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Section 338(h)(10)

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SECTION 338(h)(10)

I. INTRODUCTION

Generally, the result of a section 338(h)(10) election is to treat the purchase and sale of the stock of a target corporation as the purchase and sale of the assets of the target corporation, followed by a distribution of the proceeds of the deemed asset sale to the selling shareholders, after which the target corporation ceases to exist. Part I of this outline provides a brief overview of section 338 and section 338(h)(10) and discusses the final regulations under section 338. Part II provides an example of a typical acquisition in which a section 338(h)(10) election might be made, and analyzes the results. Parts III-VII provide a more detailed analysis of the operation and effect of section 338(h)(10).

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

A. Overview of Section 338

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

1. Operation of section 338

In general, section 338 operates as follows:

a. Purchase and election

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

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

b. Deemed sale of assets

(1) If a qualifying purchase and election occur, T is treated as if it sold all of its assets in a single, fully taxable transaction. See Section 338(a).

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

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

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

(3) The hypothetical selling price of all of the T assets is the "grossed-up" amount realized on the sale of the T stock plus the liabilities of Old T. The hypothetical purchase price is equal to P's basis in its "recently purchased" T stock, "grossed up" to reflect the value of any T stock not held by P on the acquisition date, plus P's basis in any "nonrecently purchased" stock, plus the liabilities of New T.

2. Consequences of the sale

a. As a result of the deemed asset sale, Old T (now owned by P) incurs all appropriate tax liabilities, and its tax attributes disappear.

b. As a result of the deemed asset purchase, New T holds the assets with a FMV cost basis if FMV was paid for the T stock.

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

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

3. Liquidation of T

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

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

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

(2) The combination of nonelection under section 338 and liquidation pursuant to a plan adopted within two years of the acquisition date, however, may trigger section 269(b), which allows the Treasury Secretary to disallow certain tax benefits if the principal purpose of the liquidation is the evasion or avoidance of Federal income taxes. See CCA 200238025 (June 14, 2002) (discussing the application of section 269(b)).

4. Consistency provisions

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

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

c. Following the Tax Reform Act of 1986, P.L. 99-514 ("TRA 86") and the repeal of the so-called General Utilities doctrine, the opportunity for abusive transactions was considerably narrowed. The final regulations (previously Treas. Reg. §§ 1.338-4, and -5, now renumbered as -8 and -9) reflect this by greatly simplifying the consistency rules and limiting their scope.

5. Benefits of a section 338 election

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

C. The Final Regulations

1. In general

a. Final regulations, T.D. 8940 (February 12, 2001) (the “final regulations” or “new regulations”) replaced temporary regulations issued January 5, 2000, T.D. 8858 (January 5, 2000) (the "temporary regulations"). The temporary regulations replaced Treas. Reg. §§ 1.338-0 through 1.338-3; 1.338(b)-1, -2T and -3T; 1.338(h)(10)-1; and 1.338(i)-1 (the "old regulations"). Treas. Reg. §1.338-4 and -5 (relating to asset and stock consistency and international aspects of section 338) were retained, but were renumbered as -8 and -9. The final regulations also replace Temp. Treas. Reg. § 1.1060-1T.

b. The final regulations are generally effective for qualified stock purchases occurring on or after March 16, 2001. Treas. Reg. § 1.338(i)-1. The temporary regulations are generally effective for qualified stock purchases occurring after January 5, 2000, but before March 16, 2001. Temp. Treas. Reg. § 1.338(i)-1T. For qualified stock purchases on or before January 5, 2000, the old regulations continue to apply.

c. The final regulations are substantially the same as the temporary regulations and proposed regulations that were published on August 10, 1999. Notice of Proposed Rulemaking REG-107069-97, 64 Fed. Reg. 43461 (August 10, 1999) (the "proposed regulations").

d. To the extent that the same result would be reached under the temporary regulations and the final regulations, this outline refers,

and cites to, the final regulations. When appropriate, this outline highlights differences between the final regulations and the temporary regulations.

e. In addition, this outline refers to the preamble to the Notice of Proposed Rulemaking (the "preamble to the proposed regulations"), in order to explain certain provisions in the final regulations or the temporary regulations.

2. Overview

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

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

3. Organization of the regulations

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

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

a. The final regulations provide that if a section 338 election is made, Old T is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities, and New T is treated as acquiring all of its assets from an unrelated person in exchange for consideration that includes the assumption of, or taking subject to, liabilities. If a section 338(h)(10) election is made, Old T is also deemed to liquidate following the deemed asset sale. Treas. Reg. § 1.338-1(a).

b. The final regulations provide that other rules of law apply to determine the tax consequences to the parties as if they had actually engaged in the transactions deemed to occur under section 338 and the regulations thereunder except to the extent otherwise provided in the regulations. For example, if T is an insurance company for which a section 338 election is made, the deemed asset sale would be characterized and taxed as an assumption-reinsurance transaction under applicable Federal income tax law. See Treas. Reg. § 1.338-1(a)(2).

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

d. The final regulations include a next day rule to section 338 transactions. Treas. Reg. § 1.338-1(d). The next day rule is intended to ensure that all tax liability stemming from a post acquisition sale of acquired assets falls on the acquiring corporation by providing that the target and all persons related thereto must treat a post acquisition sale of assets as occurring at the beginning of the day following the transaction and after the deemed purchase of new target. NOTE – No such rule exists under the temporary regulations applicable to qualified stock purchases before March 16, 2001 and after January 5, 2000.

5. Treas. Reg. § 1.338-2 -- Nomenclature and definitions: mechanics of the section 338 election.

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

b. Additionally, the definitions of certain terms have been modified.

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

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

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

a. The proposed regulations provided that a purchase of T stock occurs so long as more than a nominal amount is paid for the stock. Old Prop. Treas. Reg. § 1.338-3(b)(2)(ii). In response to comments received on this provision, the temporary regulations removed this provision and reserved this issue pending further consideration of the comments. Temp. Treas. Reg. § 1.338-3T(b)(2)(ii).

b. The final regulations do not adopt the definition of purchase from the proposed regulations. Rather, the final regulations include a single definition of purchase applicable to both targets and target affiliates. This definition generally conforms to the definition of purchase of target affiliate in the temporary regulations. Under this definition, stock in a target (or target affiliate) may be considered purchased if, under general principles of tax law, the purchasing corporation is considered to own the stock of the target (or the target affiliate) meeting the requirements of section 1504(a)(2), notwithstanding that no amount may be paid for (or allocated to) the stock. See Treas. Reg. § 1.338-3(b)(2).

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

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

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

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

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

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

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

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

c. Regarding the timing of taking liabilities into account, the final regulations provide that general principles of tax law apply in determining the timing and amount of the elements of ADSP and AGUB. Accordingly, the rule in the old regulations that liabilities are taken into account in calculating ADSP and AGUB, only when such liability becomes fixed and determinable was removed in the final regulations. See Treas. Reg. §§ 1.338-4(b)(2) and 1.338-5(b)(2).

d. The "other relevant items" that were included in the calculation of MADSP under the old regulations are not included in the calculation of ADSP under the final regulations.

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

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

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

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

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

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

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

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

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

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

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

f. The final regulations make the section 453 installment method available to Old T in its deemed asset sale, as long as the deemed asset sale would otherwise qualify for installment sale reporting. For purposes of section 453, New T is considered to be the obligor

on the installment obligation the purchasing corporation actually issued. Treas. Reg. § 1.338(h)(10)-1(d)(8).

g. The final regulations provide that, in the case of parent-subsidiary chains of corporations making section 338(h)(10) elections, the deemed asset sale at the parent level is considered to precede that at the subsidiary level. Treas. Reg. § 1.338(h)(10)-1(d)(3)(ii). The final regulations then provide, however, that the deemed liquidation of the subsidiary is considered to precede the deemed liquidation of the parent. Treas. Reg. § 1.338(h)(10)-1(d)(4)(ii).

II. EXAMPLE OF AN ACQUISITION WITH A SECTION 338(h)(10) ELECTION

A. Basic Facts

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

Assets		Liabilities	
Cash	2,000	Accts Payable	7,000
Inventory	5,000	Other Liabs.	15,000
Accts. Rec'ble	7,000		
Equipment	7,000	Total Liabs.	22,000
Land	2,000		
Plant	9,000	Equity	10,000
Total	32,000	Total	32,000

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

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

Cash	2,000
Inventory	7,000
Accts Rec'ble	7,000
Equipment	9,000
Land	3,000
Plant	12,000
Goodwill	10,000
Total	50,000

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

Cash	2,000
Inventory	6,000
Accts Rec'ble	7,000
Equipment	7,000
Land	1,500
Plant	11,000
Goodwill	8,500
Total	43,000

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

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

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

1. Consequences to S

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

2. Consequences to P

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

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

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

1. Consequences to S

As a result of the deemed sale, S will realize no gain on the sale of its T stock. Rather, T will realize gain equal to the aggregate deemed sales price ("ADSP") (see Part V.C., below) less T's inside asset basis. Provided that New T does not assume the tax liability incurred on the deemed asset sale, the ADSP is $50,000 ($28,000 grossed-up amount realized plus $22,000 of liabilities assumed). T's inside asset basis is $32,000, yielding a gain of $18,000, allocable to the individual assets as follows:

	Amount Rec'd.	Basis	Adj'd Gain
Cash	2,000	2,000	0
Inventory	7,000	5,000	2,000
Accts Rec'ble	7,000	7,000	0
Equipment	9,000	7,000	2,000
Land	3,000	2,000	1,000
Plant	12,000	9,000	3,000
Goodwill	10,000	0	10,000
Total	50,000	32,000	18,000

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

2. Consequences to P

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

D. Summary

1. The following chart compares the results under both approaches:

	Cash to S	Taxable Gain to S	S's NOLs	T's NOLs available to P	P's Basis in the T Stock	Basis of T Assets
Without Election	21,000	0	9,000	10,000*	21,000	32,000

With Election	28,000	0	12,000	0	28,000	50,000

* NOLs subject to substantial limitations.

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

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

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

5. Under the old regulations the results would have been the same, although the analysis would have differed slightly.

III. ELIGIBILITY

A. Basic Eligibility Rules

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

2. Section 338(h)(10) target

a. A section 338(h)(10) target must be either:

(1) a "consolidated target";

(2) an "affiliated target"; or

(3) an "S corporation."

See Treas. Reg. § 1.338(h)(10)-1(b).

b. Consolidated Target

(1) A consolidated target is a target that is a member of a consolidated group within the meaning of Treas. Reg. § 1.1502-1(h) on the acquisition date and is not the common parent of the group on that date. Treas. Reg. § 1.338(h)(10)-1(b)(1).

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

c. Affiliated Target

An affiliated target is a domestic corporation, in whom another domestic corporation owns an amount of stock described in section 1504(a)(2) (80 percent of vote and value) on the acquisition date, and which does not join in filing a consolidated return with such other corporation. Treas. Reg. § 1.338(h)(10)-1(b)(3).

d. S Corporation Target

(1) An S corporation target is a target that is an S corporation immediately before the acquisition date. Treas. Reg. § 1.338(h)(10)-1(b)(4).

(2) Thus, P can purchase no T stock before the acquisition date (since to do so would disqualify T from being an S corporation immediately before that date).

3. Seller requirements

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

(1) A selling consolidated group;

(2) A selling affiliate; or

(3) S corporation shareholders.

Treas. Reg. § 1.338(h)(10)-1(c)(1).

b. Selling consolidated group

A selling consolidated group is the consolidated group of which the

consolidated target is a member on the acquisition date. Treas. Reg. § 1.338(h)(10)-1(b)(2).

c. Selling affiliate

A selling affiliate is a domestic corporation that owns on the acquisition date an amount of stock in a domestic target, which amount of stock is described in section 1504(a)(2) (80 percent of vote and value), and does not join in filing a consolidated return with the target. Treas. Reg. § 1.338(h)(10)-1(b)(3).

d. S corporation shareholders

S corporation shareholders are the S corporation target's shareholders. Treas. Reg. § 1.338(h)(10)-1(b)(5).

4. Purchaser requirements

a. The purchaser must be a corporation. Individuals and partnerships cannot make a qualified stock purchase, and consequently cannot make a section 338(h)(10) election. Treas. Reg. § 1.338-3(b)(1).

b. Individuals and partnerships can get around this requirement by forming a new corporation ("Newco") to acquire the T stock. However, Newco must be considered for tax purposes as the purchaser. Facts that may indicate that Newco does not purchase the T stock include that Newco merges downstream into T, liquidates, or otherwise disposes of the T stock following the purported qualified stock purchase. Treas. Reg. § 1.338-3(b)(1); FSA 200122007 (Feb. 13, 2001)(discussing the disregarding of the corporate entity for QSP purposes).

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

B. Qualified Stock Purchase ("QSP")

1. In general

a. A QSP occurs when P, either in a single transaction or series of transactions within a 12-month period, acquires by "purchase" an

amount of stock meeting the requirements of section 1504(a)(2) -- i.e., at least 80 percent of the total combined voting power of all classes of T stock entitled to vote, and at least 80 percent of the total value of T stock (except nonvoting, nonparticipating, nonconvertible limited, preferred stock). Section 338(d)(3).

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

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

2. 12-Month acquisition period

a. Definition

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

b. Acquisition period for purchases from related corporation

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

(2) Example

(a) S owns all of the stock of T. On January 1, Year 1, P purchases 30 percent of the stock of S. On March 1, Year 1, P purchases an additional 30 percent. Under section 318 attribution, March 1 is the date on which P is first considered to own T stock (P is deemed to own 60 percent of T at that time). On February 1, Year 2, S is liquidated and P receives all of the T stock as a liquidating distribution. May P make a

section 338 election with respect to its acquisition of T?

(b) P's 12-month acquisition period with regard to T commenced on March 1, Year 1, the date when ownership of T stock was first attributed to P. Thus P's acquisition of the final 40 percent of the S stock on February 1, Year 2, falls within the applicable 12-month acquisition period and P is eligible to use section 338 with respect to T.

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

3. Acquisition date

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

4. Purchase

a. In general

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

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

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

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

"purchased" stock from T shareholder that owned 45.7 percent of P).

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

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

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

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

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

(6) The proposed regulations provided that a purchase of T stock occurs so long as more than a nominal amount is paid for the stock. Old Prop. Treas. Reg. § 1.338-3(b)(2)(ii). However, in response to comments received on this provision, the temporary regulations removed this provision and reserved this issue pending further consideration of comments. See Temp. Treas. Reg. § 1.338-3T(b)(2)(ii).

(7) The final regulations do not adopt the definition of purchase from the proposed regulations. Rather, the final regulations include a single definition of purchase applicable to both targets and target affiliates, which definition generally conforms to the definition of purchase of target affiliate in the temporary regulations. Under this definition, stock in a target (or target affiliate) may be considered purchased if, under general principles of tax law, the purchasing corporation is considered to own the stock of the target (or

the target affiliate) meeting the requirements of section 1504(a)(2), notwithstanding that no amount may be paid for (or allocated to) the stock. See Treas. Reg. § 1.338-3(b)(2).

b. Special rules for acquisitions from related corporations

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

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

c. Step Transaction Doctrine

(1) In Rev. Rul. 90-95, 1990-2 C.B. 67, the Service ruled that the step transaction doctrine does not apply to treat a QSP followed by the immediate liquidation of the target into the acquiring corporation as an asset purchase. Rather, the Service ruled that once a QSP has occurred, the step transaction doctrine will not apply and form will control.

(a) In Situation 2 of Rev. Rul. 90-95, following a QSP of the target, the target is liquidated into the parent corporation.

(b) The issue was whether the acquiring corporation should be treated as having made an asset acquisition pursuant to the Kimbell-Diamond doctrine or a QSP under section 338 followed by a liquidation of the target.

(c) The Service ruled that section 338 replaced the Kimbell-Diamond doctrine. Accordingly, the Service ruled that the step transaction doctrine does not apply to treat an acquisition of stock followed by a liquidation as an asset purchase. See also CCA

200230026 (April 15, 2002) (advising against attempting to recharacterize a stock purchase as an asset acquisition).

