was popular to redeem all of the stock owned by a member of the shareholder family group, incident to terminating the employment of that individual with the corporation, and to distribute in the redemption appreciated marketable securities or other investment property. This is the first of the exceptions repealed by TEFRA.

Old section 311(d)(1)(A) (repealed).

Under prior law, the recognition rule did not apply to a distribution of stock or an obligation of a subsidiary corporation if the subsidiary was engaged in at least one trade or business, had not received property constituting a substantial part of its assets from the distributing parent (in either a section 351 transaction or as a contribution to capital) within the five-year period ending on the date of distribution, and at least 50% in value of the outstanding stock of the subsidiary was
owned by the distributing parent corporation at any time within the
9-year period ending one year before the date of distribution. This
was the statutory exception to section 311(d)(1) upon which the
designers of Mobil-Esmark and similar transactions relied. See III
B 1. It is the second of the exceptions repealed by TEFRA.

Old section 311(d)(2)(B) (repealed).

The two other exceptions repealed by TEFRA were of lesser sig-
nificance. One related to a distribution of stock or securities pursuant
to the terms of a final judgment in a Sherman Act or Clayton Act pro-
ceeding. The other covered a distribution of stock to a distributee
which is not an organization exempt from tax under section 501(a) if,
with respect to the distributee, specified portions of section 1011 (re-
lating to distributions pursuant to the Bank Holding Company Act)
applied.

Old section 311(d)(2)(C), (G) (repealed).

2. New Exception for Certain Intercorporate Distributions

After TEFRA, the distributing corporation recognition rule of section
311(d)(1) does not apply to distribution to a corporate shareholder
if the basis of the property distributed is determined (in the hands of
the recipient) under section 301(d)(2).

New section 311(d)(2)(A).

If, as discussed above, see IV B 2 e, the pending Subchapter S
Revision Bill of 1982 is enacted to provide that an S corporation,
when it is a shareholder in a C corporation, will not be treated as a
corporate distributee under section 301, new section 311(d)(2)(A)
will not apply to a distribution to an S corporation since section
301(d)(2) applies only to a distribution to a corporate distributee.

3. New Exception for Certain Partial Liquidations

After TEFRA a corporation distributing appreciated property in
a partial liquidation no longer is protected from gain recognition by
section 336. While a partial liquidation distribution to a corporate
shareholder, to which section 301(d)(2) applies, is exempted from
section 311(d)(1) gain recognition (to the distributing corporation)
by new section 311(d)(2)(A), described immediately above, dis-
btribution in partial liquidation to a noncorporate shareholder—one, a
distribution to which section 302(b)(4) applies—is exempted from
section 311(d)(1) gain recognition if but only if the distribution “is
made with respect to qualified stock.”

New section 311(d)(2)(B).

Qualified stock, a new entry in the tax lexicon, is defined in new
section 311(e)(1).

a. The term “qualified stock” means stock held by a person (other
than a corporation) who at all times during the lesser of (i) the
5-year period ending on the date of distribution, or (ii) the period
during which the distributing corporation (or a predecessor corpora-
tion) was in existence, held, directly or by attribution, at least 10
percent in value of the outstanding stock of the distributing corpora-
tion (or predecessor corporation).
b. The new, and unfortunately undefined, notion of a “predecessor corporation” in differing circumstances may work for or against the taxpayer. If T has been in existence more than five years and A has held 10 percent in value of the outstanding T stock 3 years, A does not hold qualified stock. But if A received the T stock 3 years ago incident to a merger of his then wholly-owned (for many years) Q corporation with and into T, A does hold qualified stock in T provided Q is treated, as presumably it ought to be treated, as a predecessor corporation with respect to T. On the other hand, if A has held 10 percent of T since the date T was organized 3 years ago, but T was at that time the product of a “liquidation-reincorporation” of a predecessor corporation in which T did not own 10 percent, the predecessor corporation rule will operate, as presumably it should, to deprive the T stock held by A of qualified stock status.

c. The statute currently provides that stock held by a corporation cannot be qualified stock as to that holder. If the Subchapter S Revision Bill of 1982 is enacted, and under new section 1371(a)(2) section 301(d)(2) will not apply to dividends received by an S corporation, it ought to follow (even absent a technical amendment) that the new section 311(e)(1)(A) negative reference to “a corporation” means “other than an S corporation.” It would not seem that this change will open the door to significant tax avoidance. For example, if two previously unrelated individuals, each owning 5% in value of the stock of a C corporation, were to transfer that stock to a new S corporation in exchange for its shares, for the purpose of converting the C corporation stock to qualified stock, the plan would be unlikely to succeed.


d. New section 311(e)(1)(B) announces that the attribution rules of section 318 apply in determining ownership of stock for purposes of the qualified stock definition, but the family attribution rule of section 318(a)(1)(A) is expanded (see section 267(c)(4)) to include ancestors, lineal descendents, brothers and sisters (whether by the whole or half blood), and any spouse of any of them. In an age of elastic morality, it is a perceptive man who can identify his brother or sister by the half blood.

New section 311(e)(1)(B) is a provision, rare indeed in the tax law, under which attribution is intended to work in favor of the taxpayer.

e. The definition of qualified stock in new section 311(e)(1)(A) also is unusual. It focuses, not on the shares held (actually or constructively) by a particular noncorporate person, but rather on that person. If Mr. A has held (actually or constructively) 10% in value of the outstanding stock of T for 5-years, those long-held shares are qualified stock. But if Mr. A has held an additional 20% of the stock of T less than 5 years—indeed, for all of five minutes—those additional shares also constitute qualified stock. Taking the matter to its extreme,
if the only shares of T actually held by A are the 20% he purchased
five minutes ago, but members of his attributing extended family have
held an aggregate of 10% of the stock of T at least 5 years, A's 20% is
qualified stock which, if turned in by him in exchange for a non
pro rata partial liquidation distribution from T, will afford T the non-
recognition benefits of new section 311(d)(2)(B).

See Conference Report 529.

f. Obviously the potential of tax avoidance planning is in the air.
Consider this case, a commentary on the employment of attribution
rules for the benefit of taxpayers.

T is a medium-size corporation. Its shares are traded over-the-
counter but members of the A family and trusts for the benefit of some
of them in the aggregate long have owned well over 10 percent of
the T stock. For many years T has operated various separate businesses
in divisional form. One of these, the H business, has substantially ap-
preciated assets but little in the way of recapture items, and on the
right terms T would be prepared to dispose of it. Mr. C owns no
shares of T but he is a member of the A family and, by extended
 attribution, is treated as holding more than 10% in value of the stock
of T. Mr. C is a member of a modest size investment partnership.

Messrs. X, Y, and Z are wealthy investment bankers. They are
very interested in acquiring the H business. Well-advised, they under-
stand that an uncomplicated purchase of the H business from T would
subject T to substantial tax liability. They also understand that if
the tax could be avoided T would be prepared to dispose of the H
business at a lower price.

Messrs. X, Y, and Z make a substantial investment in C's partner-
ship thereby becoming very much the dominant partners. The partner-
ship then makes a successful tender offer to acquire, mainly from the
public but partly from the A family, 35 percent of the outstanding
stock of T (the members of the A family retain at least 10 percent of
the T stock). The partnership then negotiates a redemption exchange of
the newly purchased T shares for the assets of the H division. This
exchange qualifies as a partial liquidation under section 302(e) to
which section 302(b)(4) applies.

Will T recognize gain (other than recapture items) on the trans-
action?

Under section 318(a), C is treated as owning the T stock owned
by the other members of the A family, and the investment partnership
is treated as owning the T shares which C is deemed to own. This is
more than 10 percent in value of the stock of T and it is deemed
held more than five years. Thus, since the partnership is "a person,"
meeting the requirements of the qualified stock definition, the 35% of
T newly purchased and actually owned by the partnership is, as to
it, qualified stock. That there has been a very large admission of
new partners into the partnership does not seem relevant under the
present statutory definition. Accordingly, on the face of it, the re-
quirements of section 311(d)(2)(B) are met and T is in line for absolution.

It is, of course, Mobil-Esmark revisited, this time in a far better factual setting since the partnership, when it purchased the T stock, did not have a redemption agreement with T.

Query: Can the Treasury write a regulation under new section 346(b) that will adequately inhibit this sort of planning?

Alternatively, one might suggest that a technical amendment is in order. A passthru entity such as a partnership should not be treated as a person holding the newly purchased T shares as qualified stock in cases of the sort illustrated. Some form of look through rule, perhaps one disqualifying at least those recently acquired shares that can be attributed to recently acquired partners, might be in order.

g. Assume Mr. A has owned 10 percent in value of the stock of T more than 5 years. He dies. Mrs. A is sole beneficiary of the estate. Are the shares qualified stock in the hands of the estate? After the estate distributes to Mrs. A, are the shares qualified stock in her hands?

Under old section 311(d)(2)(A), which contained a 10 percent interest and one year holding period requirement but no beneficial attribution rule, the Internal Revenue Service ruled that the exemption from section 311(d)(1) recognition was unavailable to the redeeming corporation when the redemption was made less than one year following the date of death.


Under new sections 311(d)(2)(B) and 311(e)(1), a partial liquidation distribution in redemption of shares held by Mrs. A, after the estate has distributed to her, ought to qualify. Taking attribution into account, first from her husband and then from his estate, she has held 10 percent of the stock of T over an uninterrupted period of more than 5 years. If the redemption distribution is to the estate, well within 5 years following A's death, the matter is more difficult. There could be no direct attribution from A to his estate, absent an application of metaphysics, since both did not co-exist at any point in time. Mrs. A does attribute to the estate, both existing at once, and it can be argued that even though the estate did not exist when A was alive and Mrs. A was deemed to own his T shares, the estate ought to be given credit for that time. It can as well be argued the other way. At the moment it is all a great mystery which, perhaps, forthcoming regulations will resolve.

h. If T distributes appreciated property to noncorporate shareholders in a partial liquidation to which section 302(b)(4) applies, but no redemption of T shares accompanies the event, a redemption will be imputed if doing so will have tax significance.

Conference Report 530.

Doing so will indeed be tax significant if a noncorporate distributee shareholder does not hold qualified stock. With respect to that portion of the distribution in deemed redemption of shares, T will be
required to recognize gain under section 311(d)(1). The TEFRA revision to section 311(d) thus works an interesting reversal. Before TEFRA, section 311(d) did not apply to a distribution in partial liquidation, and as to the distributions to which the section did apply an actual redemption was required. No redemption meant no distributing corporation gain recognition under section 311(d)(1), but the shareholder was charged with dividend income on the distribution. After TEFRA the focus is on partial liquidations, an actual redemption is not required to ring in section 311(d)(1), gain is recognized at the distributing corporation level unless the noncorporate shareholder holds qualified stock, and with the imputation of a redemption the shareholder—whether or not he holds qualified stock—is afforded gain rather than dividend treatment, on the distribution in partial liquidation, under new section 302(b)(4).

4. New Exception for Distribution of Interests in Certain Subsidiaries
Old section 311(d)(2)(B), quoted above in 11 B 1, was generous in allowing T to distribute, in exchange for T shares and without recognition of gain to T, appreciated stock (or an obligation) of a (at some past time) 50 percent or more owned subsidiary. TEFRA repealed this provision and substituted a substantially more restrictive permission which, in general, parallels the partial liquidation exception in new section 311(d)(2)(B).

New section 311(d)(2)(C).

The new provision exempts from section 311(d)(1) gain recognition at the distributing corporation level a distribution of stock (or of an obligation) of another corporation if the requirements of section 311(e)(2) are met with respect to that distribution. Section 311(e)(2), another provision new in TEFRA, is something of an amalgam of old and new sections 311(d)(2)(B).

a. The first requirement of the new provision is that the distribution be made with respect to qualified stock, that term being defined in new section 311(e)(1), discussed above.

New section 311(e)(2)(A)(i).

b. Substantially all of the assets of the controlled corporation (the corporation stock or an obligation of which is distributed) must consist of the assets of one or more qualified businesses.

New section 311(e)(2)(A)(ii).

The term "qualified business" means any trade or business actively conducted throughout the five-year period ending on the date of distribution which was not acquired by any person within such period in a transaction in which gain or loss was recognized in whole or in part. This definition is essentially the same as the definition of a "qualified trade or business" in new section 302(e)(3).

New section 311(d)(2)(B)(i).

c. No substantial part of the controlled corporation's non-business assets was acquired by it from the distributing corporation, in a transaction to which section 351 applied or as a contribution to capital, within the five-year period ending on the date of distribution.
New section 311(e)(2)(A)(iii).

The term "nonbusiness asset" means any asset not used in the active conduct of a trade or business. No doubt this definition will present interpretative problems in practice. We are informed that cash and other items that provide working capital needs of an active business will be treated as assets used in the active conduct of the business, and while that is comforting it does not resolve all potential issues.

New section 311(e)(2)(B)(ii).

See Conference Report 534.

Note that the new provision differs significantly from the equivalent provision of old section 311(d)(2)(B)(ii), which rendered the exception from section 311(d)(1) inapplicable if the controlled corporation had received, from the distributing corporation, "property constituting a substantial part of its assets." The old statute did not distinguish nonbusiness assets from other assets.

d. More than 50 percent in value of the outstanding stock of the controlled corporation must be distributed by the distributing corporation with respect to qualified stock.

New section 311(d)(2)(A)(iv).

Assume Messrs. A, B, C, and D, unrelated individuals, each owns 100 of the total 400 outstanding shares of T corporation. A, B, and C have held their shares more than five years and thus own qualified stock. D has held his shares only three years and thus does not own qualified stock. T owns 200 of the total outstanding 300 shares of H corporation and proposes to distribute those shares pro rata to A, B, C, and D.

i. Assume first that T distributes the 200 H shares, 50 to each of its shareholders, but does not redeem any T shares. Section 311(d)(1) does not apply, in the absence of a redemption, to require that T recognize gain on the distribution (without regard to the availability of an exception under new section 311(d)(2)) unless T is "deemed" to have redeemed a portion of its shares. When the distribution is a partial liquidation under new section 302(e), the Conference Report (page 530) calls for a deemed redemption for the purpose of triggering gain recognition to the distributing corporation under section 311(d). Does a similar "deemed" redemption rule apply in the section 311(d)(2)(C) context? Presumably not, since the aggregate tax burden would be astonishing. In the case of a pro rata partial liquidation distribution to noncorporate shareholders under section 302(b)(4), the shareholders receive capital gain treatment and the imposition of tax at the distributing corporation level, to the extent the distribution is made to noncorporate shareholders who do not hold qualified stock, is unpleasant but hardly confiscatory. But when the pro rata distribution is not a partial liquidation under section 302(b)(4)—and it is not in the example case here considered since we deal with a distribution of shares and not a distribution of operating assets in kind—the noncorporate shareholders will receive dividend treatment. It would not
appear Congress intended to pile corporate level gain recognition on top of shareholder level dividend treatment.

ii. The facts are the same but, in its pro rata distribution of the 200 H shares, T does redeem a portion of its outstanding stock from the four T shareholders. Under section 302(d), because section 302(b)(4) does not apply to a distribution of controlled corporation shares (unless the Service reverses a longstanding position with regard to what qualifies as a partial liquidation), the shareholders continue to suffer dividend treatment. In addition, because there has been an actual redemption, section 311(d)(1) applies to require gain recognition by T unless section 311(d)(2)(C) comes into play to avoid the recognition result. Unfortunately, on the stated facts the exception is unavailable. T owns and distributes exactly two-thirds of the outstanding stock of H, the controlled corporation. But only 75 percent of these H shares are distributed by T “with respect to qualified stock” since only 75 percent of the outstanding stock of T is qualified stock. Seventy-five percent of two-thirds is exactly 50 percent. The statute, new section 311(e)(2)(A)(iv), requires that “more than 50 percent in value” of the outstanding stock of H, the controlled corporation, be distributed with respect to qualified stock of T. Hence, unless it somehow can be argued that the H stock distributed to Messrs. A, B, and C has a “value” greater than 50 percent of all of the outstanding stock of H, not an easy argument to sustain, T will be taxed on the distribution and all of the shareholders will suffer dividend tax consequences as well.

iii. Assume that shortly before the distribution described in ii, A purchases one share of T stock from D. Because A already owns qualified stock in T, the newly purchased share also constitutes qualified stock in his hands. In the distribution that follows, B and C each receives exactly 50 shares of H, D receives slightly less than 50 shares, and A receives slightly more than 50 shares. If the purchase arrangement is given effect for tax purposes, it follows that more than 50 percent in value of the outstanding stock of H has been distributed by T with respect to qualified stock, and the section 311(d)(2)(C) exception will apply to avoid recognition by T of any gain with respect to any of the H shares distributed. Assuming the purchase transaction is not a subterfuge, and A retains the T share he has purchased from D, this “self-help” plan should work.