(2) In Rev. Rul. 2001-46, I.R.B. 2001-42, the Service ruled that, under certain circumstances, step transaction principles apply to characterize the transaction prior to the determination of whether a QSP has been made. In such cases, Rev. Rul. 90-95 will not apply and there will be no QSP.

(a) In Rev. Rul. 2001-46, the Service analyzed two similar transactions wherein a newly formed wholly owned subsidiary of the acquiring corporation was merged into the target corporation, with the target surviving the merger.

(i) In Situation 1, the target shareholders exchanged 100 percent of their target stock for consideration comprised of 70 percent voting stock of the acquiring corporation and 30 percent cash.

(ii) In situation 2, the target shareholders exchanged 100 percent of their target stock solely for voting stock of the acquiring corporation.

(iii) In both Situations, the target corporation was merged upstream into the acquiring corporation immediately after the merger.

(iv) Absent the prohibition against the application of the step transaction doctrine, the integrated transactions in both Situations qualified as a statutory merger under section 368(a).

(b) The Service ruled that if, pursuant to an integrated plan, a newly formed, wholly owned subsidiary of an acquiring corporation merges into a target, followed by the merger of the target into the acquiring corporation, the transaction is treated as a single statutory merger of the target into the acquiring corporation that qualifies as a tax-free reorganization under section 368(a)(1)(A).

(c) The Service further ruled that a section 338 election may not be made in such a situation because the

target stock is acquired in an exchange to which sections 354 and 356 apply.

(d) Thus, the Service ruled that in both Situations 1 and 2, step transaction principles applied to recharacterize the two-stepped transaction as a single statutory merger of the target into the acquiring corporation that qualified as a tax free reorganization under section 368(a)(1)(A).

(3) On July 5, 2006, the Service issued final regulations that permit taxpayers to turn off the step transaction doctrine and to make a section 338(h)(10) election in certain multi-step transactions, as set forth in Rev. Rul. 2001-46. The Service previously issued final and temporary regulations to this effect on July 9, 2003. See Treas. Reg. § 1.338-3(c)(1)(i), (2) and Treas. Reg. § 1.338(h)(10)-1T, T.D. 9071. The temporary regulations were effective for stock acquisitions occurring on or after July 8, 2003. The final regulations, which are identical to the temporary regulations, are effective for stock acquisitions occurring on or after July 5, 2006.

(a) The regulations provide that "a section 338(h)(10) election may be made for T where P's acquisition of T stock, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P) . . . " Treas. Reg. § 1.338(h)(10)-1(c)(2).

(b) This rule applies regardless of whether, under the step transaction doctrine, the acquisition of T stock and subsequent merger or liquidation of T into P (or P affiliate) qualifies as a reorganization under section 368(a). Id.

(c) If a section 338(h)(10) election is made under these facts, P's acquisition of T stock will be treated as a QSP for all Federal tax purposes and will not be treated as a reorganization under section 368(a). See Treas. Reg. § 1.338(h)(10)-1(e), Ex. 12 & 13.

(d) However, if taxpayers do not make a section 338(h)(10) election, Rev. Rul. 2001-46 will continue to apply so as to recharacterize the transaction as a

reorganization under section 368(a). See id. at Ex. 11.

(e) Thus, taxpayers are now permitted to make a section 338(h)(10) election in transactions similar to that in Situation 1 of Rev. Rul. 2001-46, but not in Situation 2 (because, standing alone, the acquisition of T stock does not constitute a qualified stock purchase).

(f) In Rev. Rul. 2008-25, the Service applied the step transaction doctrine to rule that a transaction structured as a section 368(a)(2)(E) tax-free reorganization followed by the liquidation of the target into the acquiring corporation did not qualify as a tax-free reorganization. Rather, the transaction was deemed to be a QSP followed by a section 332 liquidation. The step transaction doctrine did not, however, integrate the transactions into an asset purchase.

(i) Before the merger, the target corporation had $150x worth of assets and $50x of liabilities.

(ii) In the merger, the target corporation shareholders exchanged all of their target stock for $10x in cash and $90x in acquiring corporation stock.

(iii) The target corporation was not liquidated into the acquiring corporation through a statutory merger.

(g) Because the target corporation was completely liquidated, the safe harbor from the step transaction doctrine did not apply. See Treas. Reg. § 1.368-2(k).

(h) The transaction failed to qualify as a tax-free reorganization because the merger and liquidation were integrated.

(i) The transaction failed as a reverse subsidiary merger under 368(a)(2)(E) because the target corporation does not hold substantially all of its properties and the properties of the merged corporation after the transaction.

(ii) The transaction also fails as an “A,” “C,” or “D” reorganization and a section 351

exchange. For example, the transaction is not a "C" reorganization because the target shareholders received more boot than is allowed under the boot relaxation rule.

(i) The Service would not treat the transaction as integrated for the purposes of giving the acquiring corporation a cost basis in the target corporation's assets because such treatment would violate the policy under section 338 where no section 338 election was made. See Treas. Reg. § 1.338-3(d); Rev. Rul. 90-95.

5. Bootstrap purchases

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

b. The regulations resolve this issue and establish a clear rule for redemptions in connection with a QSP. Redemptions from unrelated persons generally count towards the QSP, while redemptions from persons related to P do not, except in limited circumstances. See Treas. Reg. § 1.338-3(b)(5).

c. Redemptions from persons unrelated to the purchasing corporation

(1) Redemptions of T stock from persons unrelated to P that occur during the 12-month acquisition period are taken into account in determining whether P has purchased, in the 12-month acquisition period, sufficient T stock to satisfy the ownership requirements of section 338(d)(3). Treas. Reg. § 1.338-3(b)(5)(ii).

(2) The regulations state no limit on the size of the redemption. Treas. Reg. § 1.338-3(b)(5)(ii).

(3) Example

(a) S owns all 100 shares of T Stock. P purchases 60 shares of T stock on January 1 of year 1. On July 1 of year 1, T redeems 25 shares from an S. P makes a QSP on July 1, even though no purchase occurs on that date, because that is the first day on which the T stock purchased by P within the 12-month period satisfies the 80-percent ownership requirement (i.e., 60/75 shares), determined by taking into account the

redemption of the 25 shares. See Treas. Reg. § 1.338-3(b)(5)(iv), Ex. 2.

d. Redemption from the purchasing corporation or related persons

(1) General rule

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

(2) Example

T redeems 30% of its stock from P (P's entire holding in T) on December 15 of Year 1 (such stock has been held by P for several years). On December 1 of Year 2, P purchases the remaining T stock from an unrelated party. There is no QSP. For purposes of the 80-percent ownership requirement, the redemption of P's T stock on December 15 of Year 1 is not taken into account as a reduction in T's outstanding stock. See. Treas. Reg. § 1.338-3(b)(5)(iv), Ex. 3.

(3) Exception

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

(4) Example

On January 1 of Year 1, P purchases 60 of the 100 shares of X stock. On that date, X owns 40 of the 100 shares of T stock. On April 1 of Year 1, T redeems X's T stock and P purchases the remaining 60 shares of T stock from an unrelated person. The redemption of the T stock from X (a person related to P) is taken into account as a reduction in T's outstanding stock. If P had purchased the 40 redeemed shares from X on April 1 of Year 1, all 40 of the shares would have been considered purchased during the 12-month period ending on April of Year 1 (24 of the 40 shares would

have been considered purchased by P on January 1 of Year 1 and the remaining 16 shares would have been considered purchased by P on April 1 of Year 1). See Treas. Reg. § 1.338-3(b)(3). Accordingly, P makes a QSP of T on April 1 of Year 1.See Treas. Reg. § 1.338-3(b)(5)(iv), Ex. 4.

6. Going Public: "Busted" 351 and QSPs

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

b. Example

(1) Facts: S owns all of the stock of T and wants to sell the T stock to the public. On January 1, Year 1, S contributes the T stock to Newco ("N") in exchange for N stock. At the time of the contribution, S has a binding commitment to sell 60% of the N stock to an underwriter who will sell the N stock in an initial public offering ("IPO"). On January 6, Year 1, the IPO closes.

(2) Analysis:

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

(b) An example in the final regulations makes clear that N's acquisition of the T stock is a purchase within the meaning of section 338(h)(3). See Treas. Reg. § 1.338-3(b)(3)(iv), Ex. 1.

(c) N's acquisition of the T stock is one of a series of transactions undertaken pursuant to an integrated plan. The series ends with the closing of the IPO and the transfer of all the shares of stock in accordance with agreements. Immediately after the last transaction, S owns less than 50% of N. Accordingly, the purchase should satisfy the unrelated party requirement of section 338(h)(3)(A)(iii). See Treas. Reg. § 1.338-3(b)(3)(iv), Ex. 1; see also PLR 9845012, revised in

PLR 199910033 (analyzing this issue in the context of the old regulations).

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

(e) Prior to the effective date of final Treas. Reg. § 1.197-2 (effective for property acquired after January 25, 2000 and by election for property acquired after August 10, 1993), it is possible that, even if S sells all the N stock, the anti-churning rules of section 197(f)(9) may apply to historically nonamortizable intangible assets (goodwill) in the hands of New T as a result of the momentary relationship between S, N and T.

(i) Section 197(f)(9) tests the relationship of the parties immediately before and immediately after the acquisition of the goodwill. The old section 197 proposed regulations provided that in the case of a series of related transactions, the relationship is tested at any time during the period beginning immediately before the earliest acquisition and immediately after the last acquisition. Old Prop. Treas. Reg. § 1.197-2(h)(6)(ii).

(ii) Accordingly, under the old proposed section 197 regulations, it was possible that the momentary relationship created during the qualified stock purchase could cause the anti-churning rules to apply to the transaction.

(iii) Under the final section 197 regulations, the anti-churning rules would not apply to the transaction since, in the case of a series of related transactions (or a series of transactions that together comprise a qualified stock purchase), the relationship between the parties is tested immediately before the earliest such transaction or immediately after the last such transaction. See Treas. Reg. § 1.197-2(h)(6)(ii).

(iv) A taxpayer could avoid this problem by electing to apply the final section 197 regulations to property acquired after August 10, 1993 (or July 25, 1991, if a valid retroactive election has been made under Temp. Treas. Reg. § 1.197-1T).

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

(g) Therefore, if N plans to sell stock in the transaction, and the parties want to make a section 338(h)(10) election, they should make sure that the transaction does not satisfy section 351 for another reason. See TAM 9747001 (concurrent offerings by S and N could cause section 351 to apply, but did not in the ruling because of S's pre-existing commitment to sell non-voting preferred stock).

c. GE's Supercharged IPO - PLR 200427011[1]

(1) Facts: General Electric ("GE") is the common parent of a group of corporations filing a consolidated return. GEFAHI, an indirect GE subsidiary, was a holding company for a group of corporations (the "purchased subs") which operated in the financial services and insurance industry. GE wanted to reduced its investment in the financial services and insurance business. Accordingly, it adopted a plan of divestiture and took the following steps: (a) GEFAHI created a new corporation Genworth Financial ("Genworth") to which it transferred the purchased subs in exchange for 100 percent of Genworth's common stock, 100 percent of a convertible debt instrument, Genworth's assumption of certain GEFAHI liabilities, and additional non-stock consideration; (b) GEFAHI entered into a firm commitment to sell more than 20 percent of the Genworth common stock and substantially all of the convertible debt instrument in an IPO; and (c) within a certain number of months, GEFAHI would make a second public offering, reducing its interest in Genworth to less than 50 percent.

(2) Analysis: The Service ruled that Genworth's acquisition of the purchased subs from GEFAHI would qualify as a QSP

[1] See Robert Willens, General Electric "Supercharges" the Genworth Financial IPO, 2004 TNT 154-37.

within the meaning of section 338(d)(3), thus making GE and Genworth eligible to make the section 338(h)(10) election.

(i) Thus, the Service implicitly ruled that, assuming GEFAHI completed the additional offerings and sales (thereby reducing its direct and indirect ownership of Genworth stock to below 50 percent), (i) GEFAHI would not have such a carryover basis in the stock of the target subsidiaries (i.e., in the absence of a section 338(h)(10) election, section 302(a) would apply to the deemed payment) and (ii) GEFAHI and Genworth would not be in a related party relationship at the time of the Exchange. See Treas. Reg. § 1.338-3(b)(3)(iv), Example 1.

7. Intragroup Section 338(h)(10) Election

a. Example

P is the common parent of the consolidated group. T operates Businesses A and B. T distributes Business B to P. P forms Newco and transfers the stock of T to Newco in exchange for Newco common and preferred stock. Pursuant to a binding obligation, P sells the Newco preferred stock to an unrelated third party. P distributes all of the Newco common stock to its public shareholders. P's shareholders sell their P stock to Buyer.

b. Analysis

Newco's acquisition of T is a qualified stock purchase under section 338(d)(3). P and Newco are permitted to make an election under section 338(h)(10) with respect to the retained Business A held by T. See PLR 201126003; see also PLRs 201228011, 201203004 and 201145007.

8. Section 304 and QSPs

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

a. Example

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

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

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

9. Reverse subsidiary mergers and QSPs

a. Fact pattern

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

b. Result

The existence of N is disregarded and P is considered to acquire the T stock directly from the T shareholders for cash. The transaction

will constitute a QSP of T. See Rev. Rul. 73-427; Rev. Rul. 90-95; Rev. Rul. 2008-25.

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

10. Circular ownership of T stock

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

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

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

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

11. Application of purchase rules to subsidiaries of T

a. Deemed purchase

If a section 338(h)(10) election is made for T, Old T is deemed to have sold its assets to New T. Under section 338(h)(3)(B), New T's deemed purchase of stock of another corporation is a purchase for purposes of section 338(d)(3). Since New T and P are members of the same affiliated group, P's acquisition of T and New T's acquisition of the stock of the T subsidiaries are treated as made by one corporation. Section 338(h)(8). Therefore, a section 338(h)(10) election can be made for T's subsidiaries. See Treas. Reg. § 1.338-3(b)(4).

b. Contemporaneous Sale of Affiliate Stock

(1) Former Temporary regulations

P makes a QSP of T on January 1 of Year 1 and makes a 338 election for T. On the same date, T sells all of the stock of T1 to an unrelated party. Although T held all of the T1 stock on T's acquisition date, T is not considered to have purchased the T1 stock by reason of the section 338 election for T. In order for T to be treated as purchasing the T1 stock, T must hold the T1 stock when T's deemed sale of assets occurs,

which is treated as the last transaction of old T at the close of T's acquisition date. Therefore, the T1 stock actually disposed of by T on the acquisition date is not included in the deemed sale of assets and T has not made a QSP as to T1. Temp. Treas. Reg. § 1.338-3T(b)(4)(ii), Ex. 2.

(2) Final Regulations

(a) The example in the temporary regulations (discussed above), which was removed in the final regulations, is no longer applicable because of Treas. Reg. § 1.338-1(d).

(b) Treas. Reg. § 1.338-1(d) provides that if a target corporation for which an election under section 338 is made engages in a transaction outside the ordinary course of business on the acquisition date after the event resulting in the QSP of the target or a higher tiered corporation, the target and all persons related thereto (either before or after the qualified stock purchase) under section 267(b) or section 707 must treat the transaction for all Federal income tax purposes as occurring at the beginning of the day following the transaction and after the deemed purchase by new target.

(c) In order for T to be treated as purchasing the T1 stock, T must hold the T1 stock when T's deemed sale of assets occurs. Under the "next-day" rule of Treas. Reg. § 1.338-1(d), New T is treated as selling the T1 stock at the beginning of the day following Old T's deemed sale of assets. Therefore, T is considered to have purchased the T1 stock by reason of the section 338 election for T.

(d) Query whether Treas. Reg. § 1.338-3(b)(1), which provides that a purchaser may be treated as not purchasing the stock of a target for Federal tax purposes if the purchaser disposes of the target stock following the purported qualified stock purchase, precludes a QSP of T1.