Once again, however, the shareholders will suffer dividend tax consequences on the distribution since section 302(b)(4) does not apply.

iv. Contrast these rules with the partial liquidation rules now embedded in sections 302(b)(4), 302(e), and 311(d)(2)(B). A noncorporate shareholder receiving a distribution in partial liquidation, unless section 341 applies, always enjoys capital gain treatment. At the shareholder level it is not relevant whether the distribution is or is not with respect to qualified stock. At the distributing corporation level,
if the distribution is to a noncorporate shareholder who holds qualified stock gain recognition (other than as required by recapture rules and the like) is avoided, but if the distribution is to a noncorporate shareholder who does not hold qualified stock gain recognition is required. And this is so whether there is or is not an actual surrender of shares in the distributing corporation. Thus, the partial liquidation rules, at the distributing corporation level, work in a piecemeal fashion.

When stock (or an obligation) of a controlled corporation is distributed pro rata to noncorporate shareholders, however, the rules are quite different. The shareholders suffer dividend treatment whether or not there is an actual surrender of stock in the distributing corporation. The distributing corporation recognizes no gain if there is not an actual surrender of shares, and if there is an actual surrender of shares gain must be recognized on the entire distribution if the requirements of new section 311(e)(2)(A) are not met, while no gain at all will be recognized by the distributing corporation if those requirements are met. Further to compound the confusion, if in either a partial liquidation distribution or a distribution of controlled corporation stock the distributee is a corporation (other than an S corporation if the pending Subchapter S Revision Bill is enacted), the distributing corporation does not recognize gain (other than recapture items and the like in a partial liquidation) and the recipient corporation always receives dividend treatment, provided the basis of the distributed property carries over to the recipient corporation under section 301(d)(2).

v. A final notation. If in the example case T has owned at least 80 percent of the outstanding stock of H, and a distribution of the H shares (whether or not in redemption of T shares) would have qualified for nonrecognition treatment under section 355, that provision overrides, neither section 301 nor section 302 nor section 311 would come into play, the shareholders would recognize no gain on the H stock distribution, and T would recognize no gain on that distribution. Unless, of course, the taxpayer somehow is using section 355 to circumvent the TEFRA amendments to sections 331 and 336, relating to partial liquidations, in which event new section 346(b) regulations may come into play. What this all means, knows God.

5. Certain Zenz Transactions

Mr. A owns all of the stock of T corporation. T operates a widget business worth 80 and owns appreciated investment land worth 20 (basis 4). The land is not a business asset and the distribution of it by T would not qualify as a partial liquidation. P, wishing to acquire the widget business but not the investment land, purchases from A 80% of the stock of T paying 80, and simultaneously T redeems the other 20 shares from A distributing in exchange the investment land. On the redemption A receives capital gain treatment.

Section 302(b)(3).

Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954).

If this is all that happens, section 311(d)(1) will apply to require recognition by T of the 16 gain on the redemption distribution. However,
if P timely elects under new section 338, discussed below, so that T is thereby treated as having sold all of the widget assets to a "new T" in a single transaction to which section 337 applies, the section 302(b)(3) complete redemption of A's interest in T will be governed at the T level, not by section 311, but by far more permissive section 336. For more, however, see VI G, below.

Section 338(c)(2).

V. CERTAIN STOCK PURCHASES TREATED AS ASSET PURCHASES

The above heading is the title of new section 338, the provision of subchapter C that replaces now repealed old section 334(b)(2). The basic notion of the old section was and the new section is the same: After purchasing the controlling stock of T, P may elect to step-up the basis of the assets of T, to an amount reflective of the purchase price paid for the T stock, at a toll charge measured by the recapture taxes imposed on T by reason of the basis change. In concept, the sensible, if not always well articulated, notion was and is that in a taxable corporate acquisition the tax consequences—asset basis and gain recognition—as nearly as possible ought to be the same whether the transaction is carried out as an asset acquisition under section 337 or as a stock acquisition followed by a triggering "election."

But, under prior law, the concept failed in practice in many cases and for many reasons. And the method of electing basis step-up after a stock purchase—the requirement that T be liquidated into P—was inefficient, often costly, and on occasion proved a trap for the inadequately advised. The substitution of new section 338's explicit election for prior law's election-by-liquidation should prove, if the forthcoming regulations and perhaps some technical amendments to the statute provide needed clarification, a sizable advance in the transactional simplification of the tax law.

A. Section 338: An Introductory Summary

Part VI, below, presents a detailed analysis of new section 338 as it applies to the purchase of the controlling stock of a single corporation. Part VII, below, considers acquisitions out of a selling affiliated group in which P or a P affiliate purchases, in addition to the controlling stock of one corporation, assets or stock of an affiliate of that corporation. Leaving a discussion of detail to those later segments of the outline, the following is an introductory summary of the way in which section 338 is designed to operate.

At the threshold, at one time or from time to time over a period of not more than 12 months P (or the corporate members of P's affiliated group) must purchase the controlling stock of T.

With exceptions not material to this introductory discussion, purchase is defined in new law as it was defined in old section 334(b)(3).
Similarly, the quantum of T stock that P must purchase is exactly what it was under old section 334(b)(2): 80% of the total combined voting power of all classes of T stock entitled to vote, and 80% of the total number of shares of each other class of T stock except nonvoting stock which is limited and preferred as to dividends. The purchase of at least that amount of T stock is termed a “qualified stock purchase.”

If P has made a qualified stock purchase of T, and if P timely makes an election under section 338 (or is deemed to have done so), T is treated as having sold all of its assets at the close of the acquisition date (the first day on which P has acquired control of T by purchase) in a single transaction to which section 337 applies. Further, T is then treated as a new corporation which has purchased all of the assets of “old” T as of the beginning of the day after the acquisition date.

Essentially, the object of new section 338 is to trigger recapture recognition equivalent to what that recognition would have been had T really sold its assets to P, and to give “new” T a basis in the assets, post election, equivalent to what that basis would have been if the transaction were a real asset purchase rather than a stock purchase.

Finally, because old section 334(b)(2) is repealed, every liquidation into a parent corporation of a controlled subsidiary, whether newly purchased or old and cold, is governed by section 334(b)(1). Thus, if T liquidates into P and no section 338 election is made, the historic basis of the T assets carries over. If a section 338 election is made, the stepped-up asset basis carries over to P.

B. Some Discontinuities Under Prior Law

New section 338 eliminates a number of the discontinuities, between the tax treatment of asset purchases and the tax treatment of stock purchases, that inhered in prior law. It does so by applying section 337(a) to T corporation in the stock purchase transaction. Section 337 is, of course, the provision ordinarily applicable when T adopts a plan of complete liquidation and sells its assets to P. By applying basically the same target corporation level nonrecognition rule to both sorts of corporate acquisition, new law for the first time provides the grounding for harmonizing the tax treatment in both sorts of acquisition. Nonetheless, because there are unavoidable differences in stock and asset transactions—as an obvious example, in the stock acquisition P may purchase less than all of the outstanding shares of T—harmony under new law is less than complete. In addition, as seems inevitable in subchapter C, there are circumstances in which the replacement of old section 334(b)(2) by new section 338 extends or creates new dis-harmonies.

C. Discontinuities Not Affected By TEFRA

1. Installment Sales

Before the Installment Sales Revision Act of 1980 ("Installment Sales Act") the single most important discontinuity in the tax treat-
ment of asset transactions and stock transactions related to an installment sale. If A sold the stock of T to P for future payment, in qualifying circumstances A could elect to report the sale on the installment method under section 453.

If, however, in a manner comporting with section 337 T sold its assets to P for an identical future payment obligation, A upon receiving the P note in a liquidating distribution from T was not permitted to report his transaction on the installment method. The Installment Sales Act reversed the latter rule. In an asset transaction as in a stock transaction, A now reports on the installment method unless he elects current recognition of gain.

Section 453(h).

The Installment Sales Act did not, however, eliminate all differences in reporting treatment. If T is a collapsible corporation and no exception or limitation applies, on a stock sale for future payment A receives installment treatment (although long-term gain as recognized is ordinary income). In an asset transaction (sale of assets by T to P and liquidating distribution by T to A of the sale proceeds including P's installment note) A is not permitted to report on the installment method since section 453(h)(1)(A) refers to a liquidation to which section 337 applies, and section 337 does not apply to T if it is a collapsible corporation as defined in section 341(b) and the exception contained in section 341(e)(4) is unavailable.

Section 337(c)(1)(A).

In addition, shareholder installment treatment under section 453(h) is unavailable to the extent P's debt obligation is attributable to a non-bulk sale of inventory or other section 1221(1) property by T to P. Had A instead sold the stock of T to P for a debt obligation, installment treatment would have been available to A without regard to the level or composition of T's ordinary income property.

Section 453(h)(1)(B).

The two discontinuities in installment sale treatment, described above, that survived enactment of the Installment Sales Act were not affected by the enactment of TEFRA, and remain with us. While there are practical reasons to afford special treatment to installment obligations generated in a non-bulk sale of inventory, there does not appear to be a good reason to deprive A of installment treatment when T, selling its assets and liquidating, is found to be a collapsible corporation.

2. More on Collapsible Corporations

Another set of disharmonies that survives enactment of TEFRA relates to the limitations on the application of section 341 that are contained in subsection (d) of that provision. There are three of them, known respectively as the five percent limitation, the 70:30 rule, and the three-year limitation. They apply to a sale of stock in an otherwise collapsible corporation. They do not apply when a collapsible corporation, as that term is defined in section 341(b), adopts a plan of liquidation and sells its assets.

a. *Three-Year Limitation*

Assume T, organized in 1975, subsequently constructed two apartment buildings thereafter held by it for rental income. Building-1 was completed in 1977. Building-2 was completed in 1980. On September 1, 1982 the value of both buildings is substantially appreciated and T is worth 250, 100 attributable to Building-1, 100 attributable to Building-2, and 50 to miscellaneous items of highly appreciated depreciable property held by T less than one year. Assume A's basis in the T shares is 10. If on September 1 A sells the T shares for 250, and assuming that T is a collapsible corporation and section 341(e)(1) will not apply on these facts, the portion of A's gain attributable to Building-1 (held more than three years) will be long-term capital gain under section 341(d)(3), and the balance of his gain will be ordinary income under section 341(a)(1).


On the other hand, if on September 1, 1982 T adopts a plan of complete liquidation, immediately sells all of its assets for 250, and distributes the proceeds to A, T must recognize and pay tax upon all of the gain realized on that sale. The three-year limitation of section 341(d)(3) does not apply, at the T corporate level, to render section 337 effective with respect to gain realized by T on Building-1. It is not at all clear as a matter of policy why this should be so.

b. *Five Percent and 70:30 Limitations*

Assume Messrs. A, B, and C, unrelated individuals, respectively own (and at all times have owned) 55%, 40%, and 5% in value of the outstanding stock of T. T is a collapsible corporation and, let us assume, neither the three-year limitation of section 341(d)(3) nor any exemption contained in section 341(e) has relevance. Assume further that T has engaged in two separate projects on the larger of which it has enjoyed "substantial realization" of the taxable income to be derived therefrom, while on the smaller project it has not. Finally, assume B's basis in his shares is low while A, who inherited the shares a couple of years ago, has a fairly high basis in them.

On his sale of shares, C will enjoy long-term capital gain under the five percent limitation of section 341(d)(1). On his sale of shares A, we may safely assume, must recognize ordinary income. B's case is special. Depending upon the exact facts and calculations, B may qualify for capital gain treatment under the 70:30 limitation of section 341(d)(2).

If T adopts a plan of complete liquidation, sells its assets, and distributes the proceeds to the shareholders, T must recognize and pay tax upon the total gain realized. The disharmony in treatment, between stock sale and asset sale, could be ameliorated by statutory amendment. Section 337(d) outlines the mechanism. As now, T would be required to pay full tax. However, C, and if section 341(d)(2) benefits would have been available to him on a stock sale then B as well, would be afforded gross-up and credit relief measured by the
portion of the T corporate tax appropriate to the percentage of T shares held by C and B. A, entitled to no relief under section 341(d), would receive none.

D. Discontinuities Eliminated by TEFRA

The following necessarily is a representative catalog. It is in part incomplete because, at this early stage, it cannot be known how the forthcoming regulations and subsequently the courts will treat under the new statutory structure all of the anomalies of prior law.

The legislative history of TEFRA clearly points in one direction, but the finger shakes a bit. These two statements follow one another in the Conference Committee Report:

"Gain or loss will not be recognized [to T under section 338] to the same extent gain or loss is not recognized under present law (sec. 337) when a corporation sells all its assets in the course of a complete liquidation."

"This provision is intended to provide nonrecognition of gain or loss to the same extent that gain or loss would not be recognized under section 336 if there were an actual liquidation of the target corporation on the acquisition date to which present law section 334(b)(2) applied."

Conference Report 536.

Use of the phrase "to the same extent" in both sentences quoted suggests the authors of the Report believed the scope of nonrecognition of gain or loss to have been the same under section 337 and under section 336. While there has been some division (perhaps soon to be resolved) in judicial authority as to the extent of the differences, it is clear the nonrecognition benefits under section 337 and 336 at least to some degree are not coextensive.

A simple illustration. T operates a single business. The inventory (FIFO) of the business is substantially appreciated. T adopts a plan of complete liquidation and promptly sells 40% of the inventory and all of the operating assets to P. Because T has not sold substantially all of its inventory to a single buyer in a single transaction, under section 337(b) T, even though it completes its liquidation within the requisite 12-month period, must recognize gain on the inventory sale to P. For the same reason, if T sells the balance of its inventory to another buyer, T will recognize the gain on that sale. But if T distributes the balance of its inventory to A in the completion of its liquidation (and assuming A retains the distributed assets so that Court Holding Company is not implicated), section 336 will apply to that distribution and T will not recognize gain with respect to it.

The sentences quoted from the Conference Report do furnish important guidance in making clear the congressional intent that under section 338 T is not to recognize a greater quantum of gain than T would have recognized under prior law. But because there are circumstances in which, under prior law, T would have recognized different
amounts of gain depending upon whether section 337 or section 336 was in point, there is sorting out to be done in the forthcoming regulations.

Nonetheless, it is clear that insertion of section 338 into the taxing equation has eliminated some significant differences in the tax treatment under prior law.

1. *P Holds T Debt*

The stock of T is worth 90 and it is held by A. T has outstanding a debenture, face amount 10, which P purchased for that amount and continues to hold. T has no other liabilities and a single asset, investment land, value 100 and basis 40.

If in a transaction comporting with section 337 T sells the land to P for 100, P's basis in the property will be 100. T will use sale proceeds of 10 to redeem the debenture held by P and will distribute the 90 balance to A in liquidation. On the transaction, P's total outlay is 90, 100 paid T less 10 received from T.

Under prior law, if P purchased the stock of T for 90, its fair value, and then caused T to liquidate under section 334(b)(2), the tax result would be quite different. On its liquidation T would recognize no gain, section 332(c), and P would recognize no gain with respect to the debenture or, under section 332(a), with respect to the T stock. But, in the hands of P, the basis of the land would not be 100 but rather would be 94. This strange result obtained because, as to the 10% of the land (allocated basis 4 and value 10) deemed distributed on the debenture, section 334(b)(1) and not old section 334(b)(2) applied and required carryover of basis from T to P.


This was a particularly unsatisfactory rule in that, better advised, P at an earlier point would have sold the T debenture at its fair value of 10 to a third party purchaser. In the subsequent acquisition and liquidation of T under old section 334(b)(2), proper reflection of the debenture liability would have produced a basis of 100 in the land in P's hands.

Because new section 338 employs the approach of a deemed purchase of assets, the discontinuity of prior law disappears. Basis is stepped-up to 100 on the facts of the example.

2. *Dropdowns and Pushups*

Under prior law qualification of a liquidation under old section 334(b)(2) in some cases was and in other cases may have been—the law was unsettled—hostage to the avoidance of post acquisition foot faults. The possibility of error and attendant opportunity of entrapment of the inadequately advised was significant. Substantially, and perhaps entirely if forthcoming regulations are well and sensibly crafted, new section 338 provides automatic protection.

a. After purchasing the stock of T, P contributes more than 20 percent (perhaps all) of the T stock to S, P's subsidiary.

Under prior law, the liquidation of T into S did not qualify under section 334(b)(2). That provision required that the controlling stock
of T have been acquired "by the distributee"—in this case S—by purchase. Old section 334(b)(3) announced that the T stock, received by S from its parent corporation P by way of a contribution to capital, was not "purchased" stock in the hands of S.

*Chrome Plate, Inc. v. United States*, 614 F.2d 990 (5th Cir. 1980).

New section 338 also contains the threshold requirement that the controlling stock of T have been "acquired by another corporation by purchase." New section 338(d)(3). The definition of "purchase," now contained in new section 338(h)(3)(A), has not changed relative to the issue at hand. But the new statute, unlike the old, merely requires purchase "by another corporation." It does not, as did prior law, require that the purchase have been "by the distributee" since, of course, under section 338 there is no liquidation and thus no distribution. Thus, in the example, if P timely elects under section 338(a), whether before or after its contribution of the T shares to S, that section will apply to step-up the basis of the T assets and trigger attendant recapture taxes in T. Legislative history provides direct confirmation.

Conference Report 538 n.2.

b. Assume S purchases the T stock and distributes more than 20% of the T stock to P. Under prior law "purchase" qualification was lost and old section 334(b)(2) did not apply to the liquidation of T into P. Under new section 338, if S timely elects the basis of the T assets will be stepped-up and recapture gains recognized in T. Conference Report 538 n.2.

Query: Suppose, under new law, P purchases the stock of T, distributes the T stock to P's shareholder B who is an individual, and then files the section 338 election with respect to T. Is the election effective? The Conference Report adverts only to transfers within the P affiliated group. But why not make the election effective?

c. Under prior law, P purchases the stock of T, promptly causes T to liquidate, and shortly thereafter transfers part or all of the T operating assets to S. It is the questionable position of the Internal Revenue Service that T has not undergone the "complete liquidation" required by section 332(b)—i.e., S is "really" T—so that old section 334(b)(2) does not apply and the former T assets held by S retain their historic basis and do not take on a stepped-up basis.

LTR 7836002 (Technical Advice Memorandum).

The current law analogue would be purchase by P of the T stock, filing by P of a section 338 election, liquidation of T into P, and transfer by P to S of part or all of the T operating assets. By reason of the section 338 election, T is treated as having sold its assets to a "new" T in a single transaction to which section 337 applies. The subsequent liquidation of T is governed by section 334(b)(1) and the basis of the assets distributed to P, and thereafter contributed by P to S, is the stepped-up basis. That is, just as the "liquidation-reincorporation" doctrine has no application when P purchases the T assets in a "real"
section 337 transaction, the doctrine has no application under section 338 which calls for a “deemed” sale of assets to a “new” T.

d. Under prior or present law, if P purchases the assets of T and transfers part or all of the assets to S, the basis of those assets is a purchase price basis. Under prior law, if P purchased the stock of T, T transferred part of its operating assets to H, a T subsidiary, and T then liquidated into P distributing the H stock, the Service would claim that there has not been a complete liquidation of T and neither section 332(b) nor old section 334(b)(2) applied. Under present law, because a section 338 election is deemed effective at the inception, the basis of the assets retained by T as well as the assets transferred by T to H should be stepped-up to reflect purchase price and recapture gains recognized in full.

3. Asset Basis

Assume T corporation has no liabilities and a single asset, a milling machine adjusted basis 100 and value 400. The machine was purchased by T some years ago for 300 and hence recapturable depreciation under section 1245 is 200. For convenience assume a corporate tax rate of 50%.

If P purchases the machine from T P will pay 400, its fair value. Liquidating under section 337, T will pay tax of 100 on its section 1245 recapture gain (for convenience assume no investment credit recapture) and A will receive a long-term capital gain distribution of 300. In the hands of P, the basis of the machine will be its 400 purchase price. This “real” asset sale is the model case.

If A were to sell the stock of T to P, in light of the model case A would expect to receive 300 as the purchase price of the stock. Under prior law, to obtain the machine with a stepped-up basis P would cause T to liquidate under old section 334(b)(2). In that liquidation, P would receive the machine and would assume and discharge T’s recapture tax liability of 100. Under prior law, in P’s hands the basis of the machine would reflect both P’s 300 basis in the T stock and the 100 T liability assumed by P. This total of 400, matching the model case, would provide a correct basis result.

But it was not inevitably the result reached under prior law. The regulations under section 334(b)(2), contemplating cases in which the liquidation of T was delayed for some time following P’s purchase of the T stock, called for an upward adjustment in asset basis to reflect earnings and profits generated in T during that interim. Although the regulations were susceptible of alternate interpretation, some case law supported the extraordinary notion that earnings and profits generated by depreciation recapture, when depreciable property was distributed in liquidation, should be reflected in the basis of the distributed asset in the hands of P. Application of this peculiar idea to the example case could yield a basis to P in the machine of 500.

See also First National State Bank of New Jersey, 51 T.C. 419 (1968).

Under new section 338, which looks to section 337 as its operative provision, this issue is avoided. Section 338 contemplates no earnings and profits adjustment to basis. Assuming, as one must to make sense of the statute, that T's recapture tax liability is a liability the forthcoming regulations will reflect in the asset basis calculation, in the hands of “new” T the basis of the machine should be 400 in the example case.

4. T Asset Worth Less Than Basis

Assume one of T's many assets, an item of section 1231(b) property, is worth 100 less than basis. P wishes to acquire all of the other assets of T but has no great interest in this item of equipment. No buyer for it as yet has been located but there is no doubt a buyer can be found within a few months.

If T adopts a plan of complete liquidation, sells all of its other assets to P, later sells the equipment to unrelated Z, and completes its liquidation within the requisite 12 month period, under section 337 T will recognize no loss on the sale to Z.

If, under prior law, A sold all of the stock of T to P for a total purchase price that reflects the fair value of the equipment, P would cause T to adopt a plan of complete liquidation and distribute to P all assets other than the unwanted equipment. If T thereafter sold the equipment to Z at fair value, absent special facts T would be allowed an ordinary loss of 100. And this would have been so even if the sale and completion of T's liquidation occurred within 12 months of adoption of the liquidation plan. Old section 337(c)(2)(B), which governed the tax treatment of T in these circumstances, limited or eliminated recognition of gain by T but did not affect T's recognition of loss.

New section 338 eliminates this discontinuity. The filing by P of an election under section 338 effects a change in the basis of T's assets from the outset. Thus, when T sells the equipment to Z at fair value, sale price and basis should be the same and “new” T will realize no loss.

5. Prepaid Subscription Reserve

If T publishes magazines and sells to subscribers who pay in advance, under section 455 it may establish a prepaid subscription reserve. T takes the reserve into income over time as it fulfills its obligation to subscribers.

If T sells its assets to P, it must take the then balance of the reserve into income. Section 337 will not shelter this item. But, in the asset transaction, T will be awarded an offsetting deduction on the following reasoning. Because P has assumed the obligation to subscribers, it has paid less cash to T for T's assets. Divided into its component parts, the arrangement can be viewed as one in which P has paid additional cash to T in the amount of the obligation, and T has paid P
the same amount in consideration of P's assuming that obligation. It is this deemed payment to P that creates the offsetting deduction to T. See *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67, 71-72 (8th Cir. 1964).

If the acquisition proceeded by way of a stock purchase and liquidation of T under old section 334(b)(2), however, the Internal Revenue Service included in T's final tax return gross income the entire previously untaxed balance of its prepaid subscriptions, but awarded T no offsetting deduction.


In the new world of section 338, presumably the courts will and the Service should follow the *James M. Pierce* recipe.

6. *Cash Method Business Liabilities*

T is a cash method taxpayer. It has accrued, but as yet untaxed, items of income and accrued, but as yet not deducted, items of expense. If T sells its assets to P, the purchase price will reflect the income items and T must include them in income. Section 337 will not shelter this income. If P assumes the business liabilities it will pay T less cash in reflection of that assumption. Relying upon the approach adopted in the *James M. Pierce* case, above, the Tax Court in 1981 held that cash method T would be allowed to deduct the unpaid business liabilities which would have been deductible by T, when incurred, had T been an accrual method taxpayer.


If the transaction had proceeded under prior law as a stock acquisition followed by a liquidation of T under old section 334(b)(2), the Internal Revenue Service would have denied a deduction to T for the unpaid business liabilities. It is doubtful the Service's determination would have been overturned in court.

See *Arcade Restaurant, Inc.*, 7 T.C.M. 563 (1948).

Under new section 338, it seems likely the courts will, and the Service should, award "old" T a deduction in its final return for the business liabilities which T, had it been an accrual method taxpayer, would have deducted when incurred.

7. *P Exercised a Purchase Option*

See the discussion in VI A 1 b, below.

E. OTHER DISCONTINUITIES

While the enactment of section 338 and repeal of old section 334(b)(2) has done such to harmonize the tax treatment of different forms of taxable corporate acquisitions, and will do more if sensible regulations under section 338 are promulgated, discontinuities remain. The examples in V C are illustrative. In addition, section 338 itself embodies some new disharmonies. They are considered at appropriate points in parts VI and VII, below.
VI. SECTION 338 SETTING ASIDE THE CONSISTENCY REQUIREMENT

In this part we consider only those simple cases in which P purchases stock of T, and does not acquire stock or assets of any corporation that earlier was affiliated with T.

A. Statutory Nomenclature

Section 338 brings us a series of new, or in some cases revised, statutory definitions. The following is a basic if incomplete list.

1. Purchase

Derived from old section 334(b)(3), in section 338 the term "purchase" means any acquisition of stock with the following exceptions.

a. The basis of the T stock in the hands of P must not be determined in whole or in part by reference to the adjusted basis of the T stock in the hands of A, the person from whom P acquired the stock, and must not be determined under section 1014(a) (property acquired from a decedent).

b. The T stock must not be acquired in a section 351 exchange.

c. The T stock must not be acquired from a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) thereof), be attributed to P.

New section 338(h)(3)(A).

In addition, if P purchases stock of A corporation and, by section 318 attribution from A, P is thereby treated as owning stock of T, P is treated as having purchased that T stock on the first day on which P is considered under section 318(a) as owning such T stock.

New section 338(h)(3)(B).

a. Target Corporation Subsidiaries

New section 338(h)(3)(B) may have unexpected consequences. Assume on January 1, 1983 P purchases 60% of the stock of A corporation which owns all of the stock of T. Under section 318(a)(2)(C) P is treated as owning 60% of the stock of T. On July 1, 1983 A corporation is completely liquidated under section 331; as part of its liquidating distribution P receives all of the stock of T. May P, within the 75 days following July 1, 1983, file an effective section 338 election with respect to T? Although P is deemed to have purchased 60% of T on January 1 and has acquired the balance of T on July 1, within the permissible 12 month period under new section 338(d)(3), it is questionable whether P has "purchased" that 40% since P has acquired those T shares from A corporation, a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) thereof) be attributed to P. Facially, the special "deemed purchase of stock of subsidiaries" rule of new section 338(n)(3)(B) in its reference to "such stock"—presumably meaning the original 60% of T—does not provide a cure.

There is no particular reason to believe Congress intended to disallow a section 338 election in this circumstance. A timely liquidation
of T into P would have attracted old section 334(b)(2) treatment. Presumably the forthcoming regulations can "bend" the statute here, if the Treasury wishes to avoid what seems to be an unintended hardship, but what the Treasury will do remains to be seen.

b. Option to Purchase T Stock

The new reference to section 318(a) "(other than paragraph (4) thereof)" is salutory. Under prior law, if P acquired an 18-month option to purchase the stock of T and exercised in the 14th month, section 334(b)(2) did not apply to an ensuing liquidation of T. This was a senseless rule since, had P instead acquired an option to purchase the assets of T, a stepped-up basis would have been forthcoming. Sensibly, new law's excluding reference to section 318(a)(4) resolves the problem by assuring P that a section 338 election with respect to T will be effective.

c. Section 368(a)(2)(E) Reorganization: Stock Purchase?

See the discussion in VI C 5, below.

2. Qualified Stock Purchase

A qualified stock purchase is any transaction or series of transactions in which stock of T possessing at least 80% of the total combined voting power of all classes of T stock entitled to vote, and at least 80% of the total number of shares of each other class of stock (except nonvoting stock which is limited and preferred as to dividends) is acquired by P—or, except as regulations otherwise provide, by the members of P's affiliated group—by purchase during the 12 month acquisition period.

New section 338(d)(3), (h)(7).

3. Twelve-Month Acquisition Period

The term "twelve-month acquisition period" means the 12 month period beginning with the date of the first acquisition by purchase of T stock that is included in a qualified stock purchase.

4. Acquisition Date

The term "acquisition date" means, with respect to T, the first day on which there is a qualified stock purchase with respect to the stock of T.

New section 338(h)(2).

Thus, if P purchases 50% of the stock of T on January 1, 30% on July 1, and the other 20% on August 1, the acquisition date is July 1, since a qualified stock purchase is a transaction or series of transactions in which P acquires 80% control of T.

New section 338(h)(2).

5. Purchasing Corporation

A purchasing corporation is any corporation which makes a qualified stock purchase of stock of another corporation.

New section 338(d)(2).

6. Target Corporation

A target corporation is any corporation the stock of which is acquired by another corporation in a qualified stock purchase.

New section 338(d)(3).
7. Affiliated Group

The term "affiliated group" has a special meaning in section 338. An affiliated group, in section 338, has the meaning given to that term by section 1504(a)—a consolidated return provision—but the exceptions contained in section 1504(b) do not apply. Hence, in section 338, a foreign corporation, an insurance company subject to taxation under section 802 or 821, a section 936 corporation, or a DISC can qualify as a member of an affiliated group.

New section 338(a) (5).

B. The Election

The election under section 338 must be made (unless it is treated as made under the consistency requirements discussed in Part VI below) by the purchasing corporation.

New section 338(a).

The statute requires that, except as otherwise may be provided in regulations, the election shall be made by P (not by T) not later than 75 days after the acquisition date, shall be made in such manner as the regulations may prescribe, and once made shall be irrevocable.

New section 338(g).

C. Effect of Election

The statute announces that "for purposes of this subtitle"—i.e. all of the income tax provisions of the Code—if there has been a qualified stock purchase and P makes a timely election, the target corporation (T)—

(i) shall be treated as having sold all of its assets at the close of the acquisition date in a single transaction to which section 337 applies, and

(ii) shall be treated as a new corporation ("new T") which purchased all of the assets referred to in paragraph (1) as of the beginning of the day after the acquisition date.

New section 338(a).

The object of this bifurcation in time—sale as of the close of the acquisition date but purchase as of the beginning of the day after the acquisition date—is to keep the tax effects of the sale (depreciation recapture gain, etc.) out of P's consolidated return:

"Under the elective treatment provided by the bill, any recapture income of the target corporation attributable to the deemed sale of its assets is not to be included in any consolidated return of the acquiring corporation. The target corporation will not become a member of the acquiring corporation's affiliated group until the day following the date of acquisition. Recapture items of the target corporation will normally be associated with the final return of the target
corporation (as the selling corporation) ending on the date of acquisition."