12. Effect of post-acquisition events

a. Post-acquisition elimination of T

(1) P may make a section 338(h)(10) election even though T is liquidated on or after the acquisition date. If T is liquidated

on the acquisition date, the liquidation is deemed to occur on the following day and immediately after New T's deemed purchase of assets. P may also make a section 338 election even though T is merged into another corporation, or otherwise disposed of by P provided that, under the facts and circumstances, P is considered for tax purposes as the purchaser of the T stock. Treas. Reg. § 1.338-3(c)(1).

(2) Example

On January 1 of Year 1, P makes a QSP of T. On that date, T owns the stock of T1. On March 1 of Year 1, T sells the T1 stock to an unrelated corporation ("X"). On April 1 of Year 1, P makes a section 338 election for T. Notwithstanding that the T1 stock was sold on March 1 of Year 1, the section 338 election for T on April 1 of Year 1, results in a qualified stock purchase by T of T1 on January 1 of Year 1. See Treas. Reg. § 1.338-3(c)(1), Ex. 2.

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

A. Joint Election Required

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

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

2. In the case of a target that is a nonconsolidated subsidiary, the selling affiliate; or

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

    a. Under the old regulations, it was not clear whether all S corporation shareholder must consent to the Section 338(h)(10) election, or merely those shareholders who sell stock in the QSP.

    b. Prior to their revision, the instructions to Form 8023 suggested that only S corporation shareholders who sell their stock in the QSP were required to consent to the section 338(h)(10) election (since only their signatures are required on the form).

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

d. The preamble to the final regulations provides that the Service will revise Form 8023 to make clear that nonselling S corporation shareholders must also sign Form 8023. The preamble also provides that the Service will recognize the validity of otherwise valid elections made on the current version of Form 8023 even if not signed by the nonselling shareholders, provided that the S corporation and all of its shareholders (including nonselling shareholders) report the tax consequences consistently with the results under section 338(h)(10).

e. Form 8023 has been revised, and the Instructions to Form 8023 now state: "If a section 338(h)(10) election is made for an S corporation, Form 8023 must be signed by each S corporation shareholder regardless of whether the shareholder sells his interest in target stock in the QSP."

B. Timing of Election

1. The section 338(h)(10) election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. Treas. Reg. § 1.338(h)(10)-1(c)(3).

2. Relief under Treas. Reg. §§ 301.9100-1 and 301.9100-3 may be available if these filing deadlines are missed. In general, a request for relief under Treas. Reg. § 1.301.9100-3 will be granted when the taxpayer provides evidence to establish that the taxpayer acted in good faith, and that granting relief will not prejudice the interests of the Government. See Treas. Reg. § 1.301.9100-3(a); See e.g., PLR 200546020; 200129034; 200128008; 200128012; 199934012; 9853027; 9852042.

3. The Service issued Rev. Proc. 2003-33, I.R.B. 2003-16, which grants certain taxpayers an automatic extension of time pursuant to Treas. Reg. § 301.9100-3 to file elections on Form 8023.

a. In order to obtain an automatic extension under Rev. Proc. 2003-33, the required filer or filers must file the Form 8023 no later than 12 months after the discovery of the failure to file the election.

b. In addition to filing the Form 8023 within the requisite time period, all required filers must attach to Form 8023 a single statement that conforms to the requirements of Section 5 of the Revenue Procedure. The statement must be filed by all required filers under penalties of perjury.

c. The following heading must appear at the top of the statement: "AUTOMATIC EXTENSION OF TIME TO FILE FORM 8023 FILED PURSUANT TO REV. PROC. 2003-33."

d. Rev. Proc. 2003-33 is generally effective for elections under section 338 that are filed after April 2, 2003 (other than elections filed pursuant to the terms of a letter ruling that was issued prior to April 2, 2003, or that is issued on or after April 2, 2003 in response to a ruling request filed on or before April 2, 2003).

4. Regardless of whether the election is timely filed or filed pursuant to Rev. Proc. 2003-33, Form 8023 must be filed with the Internal Revenue Service, Submission Processing Center. P.O. Box 9941, Mail Stop 4912, Ogden, UT 84409.

C. Other Rules

1. A section 338(h)(10) election is irrevocable. Treas. Reg. § 1.338(h)(10)-1(c)(3).

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

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

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

5. The consistency rules will most frequently apply in the context of section 338(h)(10) in a situation where a T subsidiary is purchased with a section 338(h)(10) election being made, and then, within a 12-month period, the same party acquires T itself. Under the consistency rules, P will have a carryover basis in the T subsidiaries assets unless P also makes a section 338(h)(10) election for the purchase of T. Treas. Reg. § 1.338-8. This rule makes sense since the T subsidiary's gain is taken into account in determining T's basis in the T subsidiary stock under Treas. Reg. § 1.1502-32.

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

D. Other Reporting Requirements

All of the reporting requirements for section 338(h)(10) transactions, including the revised Form 8023, Form 8883, and Forms 8806, 1096, and 1099-CAP (potentially required by the new temporary section 6043(c) regulations), are discussed in greater detail in section VI of this outline. See also Attachments A-E.[2]

1. With the release of new Form 8333 (Assets Allocation Statement Under Section 338) and the issuance of temporary regulations under section 6043(c) (Information Returns for Changes in Control and Recapitalization), Form 8023 is no longer the exclusive form to be filed concerning section 338 transactions.

2. In fact, section 338 transactions now entail the filing of at least two, and potentially five, different forms -- Forms 8883 and 8023, and potentially, Forms 8806, 1096, and 1099-CAP.

3. Form 8883 was released on January 21, 2002, see IRS Announcement 2003-2 (Jan. 21, 2003), and, as a result, Form 8023 has been revised; much of the information once required by Form 8023 is now required by Form 8883.

4. The target to a section 338 transaction may be required to file Forms 8806, 1096, and 1099-CAP. The target is required to file these additional Forms only if the provisions of new Temp. Treas. Reg. § 6043-4T apply to the section 338 transaction.

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

A. Background

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

1. The first alternative (called the "liquidation approach") views the section 338(h)(10) transaction as a sale of assets followed by the distribution of the proceeds in complete liquidation under section 332.

2. The second alternative (called the "termination approach") views the section 338(h)(10) transaction as a sale of T's assets with T thereafter simply terminating as it does in a regular section 338 transaction.

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[2] Attachment A is Form 8594. Attachment B is the new Form 8883. Attachment C is Form 8023. Attachment D is Form 8806. Attachment E is Forms 1096 and 1099-CAP.

3. The old regulations adopted the first alternative (the liquidation approach) and rejected the second alternative (the termination approach).

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

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

6. However, the final regulations do not mention the term "complete liquidation" but instead provide that Old T is treated as if it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and then ceased to exist. Treas. Reg. § 1.338(h)(10)-1(d)(4). The preamble to the proposed regulations explains that the term "complete liquidation" was not used because the drafters of the proposed regulations wanted to make it clear that the transaction following the deemed asset sale does not automatically qualify as a distribution in complete liquidation under either section 331 or 332.

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

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

B. Consequences to Old T and its Shareholders

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

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

a. Old T must recognize gain or loss as if, while a member of the selling consolidated group (or owned by the selling affiliate or S corporation shareholders), it transferred all of its assets to an unrelated person in exchange for consideration that includes the assumption of or taking subject to liabilities in a single taxable transaction at the close of the acquisition date (but before the deemed liquidation). See Treas. Reg. § 1.338(h)(10)-1(d)(3). Under the old regulations, T was treated as having sold its assets and distributed the proceeds of its assets in complete liquidation. See Old Treas. Reg. § 1.338(h)(10)-1(e)(2) See Part V.C., below for the determination of the deemed sale price.

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

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

(a) However, New T remains liable for the tax liabilities of Old T (including the tax liability for the deemed sale tax consequences). For example, New T remains liable for the tax liabilities of members of any consolidated group that are attributable to taxable years in which those corporations and Old T joined in the same consolidated return. See Treas. Reg. § 1.1502-6(a); Treas. Reg. § 1.338(h)(10)-1(d)(2).

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

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

c. Consequence if T is a member of an affiliated nonconsolidated group

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

(2) The final regulations provide that Old T's tax liability incurred on its deemed asset sale is deemed assumed by New T unless the parties have agreed (or the tax or non-tax rules operate such that) the seller, and not T, will bear the

economic cost of that tax liability. See Treas. Reg. § 1.338-4(d).

d. Consequence if T is an S corporation

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

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

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

(4) If any section 1374 tax is triggered by the deemed asset sale, that tax liability remains with New T.

(5) The final regulations provide that when T is an S corporation, T's S election continues in effect through the close of the acquisition date (including the time of the deemed asset sale and the deemed liquidation) notwithstanding section 1362(d)(2)(B).

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

2. Consequence of sale of T stock

No gain or loss is recognized on the sale or exchange by the selling consolidated group (or the selling affiliate or an S corporation shareholder) of T stock included in the QSP. See Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii) and old Treas. Reg. § 1.338(h)(10)-1(d)(2)(iv).

3. Deemed liquidation

a. In general

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

b. The final regulations do not mention the term "complete liquidation" but instead provide that Old T is treated as if it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and then ceased to exist. Treas. Reg. § 1.338(h)(10)-1(d)(4). The new temporary regulations provide that this transfer is treated for Federal income tax purposes as if it had actually occurred, taking into account surrounding transactions that actually or are deemed to occur. Treas. Reg. § 1.338(h)(10)-1(d)(4), (d)(5).

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

(1) Under the old regulations, the deemed liquidation is governed by section 332.

(a) Do not recognize gain or loss.

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

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

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

accounts as such amounts are eliminated. See Treas. Reg. § 1.1502-19(c).

(3) As indicated above, under the final regulations, this transfer is treated for Federal income tax purposes as if it had actually occurred, taking into account surrounding transactions that actually or are deemed to occur. Treas. Reg. § 1.338(h)(10)-1(d)(4), (d)(5). Thus, the transfer could be a section 332 liquidation, or it could be a distribution pursuant to a plan of reorganization, a distribution in redemption, or another type of transaction.

d. Consequence if T is an S corporation

(1) Under the old regulations, the deemed liquidation is governed by section 331.

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

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

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

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

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

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

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

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

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

(4) As indicated above, under the final regulations, this transfer is treated for Federal income tax purposes as if it had actually occurred, taking into account surrounding transactions that actually or are deemed to occur. Treas. Reg. § 1.338(h)(10)-1(d)(4), (d)(5).

e. Other issues under the old regulations

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

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

4. Effect on minority shareholders

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

(1) The minority shareholders of T who do not sell or exchange their stock do not recognize gain or loss and retain their existing basis and holding period in T stock even though there is a deemed liquidation of T in the section 338(h)(10) transaction. See Treas. Reg. § 1.338(h)(10)-1(d)(6) and old Treas. Reg. § 1.338(h)(10)-1(e)(3)(iii).

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

b. If T is an S corporation

The nonselling T shareholders take into account their share of T's deemed asset sale gain or loss under sections 1366 and 1367, recognize gain or loss on T's deemed liquidation under section 331, and obtain a basis in their retained shares of T (now a C corporation) equal to FMV determined by applying the ADSP formula (MADSP under the old regulations), described below at Part V.C. See Treas. Reg. § 1.338(h)(10)-1(d)(5) and old Treas. Reg. § 1.338(h)(10)-1(e).

5. Shares retained by the selling parent

To the extent the selling consolidated group or selling affiliate do not sell or exchange all of its T stock, no gain or loss is recognized on such stock, but holders of the retained stock receive a basis in the stock equal to the net FMV of the portion of New T's assets that such members would have received if T had actually been liquidated at the beginning of the day after the acquisition date. See Treas. Reg. § 1.338(h)(10)-1(d)(5)(ii) and old Treas. Reg. § 1.338(h)(10)-1(e)(2)(iii).

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

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

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

C. Deemed Sale Price

1. Under the final regulations

a. Background

The final regulations use a different computation for sale price than the old regulations. The final regulations use the calculation for "aggregate deemed sales price" or "ADSP" generally applicable to section 338 transactions to determine sale price for purposes of section 338(h)(10).

b. ADSP formula

Treas. Reg. § 1.338-4(b)(1) provides that the deemed sale price of each asset is calculated by determining the ADSP and then allocating the ADSP among Old T's assets in accordance with Treas. Reg. §§ 1.338-6 and 1.338-7. ADSP is the sum of:

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

(2) the liabilities of Old T.

c. Time and amount of ADSP

(1) Original determination

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

(2) Redetermination of ADSP

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

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

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

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

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

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

e. Liabilities of Old T

(1) The liabilities of Old T are the liabilities of T (and the liabilities to which T's assets are subject) as of the beginning of the day after the acquisition date (other than liabilities that were neither liabilities of Old T nor liabilities to which Old T's assets were subject). Treas. Reg. § 1.338-4(d)(1).

(2) In order to be taken into account in ADSP, a liability must be a liability of T that is properly taken into account in amount realized under general principles of tax law that would apply if Old T had sold its assets to an unrelated person for consideration that included the person's assumption of, or taking subject to, the liability. Id.

(3) Such liabilities may include liabilities for the tax consequences resulting from the deemed sale.

(4) The time for taking into account liabilities of Old T in determining ADSP and the amount of liabilities taken into account is determined as if Old T had sold its assets to an unrelated person for consideration that included the discharge of the liabilities by the unrelated person. Treas. Reg. § 1.338-4(d)(2).

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

2. Under the old regulations

MADSP formula

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

a. The MADSP formula is:

MADSP = G + L + X

G = grossed-up basis of P's recently purchased T stock

L = liabilities of New T as of the beginning of the day after the acquisition date

X = other relevant items

Old Treas. Reg. § 1.338(h)(10)-1(f)(2).

b. Definitions

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

(2) Nonrecently purchased stock -- any T stock which is held by P on the acquisition date and which was not purchased by such corporation during the 12-month acquisition period. Section 338(b)(6)(B).

c. Grossed-up basis is determined as described below:

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

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

d. Liabilities

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

(2) Liabilities do not include the tax liability resulting from the deemed sale imposed on Old T. Old Treas. Reg. § 1.338(h)(10)-1(g). This is appropriate in situations where

Old T was a member of a consolidated group because the selling group, and not P, is liable for the tax. However, if Old T was an affiliated nonconsolidated corporation, this result is inappropriate because New T remains liable for the tax liability and therefore should be able to include it in its basis.

e. Other relevant items include:

(1) Reductions for P's acquisition costs incurred in connection with the qualified stock purchase that are capitalized in the basis of recently purchased T stock (e.g., brokerage commissions and any similar costs incurred by P to acquire T stock); and

(2) Reductions for selling costs of the selling consolidated group (or selling affiliate or S corporation shareholders) incurred in connection with the qualified stock purchase that reduce the amount realized on the sale of recently purchased T stock (e.g., brokerage commissions and any similar costs incurred by the selling group to sell T stock).

Old Treas. Reg. § 1.338(h)(10)-1(f)(4).

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

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

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

3. Subsequent adjustments to MADSP

a. Subsequent adjustments may affect the price at which Old T was deemed to sell its assets. To the extent general tax law principles would require a seller in an asset sale to account for subsequent adjustments, T (or a member of the selling consolidated group in the event of an election under section 338(h)(10)) must take into account such subsequent adjustments in reporting income, loss, or other amounts. Old Temp. Treas. Reg. § 1.338(b)-3T(h)(1)(i).