"The conference agreement expressly provides that the target corporation will be treated as having sold all of its assets at the close of the acquisition date in a single transaction to which section 337 applies and, as the 'new' corporation, will be treated as having purchased all of the assets at the beginning of the day following the acquisition date. This amendment provides an explicit statutory rule clarifying the intent of the Senate amendment that the deemed sale is reported on the return of the 'old' corporation and that it is only the 'new' corporation that becomes a member of the purchasing corporation's affiliated group."

Conference Report 537, 539.

New section 338(h)(8), added by the Technical Corrections Act of 1982.

See, however VI C 2 a, below, when T is sold out of a consolidated return group.

1. A Single Transaction to Which Section 337 Applies

The words are carefully chosen. Assume A corporation owned and sold to P all of the stock of T. With TEFRA's repeal of old section 337(c)(2)(B), under new section 337(c)(2) section 337 could not apply to an actual sale of assets by T. But, under the section 338(a)(1) operative phrase "a single transaction to which section 337 applies," a nonrecognition result unavailable in an actual sale of assets is forthcoming under the section 338 elective "deemed" sale of assets.

Similarly, if T is a collapsible corporation and no exception or limitation applies, under section 337(c)(1) the nonrecognition benefits of section 337(a) are unavailable on an actual sale of T assets. But, again, those benefits obtain if A has sold the stock of T to P and P makes the election under section 338. This, of course, is a comprehensible result since section 341(a)(1) has converted A's long-term sale gain to ordinary income, and it would make no sense to impose penalty tax upon both the selling shareholder and the corporation sold.

The section 338(a)(1) application of section 337 to T will not free T of all tax burden. The recapture provisions, sections 1245 and 1250 and the like, will force income recognition to T since these provisions require recognition "notwithstanding any other provision of this subtitle." Similarly, if T is a consenting corporation under section 341(f)(1) and, on the acquisition date, holds subsection (f) assets, it will recognize gain under section 341(f)(2) because that provision also applies "notwithstanding any other provision of this subtitle."

Query: Suppose A is a foreign individual and T is a foreign corporation qualifying as a United States real property holding corporation under section 897(c)(2)(A). A sells the stock of T to P, an unrelated domestic corporation, and P promptly files a section 338 election
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with respect to T. What result? Note that section 338(h)(6)(B), granting regulatory authority with respect to certain foreign corporations, refers neither to the target corporation (as distinguished from a "target affiliate") nor to section 897.

*Cf.* section 897(d)(2), which states that section 337 shall not apply to any sale or exchange of a United States real property interest by a foreign corporation. See also section 897(e)(1), (2)(A). Which governs: "section 337 applies" in section 338(a)(1), or "section 337 shall not apply" in section 897(d)(2)? No doubt the Treasury will opt for the latter, but surely the statute could have been written in a less conflicting way.

2. *Recapture Items: Who is the Taxpayer?*

As earlier noted, it is clearly intended that, if P is part of an affiliated group filing a consolidated return, "old" T with respect to the recapture items generated on a section 338 election will not be treated as a member of the P affiliated group. Rather, "the deemed sale is reported on the return of the 'old' corporation and... it is only the 'new' corporation that becomes a member of the purchasing corporation's affiliated group."

Conference Report 539.

This announcement did not answer all questions, but Congress later filled some gaps.

a. *Corporation A Filed a Consolidated Return With T*

Corporation A is the common parent of an affiliated group of corporations filing a consolidated return. T is a member of the A corporate group. On March 15, 1984 A sells all of the stock of T to P. P has made a qualified stock purchase and March 15 is the acquisition date. P timely files a section 338 election. T is thereby treated as having sold all of its assets as at the close of the acquisition date, March 15, in a single transaction to which section 337 applies. Assume the sale generates recapture income under section 1245 of 100.

Is the income of 100 to be accounted for in the A affiliated group consolidated return, or in a "one day" T separate return (in the latter case, if T has subsidiaries of its own, may the T group file a "one day" consolidated return)? In the Technical Corrections Act of 1982, Congress resolved the main question. The normative rule is that the acquisition date is a one-day T separate return year. If T has subsidiaries, the statute does not tell us, but leaves room for regulations to tell us, whether there can be a one-day consolidated return year for "old" T and its "old" subsidiaries.

New section 338(h)(8).

The Technical Corrections Act went further. Under regulations to be promulgated, but only after they have been unless they provide otherwise, a special form of section 338 election can be made under which T, on its deemed sale of assets, will recognize gain or loss as if it sold all of its assets in a single transaction to which section 337 does *not* apply, in which event T (and undoubtedly its deemed asset selling subsidiaries) will be treated as a member of the selling con-
solidated group with respect to the sale. Further, no gain or loss will be recognized to the selling consolidated group on stock sold or exchanged in the "real" transaction with P.

New section 338(h)(9).

Does this mean the acquisition date will be treated as the last day on which T is a member of the selling consolidated group, so that there will be no day upon which T is not a member of either the A group or the P group? One would suppose so.

Suppose A sells at least 80%, but less than 100%, of the outstanding shares of T to P. At what basis will A corporation hold the retained T shares after the special section 338 election is made? The regulations will have to tell us, but fair market value (determined in light of the transaction with P) appears the best answer.

What happens to the corporate attributes of T? Certainly "new" T does not inherit them. If the proper analogy is to an asset sale and section 332 liquidation, A corporation should inherit them. Again we await regulations.

Finally, can P simply file this special election and surprise the selling consolidated group? Surely the regulations will require either a joint election by A and P or P's election accompanied by A's consent.

b. T is a Loss Corporation

Assume A (an individual) owns all of the stock of T. T has a substantial net operating loss carryover and in 1982 terminated the business that generated the loss. On March 15, 1983 A sells all of the stock of T to P which timely files a section 338 election. Sizeable recapture income is generated in T under section 1245. May T offset the recapture income against the net operating loss carryover, or will section 382(a) apply, by reason of the stock sale, to expunge the carryover? (Obviously, "new" T will not inherit any part of the carryover.)

The sensible answer is offset, and it is to be hoped that the regulations will so provide. An opposite conclusion in the section 338 case would force the parties, if well advised, to structure the acquisition transaction as a "real" section 337 asset sale and thereby avoid the application of section 382(a). The tax law operates badly when it awards differential tax treatment to equivalent commercial transactions, mildly burdening those able to afford and secure good tax advice while grossly and unfairly burdening those who are not.

c. T is an S Corporation

The facts are the same as in example a., above, but A is an individual. T is a calendar year S corporation. Under the Subchapter S Revision Act of 1982, P's purchase of the T stock on the March 15, 1983 "acquisition date" will terminate T's subchapter S year—an "S short year" that began January 1, 1983—on March 14, the day immediately preceding the day (March 15) on which P, an ineligible person, first became a shareholder. Thus, the sale by A to P of the T stock preserves T's S corporation status for the year that began January 1, 1983, but creates a short taxable year.

New section 1362(e)(1)(A).
Under the new law, March 15, 1983 becomes the first day of a short taxable year for which T is a C corporation.

New section 1362(e)(1)(B).

The timely filing by P of a section 338 election will render March 15, 1983 the last day, as well as the first day, of T's separate return C corporation year. Thus, a "one day" taxable year. Under this construction, the recapture gains produced by the section 338 election's deemed sale of "old" T's assets to "new" T will be recognized in T's one day taxable year as a subchapter C corporation. But, because new section 1363(e)(2) would allocate almost all the recapture gains back to short S year, T (with all S termination year shareholders, including P, consenting) must make the new section 1363(e)(3) cut-off election.

3. No Kimbell-Diamond Rule

Whatever vitality it may retain in other areas of the tax law, when an inter-corporate liquidation is in focus new section 338 is "intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine."

Conference Report 536.

See Kimbell-Diamond Milling Co., 14 T.C. 74 (1950), aff'd per curiam, 187 F.2d 718 (5th Cir. 1951).

Query: Where stands Yoc Heating under new law? That stepped-up asset basis decision, involving a "sidewise" transfer rather than an up-stream liquidation, did not purport to rely on the Kimbell-Diamond doctrine. Consider this question in light of the consistency requirement that is discussed in VII below.


4. What Happens to "Old" T?

What happens to "old" T corporation when P files a section 338 election and T, treated as having sold all of its assets at the close of the acquisition date (in a single transaction to which section 337 applies), also is treated as a new corporation which purchased all of those assets as of the beginning of the day after the acquisition date? It is a question of more than academic significance.

Section 338(a) tells us that T is treated as having engaged in these "treated as" transactions "for purposes of this subtitle," i.e. for purposes of all of the income tax provisions of the Code. The reference in section 338(a)(2) to T "treated as a new corporation" on the day following the acquisition date suggests that "old" T has gone away somewhere, i.e. has completely liquidated.

But there is another tune to be heard:

"However, it is not intended that any minority shareholders in the target corporation shall be treated as having exchanged stock in the selling corporation [old T] for stock in the purchasing corporation [new T]."

Conference Report 537.

What are we to make of this? At the corporate level, it seems reasonably clear, we have two different corporations, a selling target
corporation (old T) which has no corporate existence after the acquisition date, and a purchasing target corporation (new T) which springs to full blown corporate life as of the beginning of the day after the acquisition date. But at the shareholder level—minority shareholders certainly—there has been no exchange of old T stock for new T stock, just the same old shares in hand. And what is true for the minority is true for P if, for example, P owns a few T shares purchased prior to the acquisition date.

It all bears a certain warped resemblance to the Teleclone Mark V problem in philosopher Daniel C. Dennett's book, "The Mind's I." reasoning from which, perhaps it is fair to say:

- Old T is not new T.
- New T is not old T.
- The shareholders who own T stock after the acquisition date own stock in "continuing T."
- Continuing T is old T and it is also new T.
- Old T is continuing T to the close of the acquisition date.
- New T is continuing T from the beginning of the day after the acquisition date.

This may not be an entirely satisfactory formulation, but perhaps it is the best the peculiarities of new section 338 allows. It permits, and perhaps mandates, the conclusion that, viewed with respect to the target corporation—as distinguished from those who remain shareholders after the acquisition date—the section 338 election results in a complete liquidation of old T as at the close of the acquisition date.

a. Tandem Section 337 Cases

T operates through two divisions, H worth 20 and W worth 80. T has outstanding 100 shares of common stock, all owned by Mr. A. On January 1, 1983 T adopts a plan of complete liquidation and promptly sells the H division to unrelated Z for an installment obligation with a face of 20 (bearing adequate interest). T distributes the installment obligation to A as a first liquidating distribution in cancellation of 20 T shares. It is A's plan that T will sell the W division to P for 80 in cash and distribute the cash to him in completion of T's liquidation well within the year. If this is done, A will report receipt of the Z installment obligation on the installment method.

Section 453(h)(1).

In February, 1983 P announces that while it is very interested in acquiring the W division, because assets of that division are difficult to transfer (required landlord consents, etc.) P insists that it must purchase from A the remaining 80 T shares and promptly will file a section 338 election. P believes, it appears correctly, that nothing in section 338 prevents the filing of that election merely because T, when its stock is purchased, is operating under a previously adopted plan of liquidation. A accedes to P's request and sells P the 80 T shares. P makes the section 338 election and old T is deemed to have sold to new T all of the T assets (the W division) "in a single transaction to which section 337 applies."
What happens to old T with respect to its January sale of the H division, and what happens to A with respect to his receipt of the Z installment obligation?

If the section 338 election is deemed to result in the complete liquidation of old T at the close of business on the acquisition date, the January sale of the H division should receive the nonrecognition benefits of section 337 provided we can conclude that, in the new TEFRA tax world, the same corporation (old T) can participate in tandem section 337 arrangements, the first "real" under that section and the second "treated as" under new section 338. And, to round it out, we also must conclude that the imputed section 338 complete liquidation of old T constitutes, for purposes of the first section 337 arrangement, the distribution of the balance of all of the assets of old T in that deemed complete liquidation.

As to A, to meet the installment method requirements of section 453(h)(1)(A), we must go a bit further and conclude that, as to him, we are dealing both with a liquidation to which section 337 applies (at the corporate level) and "a transaction to which section 331 applies" (at the shareholder level). And we will want to apply section 453(h)(2) to A integrating the P cash and the Z note.

But, why not?

A little strain here and there, perhaps, but as a matter of tax policy and legislative intent, or at least the absence of the negative, surely these are the right answers.

Before the TEFRA amendments, P could not have done the deal it now insists upon. Either P would have bought the W division in a standard section 337 transaction, or P might have acquired the division by a merger of T into P for 80 cash. This too would have qualified as a section 337 transaction of the classic sort.


Or, P might have purchased the 80 T shares and completed the liquidation of T. Section 331 and not section 332 would apply to this liquidation and, again, section 337 benefits would be fully available. And with them, installment method reporting of the Z installment obligation in A's hands.

Nothing in the legislative history of section 338 in any way suggests Congress intended to withdraw from T nonrecognition benefits available under prior law, or to deprive A of the installment method treatment Congress newly granted A in the 1980 Installment Sales Act. Quite to the contrary, as demonstrated by the portions of the Conference Report quoted in V D above, with respect to nonrecognition of gain at the corporate level Congress had exactly the opposite intent. The forthcoming regulations can and, it is believed, should implement that intent for the benefit of T, and implement the clearly manifested intent of the 1980 Installment Sales Act for the benefit of A as well.

b. Same: Broken Lot of Inventory

The facts are the same as in the preceding example with these exceptions. T conducts a single business. The H assets are part of the
inventory. The W assets are the balance of the inventory and all of the other properties of T.

Availability to A of installment method reporting of the Z obligation is no longer an issue. By statute, A cannot report the Z obligation on the installment method.

Section 453(h)(1)(B).

Nonrecognition to old T of gain on the sale of the broken lot of inventory to Z is no longer in issue. T must recognize this gain when it distributes the installment obligation to A.

Section 337(b)(1)(B).

What is in issue is the gain realized by old T, incident to the section 338 election, on the portion of the inventory that is part of the W assets. Had the transaction proceeded by way of a “real” section 337 asset sale and liquidation of T, the gain realized by T on the inventory sold to P would have been recognized.

Section 337(b)(1)(A).

On the other hand, if under prior law the transaction had proceeded through A’s sale of 80 T shares to P, followed by the completion of T’s liquidation under section 331, section 336 would have applied to avoid recognition of gain by T with respect to this portion of the inventory.

Which is the proper analogy, section 337 or section 336? See the introductory discussion in V D above.

The section 338(a)(1) directive, “a single transaction to which section 337 applies,” pretty well mandates the more favorable approach. And since there does not seem to be a sufficiently powerful policy argument to the contrary, one that would encourage the Treasury Department to attempt to ignore the statutory language, perhaps the forthcoming regulations will confirm the favorable answer.

5. Reverse Triangular Merger

P acquires all of the stock of T by merging S, a newly organized transitory subsidiary of P, with and into T. In the merger A exchanges his T shares for shares of P voting stock. Assume the assets of T are worth 1250 and are held by T at a basis of 250. The liabilities of T total 100. Assume further that, immediately prior to the merger, the basis of the S stock in the hands of P was zero and the basis of the T shares in the hands of A was 50.

The reverse triangular merger is a reorganization, A recognizes no gain on his exchange of T shares for P shares, and holds the P shares at a basis of 50.

Sections 368(a)(2)(E), 354(a)(1), and 358(a)(1).

At what basis does P hold the T shares? If the acquisition were tested as a “B” reorganization, the answer would be 50, the basis at which A held those shares.

Section 362(b).

When the acquisition is treated, as it must be, as a section 368(a)(2)(E) reorganization, the statute furnishes no clear answer. The apparent choices are 50 (the “B” reorganization result) or 150,
T's internal net asset basis (250 asset basis minus 100 liabilities). In proposed regulations published January 2, 1981, and not yet adopted in final form, the Treasury Department opted for the 150 net asset basis.

Proposed Reg. § 1.358-6(c)(2).