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

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

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

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

4. Comparison of MADSP under the old regulations and ADSP under the final regulations.

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

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

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

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

D. Consequences to New T and its Purchaser

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

Except as provided in regulations, T is treated as a new corporation ("New T"), unrelated to Old T, for purposes of Subtitle A of the Code. See Treas. Reg. § 1.338-1(b)(1) and old Treas. Reg. § 1.338-2(d).

a. New T is not considered to be related to Old T for purposes of section 168 and may make new elections under section 168 without taking into account elections made by Old T. Id.

b. New T may adopt a new tax year, without obtaining prior approval from the Commissioner, under section 441, a new method of accounting under section 446 and may make new elections for depreciation under section 168. Id.

c. New T is generally not related to Old T for purposes of the section 197 anti-churning rules. See Treas. Reg. § 1.197-2(h)(8).

d. Exceptions

New T and Old T are treated as the same corporation for certain purposes including:

(1) The rules applicable to employee benefit plans;

(2) Section 108(e)(5) (relating to the reduction of purchase money debt);

(3) Certain tax credits;

(4) Any other provision designated by the Service.

See Treas. Reg. § 1.338-1(b)(2) and old Treas. Reg. § 1.338-2(d).

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

a. New T remains liable for the tax liabilities of Old T (including tax liabilities resulting from the deemed sale of assets). For example, New T remains liable for the tax liabilities of the members of any consolidated group that are attributable to taxable years in which those corporations and Old T joined in the same consolidated return. See Treas. Reg. § 1.338-1(b)(3)(i), old Treas. Reg. § 1.338(h)(10)-1(e)(5), and Treas. Reg. § 1.1502-6(a).

b. Wages earned by employees of Old T are considered wages earned by such employees from New T for purposes of sections 3101, 3111, and 3301. See Treas. Reg. § 1.338-1(b)(3)(ii) and old Treas. Reg. §.1.338-2(d)(4)(ii).

c. New T must keep the same EIN as Old T. See Treas. Reg. § 1.338-1(b)(3)(iii) and old Treas. Reg.§.1.338-2(d)(4)(iii).

3. Under the final regulations, New T is treated as acquiring all of its assets from an unrelated person in exchange for consideration that includes the assumption of, or taking subject to, liabilities. Treas. Reg. § 1.338-1(a)(1).

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

5. If P owns shares of nonrecently purchased stock (e.g., stock acquired more than one year before the QSP), it is deemed to have made a gain recognition election with respect to such shares. See Treas. Reg. § 1.338(h)(10)-1(d)(1) and old Treas. Reg. § 1.338(h)(10)-1(e)(4). The effect of a gain recognition election includes a taxable deemed sale by P on the acquisition date of any nonrecently purchased T stock. Id.; see Treas. Reg. § 1.338-5(d). To this extent, a section 338(h)(10) election produces two levels of tax, see Part V.E.3., below.

E. Purchase Price in Deemed Sale Transaction

1. Under the final regulations

a. Determination of AGUB

AGUB is the sum of:

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

(2) P's basis in P's nonrecently purchased T stock; and

(3) the liabilities of New T. Treas. Reg. § 1.338-5(b)(1).

b. Time and amount of AGUB

(1) Original determination

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

(2) Redetermination of AGUB

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

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

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

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

(2) Multiplied by a fraction, the numerator of which is 100 percent minus the percentage of T stock (by value, determined on the acquisition date) attributable to P's nonrecently purchased T stock, and the denominator of which is the percentage of T stock (by value, determined on the acquisition date) attributable to P's recently purchased T stock.

(3) Plus the acquisition costs the purchasing corporation incurred in connection with its purchase of the recently purchased stock that are capitalized in the basis of such stock. Treas. Reg. § 1.338-5(c).

(a) On December 19, 2002, the Service issued a Notice of Proposed Rulemaking, Reg. 125638-1 (December 19, 2002), proposing regulations (the "Proposed section 263(a) Regulations") that provide rules for determining the extent to which taxpayers must capitalize transaction costs that facilitate the acquisition, creation, or enhancement of intangible assets. Prop. Treas. Reg. §§ 1.263(a)-4(b)(ii), -4(e).

These regulations were finalized December 31, 2003. T.D. 9107. [3]

(b) An amount is paid to "facilitate" a transaction if that amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. An amount paid to determine the value or price of a transaction is an amount paid in the process of investigating or otherwise pursuing the transaction. An amount paid to another party in exchange for tangible or intangible property is not an amount paid to facilitate the exchange. Treas. Reg. § 1.263(a)-5(b)(1).

(c) The Preamble to the Proposed section 263(a) regulations clarified that the facilitate standard is intended to create a "bright line" rule, which is narrower in scope than a "but-for" standard and more definitive than the "whether and which" test of Revenue Ruling 99-23, 1999-1 C.B. 998.

(d) A modified version of this "bright line" rule was retained under the final regulations in addition to an "inherently facilitative" rule. Treas. Reg. § 1.263(a)-5(e).

(e) Thus, an amount paid in the process of investigating or pursuing a transaction facilitates that transaction (and must be capitalized), only if:

(i) The payment relates to activities that are performed on or after the earlier of:

[3] The section 263(a) Regulations also provide rules for the treatment of amounts incurred to acquire, create, or enhance intangible assets and amounts incurred to facilitate certain restructurings, reorganizations, and transactions involving the acquisition of capital; however, these rules are generally outside the scope of this outline and are not discussed herein. The section 263(a) Regulations are generally effective for amounts paid or incurred on or after December 31, 2003. T.D. 9107.

(a) The date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by the acquirer and target; or

(b) The date on which the material terms of the transactions, as tentatively agreed to, are authorized or approved by the board of directors (or other appropriate non corporate governing authority). Treas. Reg. § 1.263(a)-5(e)(1)(i)-(ii); or

(ii) The payment relates to activities that are "inherently facilitative," regardless of whether the amount paid is for activities performed prior to the date determined under the "bright line rule" above. Treas. Reg. § 1.263(a)-5(e)(2). "Inherently facilitative" activities include:

(a) Securing an appraisal, formal written evaluation, or fairness opinion;

(b) Structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure;

(c) Preparing and reviewing the documents that effectuate the transaction;

(d) Obtaining regulatory approval of the transaction;

(e) Obtaining shareholder approval of the transaction; or

(f) Conveying property between parties to the transaction. Treas. Reg. § 1.263(a)-5(e)(2)(i)-(vi).

(f) The section 263(a) Regulations provide that the following costs are <u>not</u> costs incurred to facilitate a transaction, unless the taxpayer elects to treat them as such:

(i) Integration costs (i.e. amounts paid to integrate the businesses of the acquirer and target). Treas. Reg. § 1.263(a)-5(c)(6);

(ii) Employee compensation;

(iii) Overhead; and

(iv) De minimis costs (defined as amounts that, in the aggregate, do not exceed $5,000). Treas. Reg. § 1.263(a)-5(d).

d. Liabilities of New T

(1) The liabilities of New T are the liabilities of T (and the liabilities to which T's assets are subject) as of the beginning of the day after the acquisition date (other than liabilities that were neither liabilities of Old T nor liabilities to which Old T's assets were subject). Treas. Reg. § 1.338-5(e).

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

(3) The time for taking into account liabilities of Old T in determining AGUB and the amount of the liabilities taken into account is determined as if New T had acquired its assets from an unrelated person for consideration that included the discharge of its liabilities. Treas. Reg. § 1.338-5(e)(2).

2. Under the old regulations

AGUB

New T's basis in its assets is determined pursuant to regulations as its "adjusted grossed-up basis" ("AGUB"). Old Temp. Treas. Reg. §§ 1.338(h)(10)-1T(d)(2) and 1.338-5T.

a. Determination of AGUB

AGUB is the sum of:

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

(2) P's basis in "nonrecently purchased" T stock, and

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

Old Temp. Treas. Reg. § 1.338-5T.

b. This aggregate amount is then allocated among New T's assets in accordance with old Temp. Treas. Reg. §§ 1.338-6T, -7T.

(1) Subsequent adjustments (including contingent payments and liabilities, and reductions in payments and liabilities) are taken into account for basis purposes when they become fixed and determinable (or when the reduction occurs) and are allocated among New T's assets held on the acquisition date in accordance with the rules described at Part V.H., below.

(2) However, adjustment events that occur during New T's first taxable year are taken into account for purposes of determining AGUB and basis of T's assets as if they had occurred at the beginning of the day after the acquisition date.

3. Grossed-Up Basis

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

(1) Recently purchased stock

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

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

(b) Where T only has one class of outstanding stock, P's grossed up basis per share in the recently purchased stock of T reflects the total price that would have been paid for all of the T stock (other than any

nonrecently purchased stock) -- i.e., it will be equal to the average price per share paid by P times the number of shares outstanding (other than nonrecently purchased shares).

(c) Example

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

$$\$900 \times \frac{100\%}{90\%} = \$1000$$

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

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

(2) Treatment of nonrecently purchased stock

(a) Mandatory gain recognition election

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

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

following formula:

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

Example

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

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

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

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

$$\$9 \text{ million} \times \frac{10\%}{100\% - 10\%} = \$1 \text{ million}$$

P will recognize gain of $800,000. The amount the new basis of the nonrecently purchased stock ($1,000,000) exceeds the old basis of the nonrecently purchased stock = $800,000.

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

(b) Effect of election

The effect of this formula is to step-up the basis of the nonrecently purchased stock to an amount equal to the basis it would have if it were recently purchased stock. Once T makes the deemed election, the grossed-up basis is the same as the grossed-up basis of the stock for purposes of applying the MADSP formula. See Part V.C.2.c., above. Old Treas. Reg. § 1.338(b)-1(e)(4).

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

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

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

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

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

5. Other relevant items

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

   a. Subsequent adjustments

      Old Treas. Reg. § 1.338(b)-1(g)(1) provides that increases (or

decreases) due to adjustment events that occur after the close of New T's first taxable year are treated for this purpose as "other relevant items." See Part V.E.5., below.

b. Adjustments by the Service

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

c. Flow-through of relevant item adjustment to subsidiary

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

6. Subsequent adjustments to AGUB

a. General

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

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

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

(3) reductions in the amounts paid for recently or nonrecently purchased stock; and

(4) reductions in liabilities of T (and liabilities to which its assets are subject) that were taken into account in determining adjusted grossed-up basis.

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

b. Contingent purchase price

Contingent purchase price that is not fixed and determinable by the close of New T's first taxable year is taken into account as an

increase in AGUB (and in the bases of T's assets) when the payment becomes fixed and determinable. Old Temp. Treas. Reg. § 1.338(b)-3T(c)(1).

c. Contingent liabilities

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

d. Reductions of purchase price

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

e. Reductions of target's liabilities

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

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

f. Amount of increase or decrease in AGUB

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

g. Allocation of increases in AGUB

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

h. Disposition or depreciation of acquisition date assets

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

i. Allocation of decreases in AGUB

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

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

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

j. Special rule for allocation of increases (or decreases) to specific assets

Old Temp. Treas. Reg. § 1.338(b)-3T(g) provides a special rule for specifically allocating amounts of contingent payments to the basis of certain assets where the contingency directly relates to the income produced by a particular intangible asset (i.e., a "contingent income

asset" such as a patent, copyright, or secret process) and not to other T assets. Old Temp. Treas. Reg. § 1.338(b)-3T(g)(1)(i).

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

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

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

(2) The amounts allocated to the contingent income asset are expressly subject to the FMV limitation and other limitations contained in Old Temp. Treas. Reg. § 1.338(b)-2T(c)(1) and (2).

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

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

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

k. Comparison of AGUB under the old regulations and AGUB under the final regulations

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

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

F. Determination of ADSP and AGUB -- Examples

In each of the examples assume that the final regulations apply.

1. Example 1: Simple transaction

a. S owns all of the stock of T, and S and T file a consolidated return. On March 1, S sells its T stock to P for $80,000, and a section 338(h)(10) election is made for T. On March 1, T owns land with a $50,000 basis and $75,000 fair market value and equipment with a $30,000 adjusted basis, and $60,000 fair market value. T also has a $40,000 liability.

b. The ADSP is $120,000 ($80,000 + $40,000 + 0). As explained in Part V.H., below, since both assets are of the same class, the ADSP will be allocated to the assets based on their relative FMV, therefore ADSP will allocated to each asset as follows:

Assets	Basis	FMV	Fraction	Allocable ADSP
Land	50,000	75,000	5/9	66,677
Equipment	30,000	60,000	4/9	53,333
Total	80,000	135,000	1	120,000

Under Treas. Reg. § 1.338(h)(10)-1(d)(3), Old T has gain on the deemed sale of $40,000 (consisting of $16,667 of capital gain and $23,333 of ordinary income attributable to depreciation recapture).

c. Under Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii), S does not recognize gain or loss upon its sale of the Old T stock to P. S also does not recognize gain or loss upon the deemed liquidation of T. See Treas. Reg. § 1.338(h)(10)-1(d)(4) and section 332.

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

e. Under Treas. Reg. § 1.338-5, the AGUB for New T is $120,000, i.e., P's cost for the Old T stock ($80,000) plus T's liability ($40,000). This AGUB is allocated as basis among the New T assets under Treas. Reg. §§ 1.338-6 and 1.338-7.

f. See Treas. Reg. § 1.338(h)(10)-1(e), Ex. 5.

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

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

b. The consequences to P, T, and S are the same as in Example 1, except that:

(1) P's basis for its 80-percent interest in the New T stock is P's $64,000 cost for the stock.

(2) Under Treas. Reg. § 1.338-5, the AGUB for New T is $120,000. The calculation is as follows:

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

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

$$\$80{,}000 + \$40{,}000 = \$120{,}000$$

(3) Under Treas. Reg. § 1.338(h)(10)-1(d)(4), S does not recognize gain or loss with respect to the retained stock in T.

(4) Under Treas. Reg. § 1.338(h)(10)-1(d)(5)(ii), the basis of the T stock retained by S is $16,000 (i.e., $120,000 - $40,000 (the ADSP amount for the Old T assets over the sum of New T's liabilities immediately after the acquisition date) x .20 (the proportion of T stock retained by S)).

(5) See Treas. Reg. § 1.338(h)(10)-1(e), Ex. 6.

3. Example 3: Unrelated shareholder

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

b. The consequences to P, T, and S are the same as in Example 2.

c. Under Treas. Reg. § 1.338(h)(10)-1(d)(6)(iii), K recognizes no gain or loss, and K's basis in its T stock remains at $5,000.

d. See Treas. Reg. § 1.338(h)(10)-1(e), Ex. 7.

4. Example 4: Target affiliate

a. The facts are the same as in Example 1, except that the land is held by T and the equipment is held by T1, a wholly owned subsidiary of T. Section 338(h)(10) elections are made for both T and T1. The T1 stock has a fair market value of $60,000. T1 has no assets other than the equipment and no liabilities. S pays Old T's and Old T1's allocable share of the selling group's consolidated tax liability for the tax year of the sale, including the tax liability for T and T1's deemed sale gain.

b. The ADSP for T is $120,000, allocated $66,667 to the land and $53,333 to the T1 stock. Old T's deemed sale gain is $16,667 (the capital gain on its deemed sale of the land). Under Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii), Old T does not recognize gain or loss on its deemed sale of the T1 stock.

c. The ADSP for T1 is $53,333 (i.e., $53,333 + $0 + $0). On the deemed sale, T1 recognizes ordinary income of $23,333.

d. Under Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii), S does not recognize gain or loss upon its sale of the Old T stock to P.

e. See Treas. Reg. § 1.338(h)(10)-1(e), Ex. 8.

G. Effect of Section 197

1. In general

   a. Section 197 governs the tax treatment of acquired intangible assets and allows a 15-year amortization period for any "amortizable section 197 intangible" that (i) is acquired after August 10, 1993, and (ii) "is held in connection with the conduct of a trade or business or any activity described in section 212." Section 197(c)(1).

   b. Regulations under section 197 were proposed on January 16, 1997 (REG-209709-94), and finalized on January 25, 2000 (T.D. 8865). The final regulations generally apply to property acquired after January 25, 2000. A taxpayer may choose, on a transaction-by-transaction basis, to apply the final regulations to property acquired after August 10, 1993 (or July 25, 1991, if a valid retoractive election has been made under Temp. Treas. Reg. § 1.197-1T). Treas. Reg. § 1.197-2(l)(2).

2. Amortizable section 197 intangible

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

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

      (2) held in connection with the conduct of a trade or business or an activity described in section 212. See Treas. Reg. § 1.197-2(d)(1).

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

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

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

(3) A qualified stock purchase treated as an asset purchase under section 338(h)(10) constitutes the acquisition of a trade or business or a substantial portion thereof only if the direct acquisition of the assets of the corporation would have been treated as the acquisition of assets constituting a trade or business or a substantial portion thereof. Treas. Reg. § 1.197-2(e)(5).

(4) Whether acquired assets constitute a "substantial portion" of a trade or business is based on all the relevant facts and circumstances. Treas. Reg. § 1.197-2(e)(4).

c. A "section 197 intangible"

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

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

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

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

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

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

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

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

(3) Section 1060 applies to any "applicable asset acquisition."

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

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

e. Anti-churning rules

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

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

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

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

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

(5) The final regulations provide that the relationship is tested:

(a) In the case of a single transaction, immediately before or immediately after the transaction in which the intangible is acquired; and

(b) In the case of a series of related transactions (or a series of transactions that together comprise a qualified stock purchase), immediately before the earliest such transaction or immediately after the last such transaction. Treas. Reg. § 1.197-2(h)(6)(ii).

(6) The old proposed regulations provided that, in the case or a series of related transactions, the relationship is tested at any time during the period beginning immediately before the earliest acquisition and immediately after the last acquisition. Old Prop. Treas. Reg. § 1.197-2(h)(6)(ii). Under the proposed regulations it was possible that a momentary relationship created during a qualified stock purchase could cause the anti-churning rules to apply to the transaction.

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

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

(c) Under the final regulations, the momentary relationship of P and T will be ignored since P and T

are not related immediately before the first transaction or immediately after the last transaction. See Treas. Reg. § 1.197-2(h)(6)(ii).

(7) In a section 338(h)(10) transaction, New T is generally not related to Old T for purposes of the section 197 anti-churning rules. See Treas. Reg. § 1.197-2(h)(8).

f. Recent Developments -- Assumption Reinsurance

(1) On March 8, 2002, the IRS published proposed regulations under section 197 that are intended to provide guidance concerning the treatment under section 197 of insurance contracts acquired through reinsurance transactions. See generally Prop. Treas. Reg. § 1.197-2(g)(5). These regulations were finalized, with certain amendments, on April 7, 2006. See generally Treas. Reg. § 1.197-2(g)(5).

(2) The final regulations:

(a) Clarify that section 197(f)(5) determines the basis of an amortizable section 197 intangible asset with respect to insurance contracts acquired in assumption reinsurance transactions governed by section 338 or 1060;

(b) Provide guidance concerning the amount required to be capitalized under section 848 in connection with assumption reinsurance transactions;

(c) Provide specific guidance regarding when recovery of basis is allowed with respect to a section 197(f)(5) intangible in the context of an indemnity reinsurance transaction; and

(d) Provide rules governing the amount of loss recognized on the disposition of a section 197(f)(5) intangible.

H. Allocation of Purchase Price Among T's Assets

1. In general

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

b. In January 1986, Treasury issued temporary and proposed regulations governing basis allocation under section 338(b). Old Temp. Treas. Reg. §§ 1.338(b) -1T, -2T, -3T. These regulations were amended in January 1994 and again in January 1997. See T.D. 8711 (January 12, 1994) and T.D. 8711 (January 9, 1997). New temporary regulations were issued on January 5, 2000 and apply to qualified stock purchases occurring after January 5, 2000 but before March 16, 2001. These temporary regulations were replaced by final regulations issued February 12, 2001. The final regulations apply to qualified stock purchases occurring on or after March 16, 2001.

2. Method of allocation

a. For asset acquisitions on or after March 16, 2001, Treas. Reg. § 1.338-6(b) provides that basis is allocated to seven asset classes in the following order:

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

(2) Class II -- actively traded personal property within the meaning of section 1092(d)(1) and Treas. Reg. § 1.1092(d)-1 (determined without regard to 1092(d)(3)). In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Class II assets do not include stock of target affiliates, whether or not of a class that is actively traded, other than actively traded stock described in section 1504(a)(4). Examples of Class II assets include U.S. government securities and publicly traded stock.

(3) Class III -- assets that the taxpayer marks to market at least annually for Federal income tax purposes and debt instruments (including accounts receivable). However, Class III assets do not include --

(a) Debt instruments issued by persons related at the beginning of the day following the acquisition date to the target under section 267(b) or 707;

(b) Contingent debt instruments subject to Treas. Reg. § 1.1275-4, Treas. Reg. § 1.483-4, or section 988,

unless the instrument is subject to the non-contingent bond method of Treas. Reg. § 1.1275-4(b) or is described in Treas. Reg. § 1.988-2(b)(2)(i)(B)(2); and

(c) Debt instruments convertible into the stock of the issuer or other property.

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

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

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

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

b. For asset acquisitions completed after January 5, 2000, and before March 16, 2001, basis is allocated to the seven asset classes in the same manner as described above, except Class II and Class III assets are defined as follows under the temporary regulations:

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

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

c. For asset acquisitions completed on or after February 14, 1997 and on or before January 5, 2000, old Temp. Treas. Reg. § 1.338(b)-2T provides for basis allocation in the following order:

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

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

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

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

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

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

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

(1) the allocation method applicable to asset acquisitions completed on or after February 14, 1997 and on or before January 5, 2000;

(2) the allocation method in place before the 1997 amendment; or

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

f. The allocation to assets within a class of assets is made based on the relative FMV of such assets. The FMV of an asset is the gross fair market value of the asset (i.e., fair market value determined without regard to mortgages, liens, pledges, or other liabilities). Treas. Reg. § 1.338-6(a)(2).

(1) The temporary regulations provide that the Service can make an independent showing of the value of goodwill and going concern value as a means of calling into question the valuation of target's other assets.

(2) The final regulations delete this sentence about valuing goodwill and going concern value. The preamble to the final regulations explains that the sentence was deleted because the Service recognized that under the residual approach low (or no) allocation to goodwill and going concern value may result from causes other than a taxpayer's overvaluation of assets in higher classes. However, the preamble also provides that the Service retains the ability to challenge a taxpayer's valuation of assets in Classes I through VI, but will do so on grounds consistent with the residual method of allocation.

(3) Under the final regulations, the Service may challenge a taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties. Treas. Reg. § 1.338-6(a)(2)(iii).

g. All of the allocations are subject to the limitation that the basis allocated to each asset cannot exceed its FMV and any other limitation imposed on an acquisition of assets from an unrelated person (e.g., section 1056, relating to basis limitation on player contracts transferred in connection with a sale of a franchise). Treas. Reg. § 1.338-6(c)(2).

h. Any excess over FMV is allocated to the next seriatim class of assets, with any residual excess allocated to "intangible assets in the nature of goodwill and going concern value." Treas. Reg. § 1.338-6(b)(2).

3. Specific lien rule

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

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

b. Generally, the specific lien rule could result in significant distortion in allocating basis that was exacerbated by appropriate taxpayer planning. In order to allocate basis to particular depreciable assets, a taxpayer could incur indebtedness by pledging a particular asset prior to an acquisition. Allocating basis to a particular asset merely

because it was pledged to obtain a debt arguably violated the spirit of the group asset purchase rules which allocate basis among all of the assets acquired based upon their relative FMVs ("pro rata rule").

4. Application to subsidiaries

a. This allocation method also applies to subsidiaries of T, treating the stock of a subsidiary as a Class V asset. See Treas. Reg. § 1.338-6(d), Exs. 1 and 2.

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

5. Adoption of the residual approach -- policy overview

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

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

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

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

(3) The mandatory adoption of the residual approach cuts two ways. In the case of a bargain purchase, taxpayers are generally benefited by not having to allocate basis to goodwill and going concern value (although since the enactment of section 197, this is of less importance). On the other hand, in the case of a premium purchase, more basis

may be allocated to goodwill and going concern value than under the formula approach. Nonetheless, the policy in the regulations is clearly not to allow basis in an asset in excess of its FMV. While this places a great deal of pressure on valuations, there is no way to avoid such pressure completely. See A.P.B. Opinions Nos. 16 and 17, "Business Combinations" and "Intangible Assets," effective Nov. 1, 1970.

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

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

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

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

Asset	FMV
Cash	$1,000
U.S Gov't Securities	$2,000
Inventory	$2,000
Equipment	$3,000
Goodwill and Going Concern	$2,000
Total	$10,000

In addition, T has liabilities of $5,000. On or after March 16, 2001 (the effective date of the final regulations), P purchases all of the stock of T from S for $5,000 and the assumption of T's liabilities.

The AGUB is $10,000, representing the grossed-up basis of the T stock

($5,000) + liabilities of New T ($5,000). Basis is allocated to T's assets using the residual approach of Treas. Reg. § 1.338-6. Basis is allocated first to Class I assets up to their FMV, and then to each following class up to its FMV, with any remaining basis allocated to Class VII assets. Therefore, basis would be allocated as described below:

Result under the final regulations

Asset	Class	FMV	Basis
Cash	I	$1,000	$1,000
U.S Gov't Securities	II	$2,000	$2,000
Inventory	IV	$2,000	$2,000
Equipment	IV	$3,000	$3,000
Goodwill & Going Concern	VII	$2,000	$2,000
Total		$10,000	$10,000

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

Result under the old regulations

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

7. Example 2 -- Premium purchase

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

Result under the final regulations

Asset	Class	FMV	Basis
Cash	I	$1,000	$1,000
U.S Gov't Securities	II	$2,000	$2,000
Inventory	IV	$2,000	$2,000
Equipment	IV	$3,000	$3,000
Goodwill & Going Concern	VII	$2,000	$7,000

Total	$10,000	$15,000

Result under the old regulations

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

8. Example 3 -- Bargain purchase

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

Result under the final regulations

Asset	Class	FMV	Basis
Cash	I	$1,000	$1,000
U.S Gov't Securities	II	$2,000	$2,000
Inventory	IV	$2,000	$2,000
Equipment	V	$3,000	$1,000
Goodwill & Going Concern	VII	$2,000	$0
Total		$10,000	$6,000

Because the purchase was a bargain purchase, all assets do not receive basis equal to their FMV. The Class I, II, and IV assets are assigned basis up to their FMV. The only Class V asset, Equipment is allocated the remaining $1,000 basis. No amount is allocated to goodwill and going concern value.

Result under the old regulations

Asset	Class	FMV	Basis
Cash	I	$1,000	$1,000
U.S Gov't Securities	II	$2,000	$2,000
Inventory	III	$2,000	$1,200
Equipment	III	$3,000	$1,800
Goodwill & Going Concern	V	$2,000	$0
Total		$10,000	$6,000

The results are quite different under the old regulations. As under the final regulations, the Class I and II assets are assigned basis up to their FMV. However, since both equipment and inventory are Class III assets, they split

the $3,000 basis available based on their relative FMVs. The following formula is used to determine the basis to allocate for each Class III asset:

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

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

9. Example 4 -- Bargain purchase with subsidiary

The facts are the same as in Example 3, except that the Government Securities and Inventory are held by T1, a wholly owned subsidiary of T for whom a section 338(h)(10) election is made. The FMV of the T1 stock is $4,000. AGUB would be allocated as described below:

Result under the final regulations

Allocation of basis for T's assets

Asset	Class	FMV	Basis
Cash	I	$1,000	$1,000
Equipment	V	$3,000	$2,143
T1 stock	V	$4,000	$2,857
Goodwill & Going Concern	VII	$2,000	$0
Total		$10,000	$6,000

Allocation of basis for T1's assets

Asset	Class	FMV	Basis
U.S Gov't Securities	II	$2,000	$2,000
Inventory	IV	$2,000	$857
Total		$4,000	$2,857

Under the final regulations, the basis allocated to Inventory was reduced from $2,000 to $857 due to the Inventory being held by T1 rather than T. Although not present in this example, the effect of a bargain purchase is magnified if there is also a bargain element in the subsidiaries themselves.

Result under the old regulations

Allocation of basis for T's assets

Asset	Class	FMV	Basis
Cash	I	$1,000	$1,000
Equipment	III	$3,000	$2,143
T1 stock	III	$4,000	$2,857
Goodwill & Going Concern	V	$2,000	$0
Total		$10,000	$6,000

Allocation of basis for T1's assets

Asset	Class	FMV	Basis
U.S Gov't Securities	II	$2,000	$2,000
Inventory	III	$2,000	$857
Total		$4,000	$2,857

Notice that the basis allocated to Inventory was reduced from $1,200 to $857 due to the Inventory being held by T1 instead of T.

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

A. Overview

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

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

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

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

2. The Service has yet to issue regulations under section 338(h)(10) pertaining to the reporting requirements. However, the section 338(h)(10) regulations do provide that the section 338(h)(10) election shall be made on Form 8023 "Elections Under Section 338 for Corporations Making Qualified Stock Purchases" in accordance with the instructions to the form. Treas. Reg. § 1.338(h)(10)-1(c)(2).

3. With the recent release of Form 8883 and the recent issuance of temporary regulations under section 6043(c), Form 8023, which has been revised, is no longer the exclusive form to be filed concerning section 338 transactions.

4. In fact, section 338(h)(10) transactions now entail the filing with the IRS of at least two, and potentially as many as five, different forms -- Forms 8883 and 8023, and potentially Forms 8806, 1096, and 1099-CAP.

   a. Form 8883 must be filed by both the Old Target and the New Target. Form 8883 must be attached to (and filed with) the Federal income tax returns that reflect the tax effects of the section 338(h)(10) transaction.

   b. Form 8023 must be filed jointly by the purchasing corporation and the common parent of the selling consolidated group, selling affiliate, or all of the S corporation shareholders (regardless of whether they have sold stock in the QSP). Form 8023 must be filed with the Ogden processing center by the 15th day of the 9th month after the acquisition date to make a section 338(h)(10) election for target.

   c. Temporary regulations under section 6043(c) require domestic corporations involved in certain large taxable transactions ($100,000,000 and above) (the "reporting corporation") to report to the IRS information describing the transaction on Form 8066. Temp. Treas. Reg. § 1.6043-4T, T.D. 9022, 2002-48 I.R.B. 909 (Dec. 2, 2002) (the "temporary regulations"). This information must be reported along with (and attached to) the corporation's timely filed income tax return.

      (1) Form 8066 must be filed by the reporting corporation within 45 days after (i) control (defined under section 304(c)) of the corporation is acquired, or (ii) the corporation undergoes a substantial change in capital structure (as defined in the regulations), or if earlier, on or before January 5th of the year following the calendar year in which the acquisition of control or substantial change in capital structure occurs.

      (2) Reporting Corporations may elect on Form 8806 to consent to the publication by the IRS of information necessary for brokers to file information returns with respect to their customers.

   d. The temporary regulations further require reporting corporations to file with the IRS information returns on Forms 1096 and 1099-CAP for each shareholder of record in the corporations (before or after the acquisition of control or the substantial change in capital structure) who receives cash, stock, or other property in the reportable transaction. The reporting corporation must file Forms 1096 and 1099-CAP on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the

acquisition of control or the substantial change in capital structure occurs. Moreover, the reporting corporation must furnish to each shareholder the Form 1099-CAP filed with respect to that shareholder by January 31 of the year following the calendar year in which the shareholder receives cash, stock, or other property as part of the acquisition of control or the substantial change in capital structure.

(1) If a corporation makes the election to permit the IRS to publish information regarding the transaction, then the corporation is not required to file Forms 1099-CAP with respect to its shareholders that are clearing organizations, or to furnish Forms 1099-CAP to such clearing organizations.

e. These Forms are discussed in greater detail below at sections VI.B-D.

5. Prior to the release of Form 8883, see IRS Announcement 2003-2 (Jan. 21, 2003), and notwithstanding that the legislative history of the Omnibus Budget Reconciliation Act of 1990, which amended sections 338 and 1060, states that a section 338(h)(10) transaction should not be considered an applicable asset acquisition, H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess 1096 (1990), taxpayers generally found that the reporting requirements applicable to applicable asset acquisitions provided useful when considering the reporting requirements that applied to section 338(h)(10) transactions.