Now assume that, promptly following the merger, P makes a section 338 election with respect to T. That election will have effect if P's acquisition of the stock of T, through the reverse triangular merger, constituted a qualified stock purchase. Under the definition of that term in section 338(d)(3), all requirements are satisfied if the acquisition by merger is a "purchase" of the T stock within the meaning of section 338(h)(3).

A purchase is "any acquisition of stock" if a few specific requirements are met. Only one of them is in issue: Under section 338(h)(3)(A)(i), the basis of the T stock in the hands of P must not be determined, in whole or in part, by reference to the adjusted basis of the T stock in the hands of A, the person from whom the shares were acquired.

Having announced in the proposed regulations that the basis of the T stock in the hands of P is the net asset basis of 150, and not A's historic basis of 50, the Treasury has informed us that the acquisition is a purchase and thus a qualified stock purchase, and therefore the section 338 election is effective.

In the hands of "new" T, asset basis will be 250 (T stock basis of 150 plus T liabilities of 100), exactly equal in the aggregate to the basis of those assets in the hands of "old" T. But there is more to the matter. While "old" T will recognize no gain on its deemed sale at basis, new T, because it is treated as a purchaser of the assets for a purchase price of 250, will hold the property free from accumulated potential depreciation recapture. That is, if an actual sale of the assets by old T would have generated 500 in recapture gain, an actual sale of the same assets by new T will generate no recapture gain at all.

If Congress had it in mind, which it did not, to repeal sections 1245, 1250, and so forth, surely it would have done so in a less obscure way.

Obviously, a change is needed and will be made. One possibility is a technical amendment to the purchase definition in section 338(h)(3), announcing that an acquisition of stock in a transaction qualifying as a reorganization under section 368(a)(2)(E) is not a "purchase" of that stock. Alternatively, and perhaps more likely, Treasury can withdraw its proposed basis regulation and announce that in a reverse triangular merger acquisition under section 368(a)(2)(E), as in a "B" reorganization, P will hold the T shares at a basis derived from A's basis in those shares.

6. Retroactive Section 338 Election

§ 224(d)(1) of TEFRA states that the new section 338 shall apply to any target corporation with respect to which the acquisition date occurs after August 31, 1982. However, § 224(d)(2) announces that
if the acquisition date occurred after August 31, 1980, and before September 1, 1982, and the target corporation was not liquidated before September 1, 1982, the purchasing corporation is permitted to make a section 338 election with respect to the target corporation, so long as that election is made not later than November 15, 1982. The Conference Report sheds no additional light.

The following discussion relates to § 224(d)(2) of TEFRA as that statute was enacted. The concluding portion of this VI C 6 considers the legislative change made in the Technical Corrections Act of 1982.

a. Before Technical Correction

Assume A corporation owned all of the stock of T and a consolidated return was filed by the A group. On November 15, 1980 A sold all of the stock of T to P corporation. T was not liquidated. On September 30, 1982, P files a section 338 election with respect to T. Now what happens?

The “acquisition date” was November 15, 1980, and under section 338(a) “old” T is treated as having sold all of its assets to “new” T (in a single transaction to which section 337 applies) at the close of November 15, 1980; “new” T is treated as a new corporation which purchased those assets as of the beginning of November 16, 1980. Assume the November 15, 1980 deemed sale generated 100 of depreciation recapture and similar income not sheltered by section 337. Who is the taxpayer with respect to this sudden, retroactively created income? T in a “one day” separate return for the taxable year beginning and ending November 15, 1980? Or the A consolidated group for the taxable year that includes November 15, 1980?

Obviously, the palatable answer is T in a one day separate taxable year. Were Treasury to suggest a different answer, A corporation likely would be grumpy and, were the Internal Revenue Service to go after it for additional 1980 tax, A might make casual reference to the Due Process Clause of the Fifth Amendment to the United States Constitution.

The palatable answer, under the statute as originally enacted, was hardly free of problems. Under the consolidated return regulations in force on the 1980 consolidated return filing date, November 15, 1980 might have been either the last day on which T was a member of the A consolidated group or the first day on which T was a member of the P consolidated group, but it was not a separate T year. Section 1503(a) does not authorize a non-statutory retroactive change in the consolidated return regulations. And, as a separate matter, a retroactive step-up in the basis of T’s assets would seem to require amendment of P consolidated returns for post November 15, 1980 periods.

b. After Technical Correction

It was kind of Congress to afford the retroactive section 338 election, but it was not the final triumph of tax simplification. It might have been better if Congress had left unscathed the pre-September 1, 1982 law.
Wisdom ought not be denigrated merely because it comes late since it comes so seldom. Congress has fixed it, but in a complex way.

The retroactive section 338 election now can be made at any time through the close of February 28, 1983. If P made an election under the original TEFRA rules, it can revoke it before March 1, 1983, and if it wishes it then can make a new one before that date. The "acquisition date" under the new rule is not the day P purchased control of T nor is it necessarily the day P files the election. Rather, it is any date P selects that is after the later of June 30, 1982 or the date P purchased control of T, and is on or before the date P makes the retroactive section 338 election. Contrary to the general directive of section 338, in the case of a retroactive election T's recapture income will be within P's consolidated return.

Because the stock purchase date and the "acquisition date" may be separated in time, the relatively uncomplicated section 338 mechanism will not work. Congress has authorized "interim adjustments" of the formerly familiar, now happily dispatched in other circumstances, "old" section 334(b)(2) sort. Suppose P on election day does not own all of the stock of T; does P have one year from the election date to buy in the minority interest in order to avoid extra gain recognition at the T level? It would seem so. Suppose instead T is liquidated into P by way of a statutory merger; is the extra T tax avoided if the minority shareholder successfully can argue that, sufficient time having passed since the original stock purchase, the merger is tax free to him if he exchanges T shares for P shares?

D. Price at Which Deemed Sale is Made

The T assets are treated as sold—and purchased—at an amount equal to—

(i) The grossed-up basis of T's stock in the hands of P on the acquisition date,

(ii) "properly adjusted under regulations prescribed by the Secretary for liabilities of the target corporation and other relevant items."

New section 338(b)(1).

1. Grossed-up Basis

We deal here with a case in which P, on the acquisition date, does not own all of the outstanding stock of T. For example, T may have outstanding only a single class of voting common stock and P owns less than all of the shares outstanding. Or P may own all of the voting common stock of T and, because the definition of a qualified stock purchase does not look to all T stock, T also may have outstanding nonvoting stock which is limited and preferred as to dividends (hereafter, "straight preferred stock") none of which is owned by P.

The statute defines grossed-up basis as an amount equal to P's basis in all of the T stock owned by P on the acquisition date, multiplied by a fraction the numerator of which is 100% and the denominator of
which is the percentage of stock (by value) of T held by P on the acquisition date.

New section 338(b)(2).

Thus, if T has outstanding 100 shares of voting common stock, and no shares of any other class, and on July 1, 1983 P purchases 90 shares from A paying 900, grossed-up basis is 1,000. In this example case, it is fair to presume, the grossed-up basis of 1,000 equals the total fair market value of all of the outstanding stock of T. But this will not always be the case. Assume P has owned 10 T shares for many years. P's basis in the 10 old and cold shares is a total of 10. On July 1, 1983 P purchases 80 additional T shares from A paying 800. July 1 is the acquisition date. Although the total fair market value of all outstanding T shares presumably is 1,000, grossed-up basis is only 900 (P's total basis of 810 in its 90 T shares, multiplied by 100%, divided by 90%). It seems fair to assume Congress adopted this formula, rather than grossing-up from the purchase price paid by P for the shares acquired on the acquisition date, because that approach would have been highly susceptible of manipulation by an aggressive P and a cooperative A. But, obviously, the statute's formula preserves and, in fact, extends a discontinuity that existed in prior law between asset basis after a "real" section 337 transaction and asset basis after an old section 334(b)(2) liquidation (under an old law liquidation, in which the holder of the remaining 10 T shares would have been taxed, the analogous basis figure would have been 910).

2. Properly Adjusted, Etc.

Here are some of the issues the forthcoming regulations ought to address.

a. Recapture Taxes

Return to the example in V D 3, above, in which T has no liabilities and a single asset, a milling machine adjusted basis 100 and value 400. Of that appreciation of 300, 200 is recapturable depreciation under section 1245. Assume for convenience a corporate tax rate of 50% and that, for the reasons given in V D 3, P purchases all of the T stock from Mr. A for 300. P promptly makes the section 338 election.

"Old" T will incur recapture tax liability of 100. Under its agreement with A, we will assume, A has no responsibility for that tax and P must finance it, perhaps by contributing 100 to the capital of T. Since the machine is worth 400 and P's total outlay is 400, 300 paid to A and 100 contributed or loaned to T, the regulations should provide that the old T recapture tax liabilities, generated by reason of the section 338 election, are to be treated as part of the price at which old T is deemed to have sold and new T is deemed to have purchased the machine.

Assume instead that the machine is worth only 200. If P were to purchase the machine rather than the stock of T, P would pay 200, T would incur recapture tax liability of 50, and A would receive from T a liquidating distribution of 150. It follows that A will be prepared to sell the T stock to P for 150. If P then makes a section 338 election,
consistency and good sense mandate that the recapture tax liability to be taken into account as a proper adjustment in reaching sale price and purchase price is 50. That is, the section 1245 recapture income triggered by the election should be 100, equal to the value of the machine in excess of old T's basis in the machine. With modest ingenuity, the regulations can be written to reach this result.

Now vary the facts of the last example to assume that, in addition to the voting common stock of T owned by A, unrelated K owns nonvoting straight preferred stock of T worth 75 (½ the total value of all T stock). P purchases the T common stock from A for 75, does not purchase the T preferred stock, and makes the section 338 election. The results ought to be the same: Recapture tax of 50, liability adjustment of 50, and an asset basis in “new” T of 200 (150 grossed-up basis in T stock plus 50 liability adjustment).

A final variation. P, and not K, owns the T straight preferred stock, has owned those shares many years, and holds them at an adjusted basis of 25. When P purchases the T common stock from A for 75, P on the acquisition date will hold all of the T shares at an aggregate basis of 100. Grossed-up basis also is 100 since P owns all of the T shares. Upon the election, deemed sale price equals the stock basis of 100 plus old T's recapture tax liability. Unfortunately, we look at something of a circle since, under section 1245(a)(1)(B)(i), in the case of a sale—presumably including a “treated as” sale—recapture income is computed in light of the amount realized and that amount would seem to be the deemed sale price, which in turn depends upon the amount of recapture tax, and so it goes. Note there was no comparable problem under old section 334(b)(2) since recapture income, on the facts of the example, would have been computed based on the fair market value of the machine, thus would have been 100 (value 200 minus T's basis 100), and would have yielded a recapture tax liability adjustment of 50.

The Conference Report, V D above, among other things tells us that nonrecognition under new section 338 is to be available to the same extent it was available in an old law liquidation governed by section 336. If this is the operative directive, and if it fairly implies the obverse—recognition is to be imposed under new law to the same extent it would have been imposed in a liquidation under old law governed by section 336—we could reasonably conclude, in the example case, that the “amount realized” for purposes of computing depreciation recapture in every case should be the lower of fair market value or the recomputed basis of the property as that term is defined in section 1245(a)(2). The regulations, when they emerge, will tell us.

b. Tax Imposed Under Section 338(c)(1)

This matter is taken up in VI F 2, below.

c. “Other Relevant Items”

The regulations are to provide a proper adjustment to sale (and purchase) price for “other relevant items.” What are, or may be, some examples?
i. Contingent Purchase Price
On July 1, 1983, P purchases from A all of the stock of T paying 1,000 in cash and promising to pay A an additional sum in 1985 of up to 1,000 more (plus interest) based upon an earnings formula. In 1985 P properly pays A an additional 500 (plus interest).

Under standard tax notions, the additional 500 is not taken into account, in computing deemed selling price or deemed purchase price for the T assets, in 1983, but should be taken into account as a "relevant item" in 1985. That is, depending upon the assets to which the 500 is appropriately allocated, in 1985 there may be additional recapture income and in 1985 there will be an addition to the bases of assets totalling 500.

Congress had this one explicitly in mind:

"In some cases, recapture items may be includable in income for a period during which the target corporation is included in a consolidated return of the acquiring corporation. Where, for example, there is an adjustment to the purchase price for its stock based on post-acquisition date earnings of the target corporation, there may be additional amounts of recapture income. Such additional income is to be separately accounted for and may not be absorbed by losses or deductions of other members of the acquiring corporation's affiliated group."

Conference Report 537.

Query: Suppose old T had a net operating loss carryover, not fully absorbed by 1983 recapture income, which was expunged by reason of the section 338 election. Does that carryover remain alive for the narrow purpose of offsetting any additional recapture income generated in 1985 in the example case? Perhaps the regulations will tell us.

ii. Post-Acquisition Date Stock Purchase
On July 1, 1983 P purchases 90% of the stock of T from A for 900. Unrelated K owns and retains the other 10%. P makes a section 338 election. Grossed-up basis is 1,000 and the deemed asset sale and purchase price is determined in light of that sum.

Assume new T is a calendar year taxpayer. After the July 1 acquisition date but before the close of 1983, P purchases K's 10% of the stock of T paying K either 120 (up case) or 80 (down case). Under the acquisition date gross-up formula, the T shares owned by K in effect were awarded a basis of 100. Is the differential, plus 20 in the up case and minus 20 in the down case, a "relevant item" for which an adjustment properly should be made? In this case, in which the purchase of the K shares is made before the end of new T's first taxable year, it seems an appealing notion. The regulations will tell us.

Suppose the stock purchase is made after the close of 1983 but before the tax return is filed?

Suppose the purchase is made after the tax return is filed but within one year following the acquisition date?
Finally, suppose K's stock is purchased in 1987? More than one year following the acquisition date seems too much. However the first three cases may be resolved, a 1987 premium or discount is hard to characterize a "relevant item."

iii. Purchase Price Reduction

P purchases all the stock of T from A for 1,000 and makes a section 338 election. Two years later P discovers that an important warranty given by A in the stock sale contract was untrue. In settlement of the ensuing dispute, A repays 200 to P.

If P had purchased the assets of T, the 200 refund would be an adjustment in purchase price calling for a basis adjustment at the time of refund. Sensibly, in the section 338 context the refund, even though made more than one year following the acquisition date, should be a "relevant item" calling for a similar basis adjustment. In addition, of course, the basis at which P holds the T stock would be reduced by 200.

E. Allocation Among Assets

The deemed sale (and purchase) price having been determined in accordance with section 338(b)(1), the statute provides that the purchase price amount "shall be allocated among the assets of the target corporation under regulations prescribed by the Secretary."

New section 338(b)(3).

In a "real" section 337 transaction or in an old section 334(b)(2) liquidation, except for recapture and similar items T is not taxed and thus is largely indifferent to the allocation of purchase price among various nonrecognition assets. P is anything but indifferent. If an allocation to P's tax advantage were an allocation to T's tax disadvantage, there would be a built-in policeman to curb P's aggressive tendencies. But when there is no policeman, the Service sensibly cannot give uncritical approval to P's announced allocation among assets. Additionally, there are in the tax law rather turbulent issues of how, for example, the amount of purchase price properly to be attributed to goodwill and the like is to be determined.


The section 338 election presents the most extreme case of absence of conflicting interests between taxpayers. P is the only interested party. There is no policeman at all. It is, therefore, reasonable to anticipate that the Treasury will approach with enthusiasm the task of writing allocation regulations and will, among other things, focus explicitly on the goodwill issue. It is to be hoped, however, that Treasury will attend to the important policy directive, that equivalent transactions ("real" section 337 vs. section 338) ought as nearly as possible be governed by the same operative tax rules so as to reach equivalent tax results. The authority to regulate is limited to section 338 transactions, and it would be unfortunate indeed if the allocation directed
by section 338 regulations should differ in any significant way from the allocation permitted in "real" section 337 transactions.

F. Post-Acquisition Date Minority Shareholders

A owns 90% of the stock of T and on July 1, 1983 sells these shares to P for $900. July 1 is the acquisition date and P makes a section 338 election. K owns the other 10% of the shares of T and retains them.

The grossed-up basis formulation of new section 338(b) will, in this case, reach exactly the same old T recapture income and new T asset basis results as would have been achieved if P, on the acquisition date, also purchased K's shares in T at their fair value of $100.

1. Minority Shareholder: Nonrecognition of Gain

If, under prior law, to obtain a stepped-up asset basis P caused T promptly to liquidate under section 334(b)(2), whatever form (setting aside section 333) that complete liquidation might have taken (including a statutory merger of T into P in which K received P shares in exchange for her T shares) K would have been required to recognize gain on the amount by which the $100 value of her T shares exceeded her basis in those shares.


Section 338 is an election rather than a liquidation provision. Party to no exchange, K holds her shares in "continuing T." K does not recognize gain, with respect to her T shares, by reason of the section 338 election:

"[T]he minority shareholders in the target corporation shall not be treated as having exchanged stock in the selling corporation for stock in the purchasing corporation."

Conference Report 537.

If, however, subsequent to the acquisition date and section 338 election, P causes T to completely liquidate, although the nonrecognition benefits of section 332 will apply to P (and the stepped-up asset basis will carry over to P under new section 334(b)(1)) K, with respect to the liquidating distribution to her, will be required to make a proper tax accounting since section 332 will not have application to her. This is a matter to which we will return shortly.

2. Partial Gain Recognition to T

Revert to the above example and assume T is not liquidated. Assume further that on the section 338 election the gain realized by old T is $600 of which $100 is recapture income, $100 relates to ordinary income property (FIFO inventory), and $400 is long-term capital gain. The $100 of recapture income is recognized in full. The remaining $500, $100 ordinary income and $400 capital gain, under section 337 normally would not be recognized. If this normal rule applied, new T would gain the advantage of a fully stepped-up basis with respect to the $500 at no corporate tax cost, while K does not recognize the gain inherent
in the 10% of the T shares that she has retained. Prior law did not offer so great an aggregate advantage.

Neither does new law. Having determined K will not be taxed currently, Congress determined to tax an equivalent portion of old T’s realized gain, thereby placing old T in the position of a surrogate for K. Since K owns 10% in value of the stock of T, section 337 does not apply to 10% of the gain realized by old T. In the example case, it would appear, in addition to the recapture income of 100 old T must recognize ordinary income of 10 (10% of 100) and long-term capital gain of 40 (10% of 400).

New section 338(c)(1).

Should T, in computing the deemed sale and purchase price of its assets, see VI D above, treat the resulting “nonsection 337” tax liability as a “proper adjustment” under section 338(b)(1)? The better answer would seem to be no.

The statute provides for amelioration in two circumstances.

a. **Minority Shareholder is Bought In**

The statute provides that the percentage of T gain to which section 337 will apply is the maximum percentage (by value) of T stock held by P during the one year period beginning on the acquisition date. Thus, if prior to July 1, 1984 P purchases the T stock held by K, or T redeems that stock, the maximum percentage will be 100% and old T will recognize no gain with respect to the FIFO inventory or its capital gain property.

b. **T is Liquidated Within One Year**

The statute also provides that section 337 will be fully applicable to old T “if the target corporation is liquidated” during the one year period beginning on the acquisition date.

i. **Section 331 Applies to Minority Stockholder**

Without doubt, in adding this provision at the end of the legislative process, Congress anticipated that on the liquidation of T K would recognize in full the gain inherent in her T shares. This will be the result if section 331 is applicable to K. Since gain is not avoided at the minority stockholder level, there is no reason to impose special gain recognition at the old T corporate level.

ii. **Section 333 Applies to Minority Stockholder**

An apparent oversight in the legislative process. The liquidation of T can be crafted so that, although sections 332 and 334(b)(1) will apply to P, section 333 rather than section 331 will apply to K. Because new T is treated as a newly organized purchasing corporation, it has not inherited the accumulated earnings and profits of old T. Thus, if the section 338 election has been made immediately following the acquisition date and the section 333 liquidating distribution is made immediately thereafter, K will be charged with little if any dividend income. Further, if the T assets distributed to K do not include money, or stock or securities acquired by T after December 31, 1953, K will recognize no gain on the liquidating distribution and will hold the distributed property at a basis equal to her basis in the T shares sur-
rendered in exchange. A distribution to K of investment land would be a
case in point.

A more telling example. T is capitalized with two classes of common stock, 60 shares of each class outstanding. The shares are alike in all respects except that each share of class-1 stock carries four votes and each share of class-2 stock carries one vote. Thus, the 60 shares of class-1 stock carry 80% of the total voting power. T has been capitalized in this manner for many years; it is not an arrangement established in anticipation of a sale of shares. All 120 T shares are owned by A. On July 1, 1983 A sells the 60 class-1 shares to P and retains the 60 class-2 shares. P has thereby acquired 50% of the equity but 80% of the voting power of T and thus has made a qualified stock purchase. P immediately makes a section 338 election. On July 3, 1983 T is completely liquidated in such manner that section 333 applies to A who is a qualified electing shareholder with respect to his class-2 shares. Assume the total value of T is 2,000. Investment land worth 1,000 is distributed to A and all of the other assets of T are distributed to P. If A's basis in his class-2 shares aggregated 100, on the liquidation he will recognize no gain and will hold the investment land at a basis of 100.

This is simply too good to be true.

Nonetheless, there seems to be little doubt that it is true, and will remain so until the effective date of an appropriate technical amendment. That amendment might be to the final sentence of new section 338(c)(1), to provide that the “liquidation” there referred to cannot be a liquidation to which section 333 applies. Or, perhaps more sensibly, section 333 might be amended to provide that it does not apply to a corporation with respect to which a section 338 has applied within the preceding, say, five years.

G. Zenz and the Qualified Stock Purchase Definition

Refer back to IV D 5 which illustrates and discusses the basic workings of a section 338(c)(2) "Zenz" transaction in which T redeemed for appreciated property 20% and A sold the balance of 80% of the outstanding T shares to P which then made a valid section 338 election. We will now vary the facts of that example in order to exhume what may be—but sensibly ought not to be—a buried body.

T has outstanding 100 shares of voting common stock. The 100 shares of T are owned by A. T operates a widget business worth 75 and owns appreciated investment land worth 25 (basis 5). The land is not a business asset and the distribution of it by T would not qualify as a partial liquidation. P, wishing to acquire the widget business but not the investment land, purchases from A 75 T shares paying 75, and simultaneously T redeems the other 25 shares from A distributing in exchange the investment land. P promptly makes a section 338 election.

The buried body question is whether P's purchase of the 75 T shares,
TAX CONFERENCE

in the circumstances described, constitutes a qualified stock purchase as that term is defined in section 338(d)(3). If the answer is yes, the section 338 election is valid. It produces both a stepped-up basis for the assets of the widget business and, under section 338(c)(2), rings in section 336 to avoid recognition of gain by T on its distribution of the investment land to A in redemption of 25 T shares. On the other hand, if P's purchase of the 75 T shares does not constitute a qualified stock purchase within the meaning of the statute, there will be no step-up in the basis of the widget business assets and T will recognize gain of 20 on the redemption distribution of the investment land.

The issue at hand is familiarly known as the "backing-in" problem. It was an issue under old section 334(b)(2) as well. In the example case, the qualified stock purchase definition requires that P purchase at least 80% of the total combined voting power of all T stock. P purchased 75 of T's 100 shares but, by reason of the 25 share redemption carried out as part of the same acquisition plan, those 75 shares became all of the outstanding T shares representing 100% of the total voting power in T. That is, P purchased 75 but backed-in to 100%.

Under prior law, it was the indicated position of the Internal Revenue Service that P should not be treated as having "purchased" more than 75% of T and, accordingly, old section 334(b)(2) should not apply to the prompt liquidation of T.


The position did not present a major problem under old law since, as the cited ruling confirmed, the liquidation of T could qualify under sections 331 and 336, yielding capital gain to A, nonrecognition treatment to T, and a stepped-up basis to the distributed assets in the hands of P. But, as illustrated above, under a new law arrangement in which T is not liquidated validation of the Service's 1970 ruling approach would have disastrous tax consequences.

Under prior law the Service's argument, that P failed to purchase the required 80% or more of T, did not fare well in court. See Madison Square Garden Corp., 500 F.2d 611 (2d Cir. 1974).

George L. Riggs, Inc., 64 T.C. 474 (1975) (Acq.).

In the new section 338 world, the Service ought to suppress hostility to "backing-in" purchase-redemption plans, and recognize that P's acquisition of T stock in the example case is a qualified stock purchase. Maintenance of a contrary position will serve mainly to entrap the ill advised and generate litigation in which the Service is not likely to prevail. Further, if the Service takes a hostile position it will be announcing to the better advised that the consistency requirement of new section 338(f), explored in part VII of this paper, can be avoided by structuring the sort of backing-in acquisition illustrated above.

In adding paragraph (c)(2) to new section 338 in Conference at the last hour, Congress sought to preserve an old law section 336 benefit, not lay a trap for the inadequately advised. It would be an excellent idea if the Treasury, as promptly as feasible, would announce that
transactions of the kind illustrated do give rise to a qualified stock purchase.

H. Penalty Taxes

T is a calendar year taxpayer and A owns all of its stock. On September 30 A sells all of the T stock to P which timely files a section 338 election. Because September 30 is the acquisition date, "old" T is deemed to have sold all of its assets on that date in a single transaction to which section 337 applies, and the taxable year of "old" T (we must presume) closes and its corporate attributes disappear.

Under prior law, the analogous transaction would have been P's purchase of the T stock and the immediate liquidation of T, all on September 30. Again, T's taxable year would have closed on that date.

1. Accumulated Earnings Tax

Assume that during its nine month year ending September 30, "old" T has accumulated its earnings and profits beyond the reasonable needs of its business and for the purpose of avoiding reasonable needs of its business and for the purpose of avoiding dividend tax to A, its then shareholder. Can "old" T be subject to the accumulated earnings tax in the short year?

   Section 531.
   a. Prior Law

Under prior law, the liquidation of T on September 30 or, indeed, within two-and-a-half months following September 30, totally absolved T from accumulated earnings tax liability in its year ending September 30. A liquidating dividend distributed during the year or within two-and-a-half months after the close of the year generated a dividends paid deduction which wiped out accumulated taxable income.

   See sections 535(a) (561(a)(1), 561(b), 562(b)(1), 563(a), and 563(c).

   Note that under both prior law and present law, if the September 30 transaction were carried out as a section 337 "real" asset sale and liquidation of T, the provisions cited above also would apply to eliminate accumulated earnings tax liability.

   b. New Law

The section 338 election in the example case is not accompanied by any actual distribution by T. The payment received by A emanates solely from P. The interacting Code sections that absolved T of accumulated earnings tax liability under an old section 334(b)(2) liquidation, and continue to absolve it of liability in a "real" section 337 transaction, do not have obvious application when new section 338 is used. Thus, on the face of it, a new discontinuity. When section 531 tax is on the horizon, a section 337 asset sale and prompt liquidation can produce a better tax result than a section 338 election.

   Certainly Congress intended no such disharmony. Congress did not enact section 338 with one hand and render the provision unpalatable to many taxpayers with the other hand. Congress simply did not advert to the problem.
The Treasury Department can cure it and ought to do so. The regulations simply can announce that when a section 338 election is made, “old” T for its taxable year ending on the acquisition date will not be subject to the accumulated earnings tax. A metaphysical explanation keyed to an imputed distribution in complete liquidation could be proffered, but it does not seem essential and probably would prove unwise. Just the result will suffice.

2. **Personal Holding Company Tax**

The facts are the same as in 1 above, except that for its short taxable year ending September 30 T is a personal holding company.

a. **Section 337 Transaction**

This is the useful comparison. If A retained his T stock and T, adopting a plan of complete liquidation, on September 30 sold all of its assets to P immediately distributed the proceeds to A, that liquidating distribution would not automatically expunge personal holding company tax liability for the short taxable year. But an election is available under which the penalty tax is avoided by A’s treating as ordinary dividend income the appropriate portion of the liquidating distribution.

Section 316(b)(2)(B).

b. **Section 338 Election**

No equivalent remedial provision is available when the transaction proceeds by way of a stock sale and section 338 election. There appears to be no likely way a remedy could be supplied by regulation. A continuing disharmony.

If well advised, the parties to the proposed stock sale will agree that, in advance of it, T will distribute an actual dividend to A in the amount sufficient to eliminate personal holding company tax liability. Alternatively, it would appear, since T has only common stock outstanding a consent dividend to A, in lieu of an actual dividend, could be used to avoid the penalty tax.

See sections 545(a), 561(a), 561(b), 565.

I. **No Section 338 Election: T is a Loss Corporation**

On July 1, 1983 P purchases all of the stock of T from A and no section 338 election is made. In addition to its substantial business assets, T has a sizable net operating loss carryover. At the time of purchase T is carrying on its historic business, the one that produced the loss, and has strong prospects of profitable future operations. Assume P has purchased T for valid business reasons and not for a purpose proscribed by section 269.

If T continues to operate its business as a wholly-owned subsidiary of P, under present law T will continue to enjoy the benefits of its loss carryover as an offset against T profits generated in the future. When the stock of a loss corporation is purchased in circumstances in which section 269 does not apply, net operating loss carryover is not expunged unless “such corporation [T] has not continued to carry on a
trade or business substantially the same as that conducted before any change in the percentage ownership of the fair market value of such stock."

Section 382(a)(1)(C).

Assume that shortly after its purchase of the T stock, P causes T to liquidate. The T assets are distributed to P and P thereafter conducts the former T business, using the former T assets, without change. Will P inherit T's net operating loss carryover? With the repeal of old section 334(b)(2), the section 332 liquidation of T falls under section 334(b)(1) and hence sections 381(a)(1) and 381(c)(1). They provide as a general rule that P will succeed to T's net operating loss carryover.

The issue focuses on the words "such corporation" in section 382(a)(1)(C): "such corporation has not continued to carry on" its historic business. If "such corporation" means T pure and simple, the liquidation of T expunges its loss carryover since post-liquidation T does not exist and certainly is not carrying on its historic business. But if, taking account of section 381, "such corporation" includes P as successor to the corporate attributes of T, the loss survives.

Note that if section 382(a) does not apply to expunge the loss carryover when T is liquidated into P, no other statutory provision will come into play. Section 269 does not apply to a carryover basis transfer from subsidiary (T) to parent (P), and section 382(b) applies to various reorganization acquisitions but not to a corporate liquidation. Thus, if section 382(a) is not a bar, and unless—which seems unlikely—the uncertain Libson Shops doctrine is found to have application, after the liquidation T's loss can be offset against all P future profits, and not merely against profits generated by T's former business and assets.


How the "such corporation" conundrum finally will be resolved is difficult to predict. Pending that revelation, a conservative P is not likely to liquidate T; a P with an appetite for risk may give it a whirl.

VII. Section 338: The Consistency Requirement

In a basic way, the common denominator of the perceived abuses—Mobil-Esmark schemes and a variety of partial liquidation arrangements—addressed by TEFRA's amendments to part I of subchapter C was inappropriate selectivity among target corporation assets. The selection was inappropriate, and the procedure abusive, because a tax benefit (e.g. stepped-up basis) was obtained but the congressionally mandated correlative toll charge (e.g. recognition of gain, or recapture of depreciation and investment credit, by the distributing corporation) was deferred or avoided entirely.

The resulting condemnation of selectivity spilled over to section 338. Under prior law, P was free to purchase the stock of H and the stock of W from T, maintain W as a subsidiary with asset basis intact, and
liquidate H under old section 334(b)(2) to obtain the H assets at a stepped-up basis. In so doing, P subjected H to the prompt payment of all recapture taxes associated with the H assets. No recapture tax was generated in W since the W assets retained their historic basis.

Thus, the perceived abuse that concerned Congress in the partial liquidation area (when a consolidated return was involved) was not implicated in the complete liquidation transaction. Nonetheless, Congress viewed P's ability under prior law to select H assets for step-up, W assets for non-step-up, as anathema, sufficiently similar to the partial liquidation and tailored redemption schemes to warrant change.