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

b. Parties to an applicable asset acquisition must file an information statement on Form 8594, which was recently revised to account for the seven asset classes in the final regulations; prior to its revision, the Form 8594 accounted for only five classes of assets. See Attachment A (revised Form 8594)

6. Because of the release of Form 8883, taxpayers no longer need to look to the reporting requirements for applicable asset acquisitions to determine the reporting requirements for section 338(h)(10) transactions.

7. Moreover, the release of Form 8883 coincided with a revision of Form 8023 (elections under section 338); much of the information once required by Form 8023 is now required by Form 8883.

8. The potential obligation to file Forms 8806, 1096, and 1099-CAP is also new.

B. Form 8883

1. Who Must File

Both the Old Target and the New Target (or the parties reporting the tax results of the section 338 transaction) are required to file the Form 8883.

2. When and How to File

a. Form 8883 must be attached to the timely filed tax returns that reflect the tax effects of the section 338(h)(10) transaction.

b. Old Target

(1) In the case of a section 338(h)(10) election for an S corporation target, Form 8883 must be attached to Form 1120S (U.S. Income Tax Return for an S Corporation).

(2) If the old target is a member of a selling group that will file a consolidated Federal income tax return, Form 8883 must be attached to the selling group's consolidated return for its tax year that includes the acquisition date.

(3) If the old target is a member of an affiliated selling group that does not file a consolidated Federal income tax return, Form 8883 must be attached to the return that reflects the tax effects of the section 338(h)(10) transaction; generally, this will be the return for the old target corporation.

c. New Target

(1) If the new target joins a group that will file a consolidated Federal income tax return, Form 8883 must be attached to the consolidated return that includes the day after the acquisition date.

(2) Otherwise, Form 8883 must be attached to the first return of the new target.

3. Required Information

Form 8883 requires the following information about transactions involving the deemed sale of corporate assets under section 338:

a. The name, address, and employer identification number of the filing party (i.e., the taxpayer reporting the tax results of the section 338 transaction). The filing party also must check a box indicating whether its income tax return reflects the tax results of the Old

Target or the New Target. The filing party also must indicate whether it has timely filed a valid Form 8023.

b. The name, address, and employer identification number of the taxpayer that files the U.S. income tax return, if any, that reflects the tax results under section 338 for the other party to the transaction. The Instructions to Form 8883 clarify that if the tax results of the section 338 transaction for the other party are reported on a consolidated return, the filing party must identify the common parent of the consolidated group. If the other party is a controlled foreign corporation that does not file a U.S. income tax return, the filing party must identify as the other party the U.S. shareholder owning the largest interest in the CFC.

c. The name, address, employer identification number (if any), and the state or country of incorporation of the target corporation. This information is only required if the target is not also the filing party; i.e., if the Form 8883 is filed by the common parent of a consolidated group including the target or by the seller, purchaser, or U.S. shareholder filing for a foreign target.

d. Certain general information, including the acquisition date, what percentage of the target stock was acquired during the 12-month acquisition period and on the acquisition date, the stock price, the acquisition or selling costs, the amount of the target's liabilities, the AGUB or ADSP, and information regarding the status of the target.

e. The aggregate fair market value of the Class I, II, III, IV, V, and VI and VII assets and the allocation of AGUB or ADSP to each of those asset classes; Classes VI and VII are grouped together for purposes of reporting their aggregate fair market value and allocation of AGUB or ADSP.

f. If the Form 8883 is being filed in order to amend a previously filed statement (because of an increase in AGUB or ADSP), the filing party must specify the amended aggregate fair market value of the Class I, II, III, IV, V, and VI and VII assets and the allocation of AGUB or ADSP to each of those asset classes. The filing party must also specify the reasons for the subsequent increase or decrease in AGUB or ADSP.

C. Form 8023

1. Changes to Form 8023

a. The instructions to the revised Form 8023 state that "[e]ach U.S. shareholder must also file Form 8883, Asset Allocation Statement,

Under Section 338, with Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations."

b. The Purchasing Corporation's Statement, which was formerly contained in Section F of Form 8023, is now part of Form 8883.

c. Form 8023 is no longer required to be attached to either the new target's, the old target's, or the purchasing corporation's income tax returns; instead, Form 8883 now must be attached to the return, and Form 8023 must now be filed by the 15th day of the 9th month after the acquisition date to make a section 338(h)(10) election for target.

d. Form 8023, including those filed by foreign purchasing corporations, now must be filed with the Ogden processing center.

2. Who must file

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

a. Under the old regulations, it was not clear whether all S corporation shareholders must consent to the section 338(h)(10) election, or merely those shareholders who sell their stock in the QSP.

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

c. The preamble to the final regulations provides that the Service will revise Form 8023 to make clear that nonselling S corporation shareholders must also sign Form 8023. The preamble also provides that the Service will recognize the validity of otherwise valid elections made on the current version of Form 8023 even if not signed by the nonselling shareholders, provided that the S corporation and all of its shareholders (including nonselling shareholders) report the tax consequences consistently with the results under section 338(h)(10).

d. Form 8023 has since been revised, and the Instructions thereto clarify that "[i]f the target is an S corporation, a section 338(h)(10) election must be made by all of the shareholders of the target, including the shareholders who do not sell target stock in the QSP."

3. When and Where to File

a. Form 8023 must be filed by the 15th day of the 9th month after the acquisition date to make a section 338(h)(10).

b. Form 8023 must be filed with the Internal Revenue Service, Submission Processing Center. P.O. Box 9941, Mail Stop 4912, Ogden, UT 84409.

c. Multiple Targets

One Form 8023 may be used for section 338(h)(10) elections for multiple targets if:

(1) Each target has the same acquisition date;

(2) Each target was a member of the same affiliated group immediately before the acquisition date; and

(3) Each target is a member of the same affiliated group immediately after the acquisition date.

4. Required Information

Form 8023 requires the following information about section 338(h)(10) elections:

a. The purchasing corporation's name, address, employer identification number, the date its tax year ends, and the state or country of incorporation. If more than one member of an affiliated group purchases stock of the acquired target, the information for the corporation that acquired the largest percentage of target stock must be listed on the Form; in this case, the instructions require that the parties attach to the Form 8023 a schedule providing the requisite information for each purchasing corporation (other than the corporation listed on the Form as the purchasing corporation) and providing information regarding which target stock was acquired by each purchasing corporation.

b. If the purchasing corporation is a member of a consolidated group, the common parent's name, address, employer identification number, the date its tax year ends, and the state or country of incorporation.

c. The target corporation's name, address, employer identification number, the date its tax year ends, and the state or country of incorporation.

d. If the there is a section 338(h)(10) election or if the target was either a member of a consolidated group or a controlled foreign corporation (or was a CFC within the preceding five years), the name, address, tax identification number(s), and the date the tax year ends for the common parent of the selling consolidated group, selling affiliate, U.S. shareholders of the foreign target corporation, or S corporation shareholders.

e. The acquisition date and information regarding the percentage of the target stock acquired during the 12-month acquisition period and on the acquisition date (i.e., whether multiple elections are being made).

f. The type of election being made by the party or parties and whether an election is being made for a corporation or corporations other than the target.

g. The signature(s) of the purchasing corporation(s) and, in the case of a section 338(h)(10) election, the signature of the common parent, selling affiliate, or the S corporation shareholders.

5. Prior to its revision, Form 8023 required other information (now required by Form 8883), including information regarding the amount and allocation of AGUB and ADSP.

6. The preamble to the proposed regulations indicated that the Service and Treasury were considering whether the information regarding the amount and allocation of AGUB and ADSP submitted on the Form 8023 (then in effect) should instead be submitted by the purchaser and seller separately on their income tax returns.

7. This information now must be provided on the Form 8333, which must be filed along with both the seller and purchaser's tax return.

D. Reporting Requirements Under New Temporary section 6043(c) Regulations

1. Temporary regulations under section 6043(c) (the "temporary regulations") require certain domestic corporations (the "reporting corporation") to report (on Form 8806) information regarding transactions in which (i) control of that corporation is acquired, or where (ii) the corporation either recapitalizes or undergoes a substantial change in corporate structure. Temp. Treas. Reg. § 1.6043-4T, T.D. 9022, 2002-48 I.R.B. 909 (Dec. 2, 2002).

2. If applicable, the temporary regulations also require the reporting corporation (i) to report to the IRS certain information about its shareholders (on Forms 1096 and 1099-CAP), and (ii) to furnish to its shareholders the Form 1099-CAP filed with the IRS.

3. By expressly providing that a QSP and subsequent 338 election will be treated as an acquisition of stock, rather than an acquisition of assets, the temporary regulations clarify that section 338 transactions are generally subject to the reporting requirements of section 6043 (i.e., the filing of the Form 8806, 1096, and 1099-CAP). See Temp. Treas. Reg. § 1.6043-4T(c)(5).

4. However, the temporary regulations do not require information reporting for every transaction that results in a change of control or that involves a recapitalization or a substantial change in corporate structure.

    (1) The temporary regulations only apply to acquisitions of control and changes in the capital structure of domestic corporations. Temp. Treas. Reg. § 1.6043-4T (a)(1). Thus, certain section 338(g) elections may be exempt from the additional reporting requirement.

    (2) Moreover, the temporary regulations only apply to acquisitions of control of a corporation where the fair market value of stock acquired in a transaction or a series of related transactions is $100,000,000 or more. Temp. Treas. Reg. § 1.6043-4T(c)(1)(C).

    (3) Thus, with respect to section 338 transactions, the reporting requirements of the temporary regulations only apply to QSPs involving the acquisition of more than $100 million worth of stock in domestic corporations.

5. Form 8806

    a. Who Must File

        (1) The acquired (or target) corporation is the party required to file the Form 8806 (i.e., the reporting corporation). Temp. Treas. Reg. § 1.6043-4T(a)(1).

            (a) However, in the case of an acquisition of substantially all of the assets of the target corporation (i.e., a substantial change in the capital structure), the acquiring corporation is secondarily responsible for filing the Form 8806 and is jointly liable for any penalties imposed as a result of either party's failure to file the Form 8806. Temp. Treas. Reg. § 1.6043-4T(e).

            (b) This rule should not apply in the case of a section 338 election because under Temp. Treas. Reg. § 1.6043-4T(c)(5), a QSP and section 338 election is treated as

an acquisition of stock, rather than assets, for purposes of the temporary regulations.

(2) In general, the reporting corporation must file the Form 8806 if:

(a) As a result of the acquisition, the shareholders of the reporting corporation receive cash, stock, or other property pursuant to the transaction;

(b) The proceeds from the transaction are at least $100 million; and

(c) There is either (i) an acquisition of control of the reporting corporation, or (ii) a substantial change in the capital structure of the reporting corporation. Temp. Treas. Reg. § 1.6043-4T(a)(1).

(i) Acquisition of control occurs where, as a result of a transaction or series of related transactions:

(a) Stock representing control of the first corporation is distributed by a second corporation to shareholders of the second corporation, or

(b) Before an acquisition of stock of the first corporation (directly or indirectly) by a second corporation, the second corporation does not have control of the first corporation, but after the acquisition the second corporation has control of the first corporation. Temp. Treas. Reg. § 1.6043-4T(c)(1).

(c) "Control" is defined by reference to section 304(c)(1). Temp. Treas. Reg. § 1.6043-4T(c)(2). Section 304(c)(1) defines control as the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock.

(d) The constructive ownership rules of section 318(a) apply in determining whether an acquisition of control has occurred; however these rules do not apply in determining whether the acquirer has control of the acquired corporation before the transaction. Temp. Treas. Reg. § 1.6043-4T(c)(3).

(ii) A "substantial change in the capital structure of a domestic corporation" includes:

(a) A recapitalization with respect to stock;

(b) A redemption of stock (including deemed redemptions);

(c) Mergers, consolidations (or otherwise combining with another corporation), and transfers of all or substantially all of the corporation's assets to one or more corporations;

(d) Transfers of all or part of the corporation's assets to another corporation in a title 11 or similar case and, in pursuance of the plan, stock or securities of that corporation is distributed; or

(e) Changes in a corporation's identity, form, or place of organization. Temp. Treas. Reg. § 1.6043-4T(d).

(3) However, Form 8806 does <u>not</u> have to be filed if:

(a) Information regarding the transaction was already properly filed pursuant to Treas. Reg. §§1.351-3(b), 1.355-5(a), or 1.368-3(a); or

(b) The corporation reasonably determines that all of its shareholders who receive cash, stock, or other property pursuant to the acquisition of control or substantial change in capital structure are exempt recipients as defined under Temp. Treas. Reg. § 1.6043-4T(b)(6).

b. When and How to File

(1) Form 8066 must be filed by the reporting corporation within 45 days after (i) control (defined under section 304(c)) of the corporation is acquired, or (ii) the corporation undergoes a substantial change in capital structure (as defined in the regulations), or if earlier, on or before January 5th of the year following the calendar year in which the acquisition of control or substantial change in capital structure occurs.

c. Required Information

If the temporary regulations apply, the reporting corporation must include the following information on the Form 8806:

(1) The name, address, and taxpayer identification number (TIN) of the reporting corporation;

(2) If immediately prior to the transaction the reporting corporation was a subsidiary member of an affiliated group filing a consolidated return, the name, address, and TIN of the common parent of that affiliated group;

(3) The name, address, and TIN of the acquiring corporation. Also, the reporting corporation must state whether the acquiring corporation is foreign (as defined in section 7701(a)(5)) or is a dual resident corporation (as defined in §1.1503-2(c)(2)), and in either case, whether the acquiring corporation was newly formed prior to its involvement in the transaction;

(4) If the acquiring corporation was a subsidiary member of an affiliated group filing a consolidated return immediately prior to the acquisition, the name, address, and TIN of the common parent of that affiliated group; and

(5) General information about the transaction, including:

(a) A description of the transaction or transactions that gave rise to the acquisition of control or the substantial change in the capital structure of the corporation;

(b) The date or dates of the transaction or transactions that gave rise to the acquisition of control or the substantial change in capital structure;

(c) A description and statement of the fair market value of any stock provided to the reporting corporation's shareholders in exchange for their stock, but only if the reporting corporation reasonably determines that the shareholders are not required to recognize gain (if any) from the receipt of such stock for U.S. federal income tax purposes; and

(d) A statement of the aggregate amount of cash plus the fair market value of any property (including stock, but excluding stock received without recognition of gain) provided to the reporting corporation's shareholders in exchange for their stock. Temp. Treas. Reg. § 1.6043-4T(a)(1)(i)-(v).

6. Form 1099-CAP

a. Corporations that are required to file Form 8806 must also file Forms 1096 and 1099-CAP.

b. Form 1096 is little more than a cover sheet indicating that the reporting corporation is filing a Form 1099-CAP. As a result, Form 1096 is not discussed in further detail; however, taxpayers must recognize that this Form must be filed in along with each Form 1099-CAP.

c. As discussed below, one Form 1099-CAP must be filed for each shareholder of record in the reporting corporation who receives cash, stock, or other property in the transaction; each Form 1099-CAP must include a Form 1096.

d. Furthermore, the reporting corporation that files a Form 1099-CAP with respect to a shareholder must also furnish the Form to that shareholder.

e. Who Must File

The corporation that filed the Form 8806 is the party that must file Form(s) 1099-CAP.

f. When and How to File

(1) The reporting corporation must file with the IRS Forms 1096 and 1099-CAP on or before February 28 (March 31 if filed electronically) of the year following the calendar year in which the acquisition of control or the substantial change in capital structure occurs.

(2) Moreover, the reporting corporation must furnish to each shareholder the Form 1099-CAP filed with respect to that shareholder by January 31 of the year following the calendar year in which the shareholder receives cash, stock, or other property as part of the acquisition of control or the substantial change in capital structure.

(3) The reporting corporation is not required a Form 1099-CAP for the following shareholders:

(a) Any shareholder who receives solely stock described in exchange for its stock in the corporation in a tax-free transaction;

(b) Any shareholder who does not receive in the transaction cash, stock, or other property in excess of $1000; and

(c) Any shareholder who has properly completed and provided to the reporting corporation an exemption certificate (as provided in Treas. Reg. § 31.3406(h)-3A). Temp. Treas. Reg. § 1.6043-4T(b)(6).

g. Required Information

The Form 1099-CAP filed with respect to each shareholder must include:

(1) The name, address, telephone number and TIN of the reporting corporation;

(2) The name, address and TIN of the shareholder;

(3) The number and class of shares in the reporting corporation exchanged by the shareholder;

(4) The amount of cash and the fair market value of any stock (other than stock received tax-free) or other property provided to the shareholder in exchange for its stock; and

(5) The date of the sale or exchange.

(6) Note: Additional requirements may apply with respect to Forms 1099-CAP filed by brokers.

VII. OTHER ISSUES

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

A. Use of the Installment Method

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

2. The Ticket to Work and Work Incentives Improvement Act (P.L. 106-170) generally eliminated the use of the installment method for accrual basis taxpayers effective for sales or other dispositions entered into on or after December 17, 1999. However, the Installment Tax Correction Act of 2000 (P.L. 106-573) repealed the changes made by the Ticket to Work and Work Incentives Improvement Act as if that act had not been enacted. Accordingly, the installment method may be available in a section 338(h)(10) transaction.

3. For transactions involving taxpayers for whom the installment method is not precluded by the recent legislation, the availability of the installment method may depend on whether the transaction is governed by the old regulations or the new temporary regulations.

4. Operation of section 453

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

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

5. Operation of section 453 under the temporary and final regulations

   For qualified stock purchases after January 5, 2000:

   a. The section 453 installment method is available to Old T in its deemed asset sale as long as the deemed asset sale would otherwise qualify for installment sale reporting. See Treas. Reg. § 1.338(h)(10)-1(d)(9).

   b. Old T is treated as receiving in the deemed asset sale New T installment obligations, the terms of which are identical (except as to the obligor) to P installment obligations issued in exchange for recently purchased stock of T. Old T is treated as receiving in cash

all other consideration in the deemed asset sale other that the assumption of, or taking subject to, Old T liabilities. Treas. Reg. § 1.338(h)(10)-1(d)(8)(i).

c. Old T is treated as distributing in the deemed liquidation the New T installment obligations that it is treated as receiving in the deemed asset sale. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as receiving in the deemed liquidation the New T installment obligations that correspond to the P installment obligations they actually received individually in exchange for their recently purchased stock. Treas. Reg. § 1.338(h)(10)-1(d)(8)(ii).

d. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as receiving all other consideration in the deemed liquidation in cash. Treas. Reg. § 1.338(h)(10)-1(d)(8)(ii).

6. Problem with applying section 453 to section 338(h)(10) transactions under the old regulations

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

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

7. Arguments in favor of allowing use of the installment method for section 338(h)(10) transactions under the old regulations

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

actual asset sale followed by a liquidation, use of the installment method should be allowed in a section 338(h)(10) transaction.

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

See, Report of the Committee on Taxation of Corporations and the Committee on Taxation of Partnerships and Other Pass-Through Entities of the Association of the Bar of the City of New York, "Installment Method Eligibility for Stock Sale Elections Under Section 338(h)(10) of the Code" (May 14, 1997) 97 TNT 108-38.

8. Merger of T into LLC to allow use of the installment method

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

b. Example

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

(2) Analysis:

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

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

(c) LLC is disregarded as an entity separate from S. As a result, S is not treated as owning "interests" in LLC for Federal tax purposes, but rather is treated as

owning LLC's assets directly. Thus, the sale of all of the interests in LLC, a disregarded entity, to a single buyer should be treated as a sale of assets by S.

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

B. Acquisition for Cash and Contingent Consideration

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

2. Basic Facts

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

b. P agrees to acquire T's assets for $50 in cash and a note for $15. In addition, P and S agree to an earnout arrangement that will pay S one-third of T's annual net profit in excess of $20 for the five years after the acquisition. The approximate fair market value of the earnout arrangement is $30.

3. Result under the old regulations

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

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

c. Consequences to P

(1) The old regulations provide that a "contingent amount" is taken into account for purposes of determining adjusted

grossed-up basis when such amount becomes "fixed and determinable." Old Temp. Treas. Reg. § 1.338(b)-3T(c)(1).

(2) The term "contingent amount" means the amount of the consideration to be paid for T stock that is not fixed and determinable by the close of New T's first taxable year. Old Temp. Treas. Reg. § 1.338(b)-3T(b)(2).

(3) Accordingly, under the old regulations, P would not be able to include contingent payments in its basis of the T stock until such contingencies became fixed and determinable. Therefore, P's AGUB will reflect only the cash payment of $50 and the note of $15 (a total of $65). AGUB would be redetermined when earnout payments are fixed and determinable. See old Temp. Treas. Reg. § 1.338(b)-3T(a)(1).

d. Consequences to S

(1) As discussed in Part V.C., above, under old Treas. Reg. § 1.338-1(f)(2), the deemed sale price of the assets (upon which gain or loss is calculated) is determined by reference to the MADSP formula. Under that formula, the relevant items are P's basis in the T stock and any liabilities assumed in the transaction. As discussed above, P's basis in the T stock will not represent the contingent earnout until the earnout payments are fixed and determinable.

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

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

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

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

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

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

4. Result under the final regulations

a. The final regulations do not include the "fixed and determinable" rule in the old regulations. The final regulations provide that "general principles of tax law" will apply in connection with the contingent items. See Treas. Reg. § 1.338-7(a). In addition, the final regulations remove the link in the old regulations between AGUB and MADSP.

b. The final regulations permit the use of the installment method in a section 338(h)(10) transaction. See Treas. Reg. § 1.338(h)(10)-1(d)(9).

c. Consequences to P

(1) General principles of tax law apply in determining the timing and amount of the elements of AGUB. Treas. Reg. § 1.338-5(b)(2). Under general principles of tax law, New T does not receive asset basis for the contingent earnout until the amounts are accued or paid. See Treas. Treas. Reg. § 1.461-1(a)(1), (2).

(2) Accordingly, under the final regulations, AGUB will reflect only the cash payment of $50 and the note of $15 (a total of $65).

(3) AGUB will be redetermined "at such time and in such amount" as would be required under general principles of tax law with respect to the elements of AGUB. Treas. Reg. § 1.338-5(b)(ii). AGUB will be allocated to New T's acquisition date assets under Treas. Reg. § 1.338-7.

d. Consequences to S

(1) General principles of tax law apply in determining the timing and amount of the elements of ADSP. Treas. Reg. § 1.338-4(b)(2). Under general principles of tax law, assuming the installment method is inapplicable, the contingent earnout obligation must be valued, and that value must be included in ADSP. See Treas. Reg. § 1.1001-1(g). Open transaction treatment will only be available in "rare and extraordinary" circumstances in which the fair market value of earnout obligation is not be reasonably ascertainable. Id.

(2) Accordingly, under the final regulations, the ADSP will be $95 (the sum of $50 in cash, the $15 note, and $30 value of earnout obligation). ADSP will be allocated under Treas. Reg. § 1.338-6(b). As a result, S has a gain of $25 on the Class V asset (deemed sale price of $75 less basis of $50) and a gain of $10 on the Class V asset (deemed sale price of $20 less basis of $10), for a total gain of $35.

C. Intercompany Transfers of T Stock

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

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

a. the deferred gain on the intercompany transaction involving the T stock, or

b. the loss that would otherwise have been recognized had section 331 actually applied to the deemed liquidation.

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

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

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

D. Unwanted Assets

1. What if P doesn't want to buy certain T assets (the "unwanted assets")?

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

a. Result under the final regulations

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

The final regulations provide the following example:

(1) Facts

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

(2) Analysis

Under section 338(a), the assets present in T at the close of the acquisition date are deemed sold by Old T to New T.

Because S and P had agreed that, after T's actual distribution to S of part of the assets, S would sell T to P pursuant to an election under section 338(h)(10), and because T is deemed to have transferred all its assets to its shareholder, T is deemed to have adopted a plan of complete liquidation under section 332. T's actual transfer of assets to S is treated as a distribution pursuant to that plan of complete liquidation. See Treas. Reg. § 1.338(h)(10)-1(e), Ex. 2.

b. Result under the old regulations

(1) Under the old regulations, the Service determined that if the distribution is part of the overall transaction, then the distribution is part of the section 332 liquidation. Therefore, T recognizes no gain on the distribution under section 337(a) and S takes a carryover basis in the property under section 334(b)(1). See PLRs 9738031, 9735038, 9044063, and 8938036.

(2) In these rulings, T adopted a plan of complete liquidation prior to the stock sale and asset distribution, and P was obligated to purchase the T stock simultaneously with the distribution of the unwanted assets.

(3) What would be the result if after the distribution by T of the unwanted assets to S and the stock sale by S, S transferred the unwanted assets to a controlled subsidiary? Would this affect the deemed liquidation of T under section 338(h)(10)?

(4) In the context of an actual liquidation, the transfer of assets received in a liquidating distribution to a new corporation owned by the same shareholders could result in a determination that there was not in fact a "complete liquidation" of the presumably liquidated corporation. See Telephone Answering Service Co. v. Commissioner, 63 T.C. 423 (1974), aff'd without opinion, 546 F.2d 423 (4th Cir. 1976), cert. denied, 431 U.S. 914 (1977) ("TASCO") (no complete liquidation because new corporation was merely the "alter ego" of the liquidated corporation).

(5) It appears that the Service believes that the reincorporation of the unwanted assets could present a problem. See PLR 9210041, supplementing PLR 9137040 (Service rules that transfer of unwanted assets amounting to 3% of T's total assets to a controlled subsidiary will not cause liquidation to be taxable. However, the Service cited TASCO for this

proposition, presumably indicating that the TASCO analysis could apply to a section 338(h)(10) deemed liquidation).

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

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

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

(9) Does it matter if the controlled subsidiary is a pre-existing active corporation or a new or inactive corporation?

(10) In PLR 9847027, the Service ruled that a section 338(h)(10) election could be made for a transaction in which a life insurance company transferred its entire life insurance business to its parent under a coinsurance agreement before its stock was sold.

(a) In PLR 9847027, a publicly trading holding company owned all the stock of a life insurance company ("S"), which owned all the stock of a second life insurance company ("T"). In the proposed transaction, T would transfer its insurance business to S pursuant to a coinsurance agreement. T would then distribute to S all of its remaining assets other than its charter, licenses and minimum capital. Within 12 months of this distribution, S would sell all of the stock of T to an unrelated corporation ("P") or liquidate T.

(b) The Service ruled that the stock sale would constitute a QSP, and that S and P could make a section 338(h)(10) election. The Service further ruled that, if such an election were made, the transfer of the

insurance business pursuant to the coinsurance agreement and the distribution of T's assets, together with T's deemed distribution of the sale proceeds, would constitute a section 332 liquidation.

(c) The ruling is significant because previously the Service held the position that a coinsurance agreement prevents satisfaction of the complete liquidation requirement of section 332.

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

1. State treatment of a section 338(h)(10) election is not uniform

a. Some states have a similar election that will result in state tax treatment similar to the federal tax treatment.

b. Some states will allow a similar election, but provide that the state tax liability remains with T and is not the responsibility of the selling consolidated group.

c. Other states do not allow an election similar to section 338(h)(10) or a section 338 election at all.

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

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

1. Can a QSP be made for an insolvent corporation?

a. As discussed in Part III.B., above, a QSP occurs when P, either in a single transaction or series of transactions within a 12-month period, acquires by "purchase" an amount of stock meeting the requirements of section 1504(a)(2).

b. Section 338(h)(3)(A) defines the term "purchase" as "any acquisition of stock" (with certain exceptions not herein pertinent).

c. Therefore, it would appear that the acquisition of all of the stock of an insolvent T by P would be a QSP.

d. However, it could be argued that since T is insolvent, its former stock ceased to exist in a tax sense, and what "stock" there is held by T's creditors. This argument is not convincing because insolvency does not bar consolidated return filing (which looks to stock ownership for eligibility), and a creditor in an insolvent corporation

is not generally recognized as a shareholder under the Code. See Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942).

e. The proposed regulations provided that a purchase of T stock occurs so long as more than a nominal amount is paid for the stock. Old Prop. Treas. Reg. § 1.338-3(b)(2)(ii). In response to comments received on this provision, the temporary regulations removed this provision and reserved this issue pending further consideration of the comments. Temp. Treas. Reg. § 1.338-3T(b)(2)(ii).

f. The final regulations do not adopt the definition of purchase from the proposed regulations. Rather, the final regulations include a single definition of purchase applicable to both targets and target affiliates, which definition generally conforms to the definition of purchase of target affiliate in the temporary regulations. Under this definition, stock in a target (or target affiliate) may be considered purchased if, under general principles of tax law, the purchasing corporation is considered to own the stock of the target (or the target affiliate) meeting the requirements of section 1504(a)(2), notwithstanding that no amount may be paid for (or allocated to) the stock. See Treas. Reg. § 1.338-3(b)(2).

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

a. The old regulations provide that, for purposes of Subtitle A, Old T is treated as if it distributed all of its assets in complete liquidation under section 331 or section 332. Old Treas. Reg. § 1.338(h)(10)-1(e)(2).

b. Section 332 has been interpreted to require that the liquidating subsidiary be solvent. See, e.g., Spaulding Bakeries, Inc. v. Comm'r, 27 T.C. 684 (1957), aff'd, 252 F.2d 693 (2d Cir. 1958); H.K. Porter Co., Inc. v. Comm'r, 87 T.C. 689 (1986); Rev. Rul. 68-602, 1968-2 C.B. 135; Prop. Treas. Reg. § 1.332-2(b).

c. Thus, the old regulations can be read to preclude the application of section 332 if T is insolvent. See also CCA 200818005 (holding deemed liquidation of insolvent subsidiary pursuant to section 338(h)(10) election does not qualify under section 332(a)).

d. However, if the deemed liquidation not governed by section 332, it is still arguable that section 331 will not apply because a complete liquidation is not taking place because there will be no distribution to shareholders. See Rev. Rul. 56-387, 1956-2 C.B. 189.

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

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

G. Proposed Regulations on Sale and Acquisition of Insurance Business

1. On March 8, 2002, the IRS published proposed regulations under section 338 (REG-118861-00; 2002-1 C.B. 651; 67 F.R. 106040-10652) that generally treated the transfer of insurance or annuity contracts and the assumption of related reserve liabilities in a deemed asset sale under section 338 similar to ordinary assumption-reinsurance transactions under Treas. Reg. § 817-4(d) and other subchapter L provisions. See Preamble to Prop. Treas. Reg. § 1.338-11.

2. The package of proposed regulations also included proposed regulations under section 197, 381, and 1060. See Prop. Treas. Reg. §§ 1.197-2(g)(5), 1.381(c)(22)-1(b)(7), and 1.1060-1(a)(2), (b)(9), (c)(5). This portion of the outline, however, is concerned primarily with the regulations under section 338.

3. Under the Proposed section 338 Regulations (the “Proposed Regulations”), the general rules of section Treas. Reg. § 1.338-1 clarified that if a section 338 or 338(h)(10) election had been made for a target that is an insurance company, the deemed asset sale resulted in an assumption reinsurance transaction (under Treas. Reg. § 1.817-4(d)) with respect to the insurance contracts deemed transferred from old target to new target. Prop. Treas. Reg. § 1.338-1(a)(2).

4. The Proposed Regulations also added a new section to the section 338 regulations, Prop. Treas. Reg. § 1.338-11. The rules contained under Prop. Treas. Reg. § 1.338-11 were intended to apply in addition to the regulations generally applicable under section 338 and control any conflicts between itself and any other provision of the Code that may have applied to the transaction. See Prop. Treas. Reg. § 1.338-11(a).