The product of this decision is the consistency requirement of new section 338(f) and allied segments of that statute. It is an all-or-nothing rule. At its simplest, it announces that if P makes a section 338 election with respect to H, P will be deemed to have made a section 338 election with respect to W. And if P purchases the assets of H and the stock of W, the asset purchase is a deemed section 338 election for W.

The section 338 consistency requirement appears doubtful as a matter of tax policy. It is difficult to distinguish on rational policy grounds those situations to which the consistency requirement designedly does not apply from those to which it is intended to apply. The requirement serves as a most inadequate surrogate for eliminating or substantially circumscribing the General Utilities doctrine, that is, a substantial narrowing or outright repeal of sections 336 and 337. And the consistency requirement, it is believed, will not work well in practice if it works at all.

A. More Statutory Nomenclature

In addition to the definitions listed in VI A above—and note in particular the expanded definition of "affiliated group" explained in VI A 7—section 338, relevant to the consistency requirement, brings us the following.

1. Consistency Period

The term "consistency period" means the period consisting of—

(i) the one year period before the beginning of the twelve-month acquisition period for the target corporation.

(ii) such acquisition period (up to and including the acquisition date), and

(iii) The one year period beginning on the day after the acquisition date.

New section 338(h)(4)(A).

Further, the normal consistency period is extended to include any period during which the Internal Revenue Service determines that there was in effect a plan to make a qualified stock purchase plus one or more other qualified stock purchases (or asset acquisitions proscribed by new section 338(e)) with respect to the target corporation or any "target affiliate."

New section 338(h)(4)(B).
2. Target Affiliate
A corporation is treated as a target affiliate of the target corporation if each of these corporations was, at any time during so much of the consistency period as ends on the acquisition date (with respect to the target corporation), a member of an affiliated group (expanded definition) which had the same common parent.

New section 338(h)(6)(A).

a. Certain Foreign Corporations
Late in the legislative process it was noticed that application of the consistency requirement to foreign corporations and other "international animals" would or might produce unintended consequences if not outright chaos. Congress responded by specifying that, except as otherwise provided in regulations (and subject to such conditions as may be provided in regulations)—

(i) 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, and

(ii) stock held by a target affiliate in a foreign corporation or a domestic corporation which is a DISC or described in section 1428(e) shall be excluded from the operation of section 338.

New section 338(h)(6)(B).

All of this qualifies as something of a mess and there remains a great deal of sorting out to do. There is no reason to believe the required regulations will be promulgated with great dispatch.

b. Target's Affiliated Group
Key to the definition of a target affiliate is the requirement that it and the target corporation have been members of the same affiliated group of corporations on the date of P's qualified stock purchase of the target corporation or at some time within the preceding year (or possibly more). The expansive definition of an "affiliated group" does not change the essential requirement that there have been a section 1504(a)-80 percent affiliation of the two corporations.

Thus, if T owned all of the stock of H and of W, but T were an individual or a partnership rather than a corporation, P could purchase from T all of the stock of H and W and the consistency requirement would not apply. It is difficult to understand why the consistency requirement applies if T is a corporation when it does not apply if T is not a corporation. Should P be required so greatly to care whether the seller is or is not incorporated?

B. T and Its Subsidiaries
T owns all of the stock of H and H owns all of the stock of W. P purchases the stock of T and makes a section 338 election with respect to T. The election applies to H and to W as well.

1. Methodology
As a result of its acquiring all of the stock of T, under section 318(a) P is treated as owning the stock of H and, through H, the
stock of W. Because P purchased the stock of T, P is treated as having purchased that portion of the stock of H and of the stock of W which is attributed to P under section 318(a). Under that provision all of the stock of these corporations is attributed to, and thus treated as purchased by, P. The deemed purchase of the subsidiaries' stock by P is treated as made on the first day on which P is considered under section 318(a) as owning the subsidiaries' stock.

New section 338(h)(3)(B).

P is thus deemed to have made qualified stock purchases of a target corporation (T) and one or more target affiliates (H and W) during the consistency period (in fact on the same day). The section 338 election with respect to the first such purchase (T) applies to each other such purchase (H and W).

New section 338(f)(1).

2. Attribution Arithmetic

Note well the following:

“A purchase of over 80 percent but less than 100 percent of the stock of a target corporation which in turn owns 80 percent of the stock of a third corporation is not a qualified stock purchase with respect to the third corporation because the purchasing corporation has not acquired by purchase the requisite 80 percent of the third corporation's stock. This is so, even though the purchasing corporation, the target corporation, and the third corporation constitute an affiliated group as defined in section 1504(a).”

Conference Report 537-38.

Thus, if P purchases 99% of the stock of T and, on that acquisition date, T owns only 80% of the stock of H, P has made a qualified stock purchase of T but has not made a qualified stock purchase of H or, of course, of H's wholly-owned subsidiary W. If P makes a section 338 election as to T, the consistency requirement will not apply and no section 338 election is deemed made, or indeed could be made, with respect to H or W. It is irrelevant that H and W are target affiliates with respect to T.

Assume that on June 1, 1983 T owns all of the stock of H and Mr. A owns all of the stock of T. On June 30 Mr. B, sole stockholder of P, purchases from T 20% of the voting stock of H and purchases from A 1% of the stock of T. On July 1 P purchases the remaining 99% of the stock of T from A and makes a section 338 election with respect to T. Does the consistency requirement apply to treat the election as a section 338 election with respect to H as well? It would seem not, despite the regulatory authority discussed in VII C 2, below.

The example in the Conference Report illustrates—it would seem quite correctly—the way section 318(a)(2)(C) works and interrelates with new section 338(d)(3). The planning opportunities suggested by the example are immense, and will be explored hereafter.

3. Purchase of T Subsidiaries

P purchases from T all of the stock of H and of W. The filing of a
section 338 election as to either H or W will be treated as the filing of the election with respect to the other as well.

New section 338(f)(1).

Assume P purchases the stock of W from T on July 1, 1983 and the stock of H from T on October 1, 1983, more than 75 days after the first purchase. P makes no section 338 election with respect to W, the corporation first purchased. P cannot make a section 338 election with respect to H, the corporation second purchased

New section 338(f)(2).

C. Devious Planning

1. Use of Noncorporate Shareholder of P

Mr. B owns all of the stock of P. Mr. A owns all of the stock of T and T owns all of the stock of H and of W. T sells the W stock to Mr. B and the H stock to P. P makes a section 338 election with respect to H. Mr. B makes no election with respect to W and, since he is not a corporation, he is not permitted to file a section 338 election with respect to W.

The consistency requirement does not apply. Although (except as may be provided in regulations) an acquisition of stock (or assets) by any member of an affiliated group of corporations which includes a purchasing corporation will be treated as made by the purchasing corporation, this rule has no application to Mr. B since, although he is sole stockholder of P, he is not a corporation and thus cannot be a member of an affiliated group.

See new section 338(h)(7).

Now add this. B bought the stock of W with money he borrowed from a bank (acquisition indebtedness). Later, B establishes a new Holding Corporation (Q) and in exchange for Q's stock, transfers to it all of the stock of P and of W. Q assumes the acquisition indebtedness. Thereafter Q, P, H, and W file a consolidated return.

B will not be taxed on Q's assumption of the acquisition indebtedness.

New section 304(b)(3)(B).

What of the consistency requirement now?

Cf. new section 338(h)(5), quoted in VI C 2 below.

Does it—should it—make a difference if the transfer to Q takes place shortly after, or long after, P buys H?

2. Use of Noncontrolled Subsidiary of P

V Corporation, a substantial operating company, is owned in part by P and in part by Mr. B, P's sole stockholder, or perhaps by an outsider or even by the pension trust. P and V are not members of the same affiliated group because the V shares owned by Mr. B, etc., either carry more than 20% of the total voting power of all classes of V stock or constitute more than 20% of a class of V nonvoting stock (other than straight preferred stock). As an extreme example, V may have issued to B, etc., all of the shares of a class of V stock (low
in aggregate value) which is nonvoting, preferred in liquidation, but participating (as distinguished from limited) in its right to receive dividends. P purchases from T all of the stock of H and makes a section 338 election. V purchases from T all of the stock of W and makes no election.

Does the consistency requirement apply? Certainly not on the face of it since P and V are not members of an affiliated group (even under the expanded definition of that term in new section 338(h)(5)). But the statute has an added provision:

"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).

New section 338(i).

It is a very broad delegation of authority to regulate, and the suggestion that the Treasury may overturn "any provision of law" is fascinating. But does it authorize regulations that will reach the example case—or the example in VI C 1 above—and trigger a deemed election under section 338 with respect to W, or a deemed asset purchase of W or of W and H both? Certainly not easily, but we can await with no little interest publication of the Treasury's reaction.

D. Mixed Asset and Stock Acquisitions

Subject to certain exceptions, a purchasing corporation will be treated as having made an election under section 338 with respect to any target corporation if, at any time during the consistency period, it acquires any asset of the target corporation or any asset of a target affiliate. Thus, if P purchases the stock of W and the assets of H, P will be deemed to have made a section 338 election with respect to W. Similarly, if P purchases the stock of W, makes no section 338 election, and within one year purchases from W a part of its assets, that purchase will be deemed a section 338 election with respect to W unless an exception (see below) applies.

1. The Seventy-Five Day Rule

A section 338 election is supposed to be made within 75 days of the acquisition date. Suppose P purchases the stock of T on January 1, makes no section 338 election, later changes its mind, and before December 31 purchases part of T's assets. Is 75 days really one year in which to elect?

"The conference agreement provides regulatory authority pursuant to which the Secretary may determine that the deemed election will not apply as the result of a de minimus acquisition of assets and may also preclude the application of the deemed election rule if it is determined that the taxpayer has acquired assets in order to avoid the
75-day limit on the period after the acquisition date within which the election must be made."

Conference Report 540.

2. What are Assets?
P purchases from T the stock of H and the stock of W. No section 338 election is made for either corporation. The stock of H and the stock of W were assets of T. Do we have an automatically deemed section 338 election for H and W? Happily, no.

"In applying these rules, stock in a target affiliate is not to be treated as an asset of any other target affiliate or of the target corporation.

Conference Report 538.

It would seem the same result obtains if P purchases all of the stock of W and only 25% of the stock of H. But if T at all times owned all of the stock of W and only 50% of the stock of H, and sold to P, because H would not have been a target affiliate and its shares were assets of T, there would seem to be an automatic deemed section 338 election with respect to W.

3. Exceptions
P will not be treated as having made an election under section 338 with respect to a target corporation, if it also acquires an asset of the target corporation or of a target affiliate, in the following circumstances.

(i) The acquisition is pursuant to a sale by the target corporation or the target affiliate in the ordinary course of its trade or business. The legislative history expands this permission somewhat to cover, e.g., a sale of used machinery that was employed in the business.

Conference Report 539.

(ii) The basis of the property acquired is determined, in whole or in part, by reference to the adjusted basis of such property in the hands of the person from whom acquired. Thus, if P purchases T, makes no section 338 election, and liquidates T under section 334(b)(1), it is not a proscribed asset acquisition by P. Similarly, if W merges into P or S in a tax free reorganization, it is not a proscribed asset acquisition.

(iii) The acquisition was before September 1, 1982.

(iv) To the extent provided in regulations, the property acquired is located outside the United States.

(v) Such acquisition is described in regulations prescribed by the Secretary.

New section 338(e)(2).

4. Exception to Exception
In paranoid fashion, the new statute announces that, whenever necessary to carry out the purposes of subsections (e) and (f) of section 338, the Secretary may treat stock acquisitions which are pursuant to a plan, and which meet the 80% requirements for a qualified stock purchase, as qualified stock purchases.

New section 338(e)(3).

If P purchases from T all of the stock of H and makes a section 338
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election, and P acquires from T all of the stock of W solely in exchange for P voting stock in a “B” reorganization, does this provision apply, at the option of the Internal Revenue Service, to trigger a deemed section 338 election for W?

Note that if instead P’s subsidiary S acquired the assets of W solely in exchange for P voting stock in a “C” or an “(a) (2) (D)” reorganization, the provision would not apply and the basis of T’s assets would carry over to S under section 362(b).

E. More Devious Planning

The “devious planning” that is the subject of VII C above, like the similar suggestion set out in the final paragraph of VII B 2, addresses cases in which T is a holding company and each business is lodged in a separate operating subsidiary of T. We turn now to a T which directly owns and operates, in divisional form, two separate businesses. The assets of the H division are highly appreciated and are not burdened with significant recapture items. The assets of the W division, also highly appreciated in value, are burdened with substantial recapture items.

Assume T is capitalized with two classes of stock, 120 voting common shares worth 10 each (total of 1200) and 80 shares of nonvoting straight preferred stock worth 10 each (total of 800). The aggregate value of T is 2,000; the H division is worth 1,000 and the W division is worth 1,000.

P and V are both sizable corporations. P owns all of the voting common stock of V, and that stock is worth 98% of the total value of V. The balance is represented by shares of nonvoting stock of V which are preferred to the common stock in liquidation, have no preferential right to receive dividends, and instead participate share for share in dividends along with the common stock. Because it has a participating rather than a limited dividend right, the V nonvoting stock is not “straight preferred stock”—that is, it is not excluded from the definition of “stock” by the “flush language” at the close of section 1504(a). The V nonvoting stock is owned by one or more individuals, a pension trust, a charity, anyone but P or a controlled subsidiary of P. Because P does not own the V nonvoting preferred stock, V is not a member of the P “affiliated group” within the meaning given to that term by section 1504(a) or by new section 338(h)(5).


Pioneer Parachute Co. v. Commissioner, 162 F.2d 249 (2d Cir. 1947).

As the cited ruling confirms, P and V are ineligible to file a consolidated return. Of course, P may file a consolidated return that includes its controlled subsidiaries, and V may file a separate consolidated return with its own controlled subsidiaries.

P purchases 100 of the 120 outstanding shares of T voting common stock paying 1,000. V purchases the remaining 20 shares of T voting
common stock and also purchases all of the outstanding shares of T nonvoting straight preferred stock, paying in the aggregate 1,000.

P has made a qualified stock purchase of T since P has acquired by purchase 80% (in fact 83.3%) of the total combined voting power of all classes of T stock entitled to vote, and no nonvoting T shares are outstanding except the shares of nonvoting straight preferred stock of T that now are owned by V.

P is careful not to make a section 338 election with respect to T.

Instead, T promptly adopts a plan of complete liquidation and, pursuant to that plan, distributes the W division to P and the H division to V.

Because P owned not less than 80% of the T voting stock and T's nonvoting straight preferred stock does not count in the relevant equation, as regards P the liquidation of T is governed by section 332.

See section 332(b)(1).

P recognizes no gain or loss on the distribution to it of the W division, T's basis in the assets of the W division carries over to P, P inherits T's relevant corporate attributes (e.g., the accounting method employed for the W division) and on its distribution of the W division assets T does not recognize gain, loss, or even depreciation recapture income.

Sections 332(a), 334(b)(1), 336, 381, 1245(b)(3), 1250(d)(3).

Because V is not in control of T, as to V the liquidation is not governed by section 332. Instead, it falls under section 331. On the distribution of the H assets, therefore, T must recognize the (modest) recapture items but is otherwise entitled to nonrecognition treatment, V is party to a taxable exchange but because its basis in T stock of 1,000 equals the value of the H assets (net of liabilities) distributed to it V does not in fact recognize gain, and in the hands of V the basis of the H assets is stepped-up to 1,000 plus the H liabilities assumed or taken subject to by V.

Sections 331, 334(a), 336.

This sort of thing is, of course, exactly what the consistency requirement is intended to prevent. The Treasury's authority to regulate, see section 338(i) quoted in VII C 2 above, is very broad. Is it broad enough to reach the example case? If the Treasury decides to try, only time and, perhaps, ultimately the courts will tell.

But there is one more issue with regard to the Treasury's authority to regulate. Although T has purportedly completely liquidated, viewed in the round the arrangement could, if with no little difficulty, be labeled the functional equivalent of a partial liquidation. The desired result, after all, is a stepped-up basis for the assets of the H division, preservation of basis for the assets of the W division. That is what partial liquidations are all about.

New section 346(b), quoted in full in IV B 3 above, contemplates regulations to ensure, among other things, that TEFRA's removal of partial liquidations from the ambit of sections 331 and 336 may not
be circumvented through the use of any "provision of law or regulations." Does the plan proposed fall within the scope of such regulations as may be promulgated under this provision? It does not seem awfully likely, but it is early days and we will see.

F. Yet More Devious Planning: Help From the Investment Bankers

One common denominator of the planning discussed in this part is P's desire to acquire one subsidiary or division of T at a stepped-up asset basis, another subsidiary or division of T with asset basis intact. A second common denominator is the assumption that, at least in significant part, P will use outside financing in the total acquisition, P's investment bankers will or can be induced to arrange that financing, and as good investment bankers are flexible and helpfully inclined.

The plans suggested below are illustrative of approaches to avoiding the conformity requirement of new section 338(e) and (f). They are by no means exhaustive. As always, experience will suggest many other plans, perhaps many better ones.

1. Substituting Use for Ownership

W is a subsidiary of T. H is either a subsidiary of T or an operation directly conducted by T. H is worth 1,000 and W is worth 1,000. P's investment bankers are prepared to arrange financing for P of 1,000, the financing arrangement to be in whatever is the most useful form. To that end, the investment bankers cause Q corporation to be organized. The investment bankers place the Q stock with individuals or a partnership of individuals who furnish part of the needed 1,000; Q borrows the balance from a bank or insurance company.

T adopts a plan of complete liquidation. T sells the stock of H to Q, Q makes a section 338 election for H, H is then liquidated into Q, and if the individuals or partnership of individuals owning Q do not wish to operate in corporate solution Q is liquidated as well. If H is a division of T, Q buys the assets (subject to liabilities) from T and follows out the balance of the litany if noncorporate ownership of the assets is desired.

P purchases the stock of W from T. No section 338 election is made. T timely completes its liquidation under section 337. Q, or the partnership that has succeeded Q in liquidation of Q, now leases all of the H properties to S, a wholly-owned subsidiary of P. The lease is long-term and structured to qualify as a "real lease" for tax purposes. S will pay annual fixed rent in an amount sufficient to allow Q or its successor to amortize principal and interest on the bank or insurance company indebtedness and to yield an appropriate return on the equity investment. S will pay additional rent annually, under an appropriate escalation provision, to defray property taxes and the like. Under the lease S will have an option, exercisable congressional intent announced in the Conference Report, at the close of the long lease term, to purchase the H assets (hotel property) at then fair value. The initial return on the Q investors'
equity, plus the perceived current value of the remainder interest, will approximate the equity investment.

So long as the lease is a true “lease” for tax purposes, there would appear to be no way the conformity requirement can apply to trigger W corporation recaptures. Nonetheless, under the plan P and its subsidiaries are placed in approximately the position they would enjoy if P had purchased the H assets as well as the W stock and section 338 imposed no conformity requirement. S will receive the gross income of the H business. S will pay rent rather than interest and principal on debt financing. S will deduct rent rather than deducting depreciation on the H assets. There will of course be some differences, but it is not at all clear those differences will work to the disadvantage of S and P.

2. Use of V

As earlier explored in VI C 2, if V is a substantial company dominated in ownership by P, but because of its capital structure is not a member of P’s affiliated group within the meaning of section 1504(a) determined without regard to the exceptions contained in section 1504(b), unless forthcoming regulations adopt an extreme position and the courts will sustain that position, V is the vehicle by means of which the consistency requirement rather easily can be avoided in a large class of cases. P purchases the assets of H or the stock of H and makes a section 338 election; V purchases the stock of W and makes no election. As simple as that. The investment bankers can be helpful, when appropriate, in taking or placing the V shares that P is not to own.

3. Taking Advantage of the Attribution Rules

Quoted in VI B 2, above, is the Conference Report’s quite accurate interpretation of the way in which section 318(a)(2)(C), the pertinent attribution rule, works, and the Conferees’ announcement of how that attribution rule is to interrelate with the qualified stock purchase definition in new section 338(d)(3). The pronouncement is important for a number of reasons. Not the least of them is that it will be extraordinarily difficult for the Treasury to promulgate a sustainable regulation under section 338(i) taking a position contrary to congressional intent announced in the Conference Report.

The Conference Report (pages 537-38) deals with a simple case. T owns 80% of the stock of W. P purchases more than 80% but less than 100% of the stock of T and makes a section 338 election for T. The Report categorically states that P’s purchase of “control,” but less than all, of T is not a qualified stock purchase with respect to W because P “has not acquired by purchase the requisite 80 percent” of the stock of W. Thus, the section 338 election steps-up the basis of T’s assets (including the basis of the stock of W owned by T), but does not step-up the basis of the assets of W or trigger recapture gains in W.

As the Conferees’ correctly comprehended, all of this is mandated by section 338(h)(3)(B). That provision declares that if P purchases stock of T, and as a result P is treated under section 318(a) as owning stock in W, P will be treated as having purchased “such stock” in
W, i.e. the W stock that is attributed from T to P. The pertinent attribution rule is section 318(a)(2)(C). It applies when P owns, directly or indirectly, 50% or more in value of the stock of T. That requirement being satisfied, P shall be considered as owning the W stock owned, directly or indirectly, by or for T “in that proportion which the value of the stock [of T] which [P] owns bears to the value of all of the stock in [T].”

In the Conference Report example, T owned 80% in value of the outstanding W stock. P purchased less than 100% in value of the outstanding T stock. Thus, if P purchased 90% in value of the outstanding T stock, and assuming the balance of the W stock was owned by a person unrelated to T, P is treated as having purchased only 72% in value of the outstanding stock of W. That is not a qualified stock purchase within the meaning of the statute.

The Conference Report example does not tell us whether either W or T has more than one class of stock outstanding. It fails to give this information, as to the T stock, because the data is clearly and explicitly irrelevant. One class or many classes, the attribution rule compares the value of the T stock owned by P with the total value of all T stock outstanding. As to the stock of W owned by T, the data would have relevance in some cases but not in the Conference Report example. Under the attribution rule P is treated as owning its percentage (of the total value of all outstanding T stock) of the W shares actually or constructively owned by T. Thus, if P owns 90% in value of the outstanding shares of T and T owns 100 shares of W voting common stock and 100 shares of W nonvoting straight preferred stock, P is treated as owning 90 shares of each class of W stock. Not 100 W voting shares and 80 W nonvoting shares. Ninety shares of each class.

This being the attribution rule, the Conference Report unequivocally announcing it is irrelevant, when P purchases control of T, whether W does or does not end up a member of the affiliated group that includes P and T, any competent high school graduate should be able to trash the conformity requirement. At a cost, perhaps, but usually an affordable one.

A key, you will almost certainly have perceived, lies in the differential treatment accorded nonvoting straight preferred stock in section 338(d)(3) (it does not count) and in section 318(a)(2)(C) (it counts).

a. Playing With Preferred Stock

W is capitalized with 100 shares of voting common stock outstanding. T owns all of the shares. H is a division of T. H and W each are worth 1,000 and T is worth 2,000. P wishes to acquire T and recognizes that both the H business and the W business require the infusion of additional working capital. T is recapitalized to authorize the issuance, at 10 per share, of up to 100 shares of nonvoting straight preferred stock. Cumulative dividend yield is substantial but not outlandish. The T preferred stock is designed to qualify as an excellent
long-term investment for a corporate investor that will enjoy the benefits of the section 243 intercorporate dividend deduction.

Through its own investment bankers or perhaps through investment bankers recommended by P, T sells to Z corporation 70 newly issued shares of T nonvoting straight preferred stock. T retains part of the 700 issue proceeds and contributes the balance to the capital of W; the funds are promptly put to work in the businesses of T's H division and in W. Z, a corporation unrelated to T and P, thereafter retains the 70 T nonvoting preferred shares.

Shortly after the preferred stock issue, P purchases all of the outstanding voting common stock of T. Because T's nonvoting straight preferred stock is not counted in the section 338(d)(3) "purchase of control" equation, this is a qualified stock purchase. P promptly files a section 338 election with respect to T. The basis of the assets of T's H division, and the basis of the W voting common stock owned by T, is thereby stepped-up.

Under section 338(h)(3)(B), P is deemed to have purchased those W shares, owned by T, which P is treated as owning under the section 318(a)(2)(C) attribution rule. That rule, in turn, specifies that P will be considered to own, through T, that proportion of the W stock owned by T which the value of the T stock owned by P bears to the total value of all outstanding T stock. The value of the voting common stock of T owned by P is 2,000. The total value of all outstanding T stock, voting common and nonvoting preferred together, is 2700. The proportion, 2,000 divided by 2700, is approximately 74%. Under section 338(h)(3)(B), therefore, P is deemed to have purchased 74% of the voting common stock of W.

That is not a qualified stock purchase under section 338(d)(3).

As confirmed by the Conference Report, it being irrelevant that W as well as T now will be part of P's affiliated group, the section 338 election filed by P for T is not an effective section 338 election with respect to W. In the hands of W, the basis of its assets remains unchanged and no recapture gains are recognized to W.

So much for the consistency requirement.

b. A Treasury Response?

The example in a. is illustrative, not all encompassing. One technique suggests the next. For example, if an infusion of substantial new equity funds is not desirable, the threshold recapitalization of T could still be undertaken. Z then would purchase 26% of the outstanding voting common stock of T and promptly would exchange those T voting common shares for new shares of T nonvoting straight preferred stock of equal value. Z would retain the T preferred shares. P would purchase all of the outstanding voting common stock of T and make the section 338 election. Less elegant, perhaps, but it should do.

What is the Treasury likely to do?

Broad authority to regulate or no, it is extremely difficult to see what Treasury can do to impose the conformity requirement on W.
The Conference Report is accurate in its comprehension of the statutory interworkings, crystalline in its clarity. So is new section 338(h)(3)(B), the "provision of law"—see section 338(i)'s grant of authority to regulate—which the Treasury will be interpreting in forthcoming regulations. To catch these cases, it is not a question of bending the statute. It is a question of breaking the statute.

c. At What Price?

Assume the W assets are appreciated 600 in excess of basis and 500 of this is recapturable depreciation. The W stock in T's hands also is appreciated 600. The H assets owned by T are appreciated 500, but only 100 is recapturable depreciation, the balance capital gain. The high school graduate's plan saves (at an assumed effective federal and state combined rate of 50%) tax of 250 in W. But, because P has purchased only 74% (in value) of T, under section 338(c)(1) T will incur "nonsection 337" tax (assuming a combined capital gain rate of 30%) of 78 (26% x 1,000 x 30%).

Not bad for a high school graduate. A 69% tax reduction. Can we do better? Yes, if a holding corporation stood between T and W, and it rather than T issued the preferred stock. Best structured, the tax (on the holding corporation) would be a bit under 47 (26% x 600 x 30%). A tax reduction of 81%.

Can we do better still? The value of the preferred stock acquired by Z could be shaved to a bit over 20% of the total value of the issuer. Twenty percent of the "nonsection 337" gain would disappear. But, of course, the definition of total victory is to eliminate the tax entirely. When T has issued the preferred stock, all "nonsection 337" tax will disappear if, within one year, either the preferred stock is bought in or T is liquidated. But this is risky business. The risk, of course, is that Z's ownership of the preferred stock will be disregarded, a mere step in a transitory plan, and the recapture gains in W triggered after all. This is not to say it cannot be done. Almost anything can be done in subchapter C. But it is early days and a safe scheme is not yet in hand. As always, however, we should look to the future with optimism.

G. The Consistency Requirement: A Concluding Comment

Replacing the election-by-liquidation of old section 334(b)(2) with a section 338 explicit election was a welcome move in the direction of rationalizing and simplifying in practice an important area of corporate taxation. In large part because the legislative process moved with undue dispatch, section 338 presents more than its fair share of problems and just plain mistakes. Some technical amendments seem highly desirable, and for the rest of it Treasury faces a difficult but undoubtedly surmountable task in writing sensible regulations.

The consistency requirement, paragraphs (e) and (f) of section 338, is quite another matter. There is no problem to which it represents a coherent response, and because it is unsound in concept—inappropriately distinguishing corporate sellers of corporations from non-
corporate sellers, corporate buyers from noncorporate buyers, affiliated corporate buyers from less affiliated corporate buyers—it is unworkable in practice.

Certainly there is a genuine problem in the tax treatment of corporate sales, liquidations, and now deemed section 337 transactions. But just as certainly the newly minted consistency requirement fails adequately to address that problem. It is the General Utilities doctrine, the notion embedded in sections 336 and 337 that permits a stepped-up basis for the assets of T at a toll charge recapture tax that does not include the appreciation in FIFO inventory, a variety of other ordinary income assets, section 1245 property in excess of original cost, section 1250 property depreciated on the straight line, and on and on. In the hearings on the Stark Bill, the Treasury was candid in confirming what ought to be apparent to everyone: If the current incarnation of the General Utilities doctrine were overturned, or if it were curbed in a substantial way, a consistency requirement would find no support for it would serve no discernible function.

The tax law now is burdened by an unsound and vastly complicating consistency requirement in large part because the tax bar did not perform at its best in the legislative process. As the hearing before the Select Revenue Measures Subcommittee amply confirms, in the area of complete corporate liquidations Congress was not prepared to make further inroads in the General Utilities doctrine in the absence of any support from the institutional tax fraternity. None was forthcoming. While every organization representative who in the hearings in either House thought to mention the consistency requirement spoke against it, no professional tax group has urged further limitations on the General Utilities doctrine and most continue to seek its expansion to again cover LIFO inventory. Shown no access to a workable solution of the nonrecognition problem, Congress thought it better to do something than nothing, to engraft the complexity of an unsound consistency requirement upon an already complex and unsound taxing scheme.

The organized tax bar trumpets the cause of tax simplification. It played a significant role in the enactment of The Installment Sales Revision Act of 1980, the rare tax bill that significantly rationalized a segment of the law and greatly simplified that segment of the tax law in practice. But it was an easy cause to support in that, while a few tax avoidance devices were obliterated or reduced importantly in scope, in the main the changes worked to the benefit of taxpayers and tax practitioners. It is not easy for the tax bar to support major limitations on the reach of section 336 and 337 nonrecognition, for this change must increase the tax burden and the bar and the accounting fraternity are not known for implacable hostility to taxpayer interests.

But there is, or ought to be, a taxpayer and a tax adviser interest in promoting the rationality and reducing the complexity of the tax law. If sections 336 and 337 were revised to require recognition when the appreciated property sold, distributed, or affected by a section
338 election is ordinary income property—LIFO or FIFO or what have you—it seems virtually certain the Treasury, in joyful exchange, would support repeal of the section 338 consistency requirement. And if the change went further, to require gain recognition when the affected property is a wasting asset held less than three years, almost certainly the Treasury, again in joyful exchange, would support repeal of section 341, the oppressive collapsible corporation provision. The resulting simplification in subchapter C would be wonderful to behold.

If the tax bar genuinely supports making the income tax system less complex, more rational, simpler in practice, it must be prepared to support as well root changes of the sort exemplified by a curbing of the General Utilities doctrine, even though the result is an expansion of the tax base. Indeed, because the result is an expansion of the tax base. If we are going to improve the income tax system a broadened tax base is essential. That, after all, is the notion fueling the growing pressure for a so-called flat rate system. One may question the wisdom of a single rate income tax, but probably few would deplore a sizable reduction in the number of rate brackets and in the maximum rate. In the end, base broadening changes that circumscribe or eliminate questionable deductions and exclusions, such as sections 336 and 337, are in the larger interests of taxpayers.

It is possible to argue quite rationally against the maintaining of any corporate tax. But so long as we have one, we ought bend our efforts toward making it rational and workable.

As to the consistency requirement, we do not need a technical amendment. We need a conceptual amendment.