5. Prop. Treas. Reg. § 1.338-11 also provided the following:

a. In general -- The general assumption reinsurance principles of subchapter L, chapter 1, subtitle A of the Code are intended to apply to transactions governed by Prop. Treas. Reg. § 1.338-11 except to the extent those principals are modified by the Proposed Regulations. Prop. Treas. Reg. § 1.338-11(c).

b. Computing ADSP and AGUB

(1) For purposes of computing ADSP and AGUB under Treas. Reg. §§ 1.338-4 and 1.338-5, old target's reserves with respect to any insurance, annuity, and reinsurance contracts deemed sold by old target to new target in the deemed asset sale will be treated as liabilities of old target assumed by new target.

(2) The reserves included in the ADSP and AGUB calculations are those reserves that are properly taken into account by old target with respect to such contracts at the close of the taxable year ending on the acquisition date (before giving effect to the deemed asset sale and assumption reinsurance transaction). Prop. Treas. Reg. § 1.338-11(b)(1).

c. Allocation of ADSP and AGUB to Specific Insurance Contracts

(1) For purposes of allocating AGUB and ADSP pursuant to Treas. Reg. §§ 1.338-6 and 1.338-7, the fair market value of a specific insurance, reinsurance or annuity contract or group of insurance, reinsurance or annuity contracts is the amount of the ceding commission a willing reinsurer would pay a willing ceding company in an arm's length transaction for the reinsurance of the contracts if the gross reinsurance premium for the contracts were equal to the old target's tax reserves for the contracts.

(2) Thus, by measuring both ADSP and AGUB based upon a fair market value standard, the Proposed Regulations generally ensure that the gross amount of the reinsurance premiums paid by the old target to the new target will equal the old target’s tax reserves for the insurance contracts.

(3) The treatment of the amount allocable to insurance contracts acquired in the deemed asset sale is governed by the rules under Prop. Treas. Reg. § 1.197-2(g)(5). Prop. Treas. Reg. § 1.338-11(b)(2).

d. Reinsurance Premium Amount

(1) In general, the gross amount of the premium paid by old target in the assumption reinsurance transaction is equal to the amount of old target's tax reserves with respect to the contracts deemed transferred from old target to new target, as computed in Prop. Treas. Reg. § 1.338-11(b)(1).

(2) Thus, old target is entitled to a deduction for this amount, and includes in income the ceding commission, if any, deemed received from new target.

(3) New target is deemed to receive a reinsurance premium from old target in the amount of the reserves for the contracts and to pay old target the amount of any ceding commission, as computed in Prop. Treas. Reg. § 1.338-11(c)(3). Prop. Treas. Reg. § 1.338-11(c)(2).

e. Ceding Commission

(1) Old target is deemed to receive a ceding commission in an amount equal to the amount of ADSP allocated to the insurance contracts transferred in the assumption reinsurance transaction, as determined under Treas. Reg. §§ 1.338-6, 1.338-7, and 1.338-11(b).

(2) New target is deemed to pay a ceding commission in an amount equal to the amount of AGUB allocated to the insurance contracts acquired in the assumption reinsurance transaction, as determined under Treas. Reg. §§ 1.338-6, 1.338-7, and 1.338-11(b). Prop. Treas. Reg. § 1.338-11(c)(3).

f. Redetermining AGUB

(1) In general, increases in the new target's reserves during any of its first four taxable years will generally increase AGUB in accordance with Treas. Reg. §§ 1.338-5(b)(2)(ii) and 1.338-7. Prop. Treas. Reg. § 1.338-11(d)(1).

(2) New target is not required to take into account reserve increases to the extent such increases occur while it is under state receivership or to the extent its deduction for the reserve increase is spread under section 807(f) over the 10 succeeding taxable years. Prop. Treas. Reg. § 1.338-11(d)(2).

(3) Increase in unpaid loss reserves -- The amount of reserve increases, if any, taken into account with respect to unpaid losses on acquired contracts is calculated under a formula in accordance with Prop. Treas. Reg. § 1.338-11(d)(3).

(4) Increases in other reserves-- The amount of the increases in reserves other than unpaid loss reserves is taken into account to the extent of any net increase (in the aggregate) in reserves for acquired contracts due to changes in methodology or assumptions used to compute the reserves for those contracts (including the adoption by new target of a methodology or assumptions different from those used by old target). Prop. Treas. Reg. § 1.338-11(d)(4).

(5) The application of section 848 to redetermination events is governed by Prop. Treas. Reg. § 1.338-11(d)(5).

(6) The rules under Treas. Reg. § 1.197-2(g)(5)(ii) may apply with respect determining the treatment upon the subsequent disposition of contracts acquired in the deemed asset sale. Prop. Treas. Reg. § 1.338-11(d)(6).

(7) Other Provisions

(a) Prop. Treas. Reg. § 1.338-11(e) governs the effect of the section 338 election on old target's capitalization amounts under section 848.

(b) Prop. Treas. Reg. § 1.338-11(f) governs the effect of the section 338 election on old target's policyholders surplus. See also Prop. Treas. Reg. § 1.381(c)(22)-1(b)(7).

(c) Prop. Treas. Reg. § 1.338-11(g) governs the effect of the section 338 election on section 847 special estimated tax payments.

H. Final and Temporary Regulations on Sale and Acquisition of Insurance Business

1. On April 10, 2006, the IRS published final and temporary regulations which substantially follow the approach suggested by proposed regulations. See T.D. 9257, 71 F.R. 17990-18007. Subsequent to issuing those regulations, the IRS issued technical corrections to those newly-issued regulations. See 71 F.R. 26826.

2. According to the preamble to the final and temporary regulations, many commentators objected to the rule requiring capitalization for increases in reserves after the transaction date. See T.D. 9257, 71 F.R. at 17992. However, the IRS believes that such a rule is a necessary corollary to the rule in the proposed regulations linking the amount of reinsurance deemed paid to the amount of old target's reserves at the time of the assumption of reinsurance transaction (with the concomitant result that new target has no income). Accordingly, in response the IRS decided to issue temporary regulations along with the final regulations that continue to require capitalization (and concomitant treatment as premium) of certain reserve increases but further limit the capitalization rule of the proposed regulations in a manner consistent with the application of subchapter L principles. See Temp. Treas. Reg. § 1.338-11T(d).

3. After the deemed asset sale, the temporary regulations apply subchapter L principles to new target. Under the temporary regulations, capitalization is required only for increases in reserves that clearly reflect a so-called

"bargain purchase" (that is, then the application of the residual method clearly indicates the initial understatement of the reserve).

4. Under the temporary regulations, new target is required to capitalize any increase in reserves for acquired contracts if the AGUB allocated to assets in Class I through Class V is less than the fair market value of the assets in those classes.

5. The proposed regulations did not provide any special rules under section 846 for new target to apply old target's historical loss payment pattern as a result of a section 846(e) election made by old target because new target is generally treated as a new corporation that may adopt its own accounting methods without regard to the methods used by old target. See Treas. Reg. § 1.338-1(b). Commentators to the proposed regulations believed that this result was inconsistent with the purpose of allowing a company to make a section 846(e) election. In response, the temporary regulations contain a new rule that treats new target and old target as the same corporation for purposes of a section 846(e) election to use an insurance company's historical loss payment pattern. See Temp. Treas. Reg. § 1.338-1T(b)(2)(vii). Therefore, if old target has a section 846(e) election in effect, new target will continue to use the historical loss payment pattern of old target to discount unpaid losses, unless new target chooses to revoke the election.

6. The final and temporary regulations are effective for transactions on or after April 10, 2006. See Treas. Reg. § 1.338(i)-1(c). Some commentators asked for an election to apply the final regulations to transactions completed before April 10, 2006. The IRS capitulated and accordingly, the final regulations permit new target and old target to elect to apply the final regulations, in whole, to qualified stock purchases occurring before April 10, 2006, if all taxable years for which the consequences of the section 338 election affect the computation of tax are open. See Treas. Reg. § 1.338(i)-1(c)(2).

7. The April 10, 2006 temporary regulations were finalized without substantive change on January 23, 2008. See T.D. 9377, 73 F.R. 3868-3874.

ATTACHMENT A
(Form 8594)

Form **8594**
(Rev. February 2006)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement Under Section 1060

► Attach to your income tax return. ► See separate instructions.

OMB No. 1545-1021

Attachment Sequence No. **61**

Name as shown on return | Identifying number as shown on return

Check the box that identifies you:
☐ Purchaser ☐ Seller

Part I General Information

1 Name of other party to the transaction | Other party's identifying number

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

2 Date of sale | 3 Total sales price (consideration)

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$	$
Total	$	$

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

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . . ☐ Yes ☐ No

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

If "Yes," attach a schedule that specifies (a) the type of agreement and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

Part III **Supplemental Statement**—Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration. See instructions.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$	$	$
Class VI and VII	$	$	$
Total	$		$

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

ATTACHMENT B
(Form 8883)

Form **8883** (December 2008)
Department of the Treasury
Internal Revenue Service

Asset Allocation Statement
Under Section 338

► Attach to your income tax return. ► See separate instructions.

OMB No. 1545-1806

Part I Filer's Identifying Information

1a Name as shown on return

1b Identifying number as shown on return

1c Check applicable box (see instructions):
☐ Old target ☐ New target

1d Was a valid and timely Form 8023 filed? . . . ☐ Yes ☐ No
If yes, enter the date filed ►

Part II Other Party's Identifying Information

2a Name of other party to the transaction

2b Other party's identifying number

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

Part III Target Corporation's Identifying Information

3a Name and address of target corporation

3b Employer identification number

3c State or country of incorporation

Part IV General Information

4a Acquisition date

4b What percentage of target corporation stock was purchased:
(i) During the 12-month acquisition period? _____ %
(ii) On the acquisition date? . . . . %

5a Stock price	**5b** Acquisition costs/Selling costs	**5c** Target liabilities	**5d** AGUB/ADSP
$	$	$	$

		Yes	No
6	Was the filer listed in Part I, above, a member of an affiliated group of corporations before the acquisition date?		
7	Was the target corporation a member of an affiliated group before the acquisition date?		
8	Is the target corporation or any target affiliate:		
a	A controlled foreign corporation? If "No," check here if it was a CFC at any time during the preceding 5 years ► ☐		
b	A foreign corporation with income, gain, or loss effectively connected with the conduct of a trade or business within the United States (including U.S. real property interests)?		
c	A qualifying foreign target under Regulations section 1.338-2(e)(1)(iii)?		
d	A corporation electing under section 1504(d) or section 953(d)?		
e	A domestic international sales corporation (DISC)?		
f	A passive foreign investment company (PFIC)?		
g	If the answer to item 8f is "Yes," is the PFIC a pedigreed qualified electing fund?		

Part V Original Statement of Assets Transferred

9 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of AGUB or ADSP
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$	$
Total	$	$

Part VI Supplemental Statement of Assets Transferred—Complete if amending an original statement or previously filed supplemental statement because of an increase or decrease in AGUB or ADSP.

10 Enter the tax year and tax return form number with which the original Form 8023 or Form 8883 and any supplemental statements were filed.

11 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of AGUB or ADSP
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$	$	$
Class VI and VII	$	$	$
Total	$		$

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

ATTACHMENT C
(Form 8023)

Form **8023**
(Rev. February 2006)
Department of the Treasury
Internal Revenue Service

Elections Under Section 338 for Corporations Making Qualified Stock Purchases

► See separate instructions.

OMB No. 1545-1428

Section A-1—Purchasing Corporation

1a Name and address of purchasing corporation	1b Employer identification number	
	1c Tax year ending	1d State or country of incorporation

Section A-2—Common Parent of the Purchasing Corporation

2a Name and address of common parent of purchasing corporation	2b Employer identification number	
	2c Tax year ending	2d State or country of incorporation

Section B—Target Corporation

3a Name and address of target corporation	3b Employer identification number	
	3c Tax year ending	3d State or country of incorporation

Section C—Common Parent of Selling Consolidated Group, Selling Affiliate, S Corporation Shareholder, or U.S. Shareholder

Complete only for a section 338(h)(10) election or if target was a member of a consolidated group or a controlled foreign corporation (CFC) or had been a CFC within the preceding five years.

4a Name and address of common parent of the selling consolidated group, selling affiliate, U.S. shareholder(s) of foreign target corporation, or S corporation shareholder(s)	4b Identifying number(s)
	4c Tax year ending

Section D—General Information

5a Acquisition date	5b What percentage of target corporation stock was purchased: *(i)* During the 12-month acquisition period? _____ % *(ii)* On the acquisition date? %

Section E—Elections Under Section 338

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

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

8 If the box on line 7 is checked for the target corporation listed in Section B on page 1, check here to make a gain recognition election for that corporation (see instructions) . . . . . ▶ ☐

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

Purchasing Corporation(s) Signature(s)

Under penalties of perjury, I state and declare that I am authorized to make the election(s) on lines 6, 7, 8, and 9 on behalf of the purchasing corporation(s).

▶ Signature of authorized person for purchasing corporation(s) | Date ▶ Title

Consolidated Selling Group or Selling Affiliate Signature (Section 338(h)(10) Election)

Under penalties of perjury, I state and declare that I am authorized to make the section 338(h)(10) election on line 6 on behalf of the common parent of the selling consolidated group or on behalf of the selling affiliate.

▶ Signature of authorized person for the common parent or selling affiliate | Date ▶ Title

S Corporation Shareholder(s) Signature(s) (Section 338(h)(10) Election)

Under penalties of perjury, I state and declare that I am a shareholder of the S corporation target or that I am authorized to make the section 338(h)(10) election on line 6 on behalf of that shareholder. If more than one shareholder, attach a schedule with other signatures.

▶ Signature of S corporation shareholder | Date ▶ Title

ATTACHMENT D
Form 8806

Form **8806**
(Rev. February 2006)
Department of the Treasury
Internal Revenue Service

Information Return for Acquisition of Control or Substantial Change in Capital Structure

OMB No. 1545-1869

Part I **Reporting Corporation** (see instructions)

1a Name of reporting corporation

b Address of reporting corporation

c EIN of reporting corporation

2a Name of reporting corporation's common parent, if any

b Address of reporting corporation's common parent

c EIN of reporting corporation's common parent

Part II **Acquiring Corporation** (see instructions)

3a Name of acquiring corporation

b Address of acquiring corporation

c EIN of acquiring corporation

d Was the acquiring corporation newly formed prior to its involvement in the transaction? . . . . . ☐ Yes ☐ No

4a Name of acquiring corporation's common parent, if any

b Address of acquiring corporation's common parent

c EIN of acquiring corporation's common parent

Part III **Information About Acquisition of Control or Substantial Change in Capital Structure**

5a Date of transaction(s) that resulted in the acquisition of control or substantial change in capital structure

b Description of the transaction(s) ▶

6a Did the reporting corporation's shareholders receive any stock or other property in exchange for their stock in the reporting corporation, for which the reporting corporation has reasonably determined that the shareholders are required to recognize gain (if any) from the exchange of such stock? (If "Yes," go to lines 6b and 6c) . . . . . ☐ Yes ☐ No

b Fair market value of the stock or other property received 6b

c Description of the stock or other property received ▶

Sign Here

Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

▶ Signature of officer ▶ Date

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code ▶ | EIN | Phone no. ( )

Part IV **Consent Election**

7 Does the reporting corporation consent to the publication of its name and address, date of transaction(s), description of shares affected by the transaction(s) and the amount of cash and fair market value of any property provided to each class of shareholders in exchange for a share, on an IRS website and/or in an IRS publication, as described in Regulations section 1.6043-4(a)(2), to assist brokers to satisfy their reporting obligations under Regulations section 1.6043-4(b)? . . . . . ☐ Yes ☐ No

Under penalties of perjury, I declare that I am an officer of the above named corporation and that I am authorized to give consent on behalf of the above named corporation for the IRS to publish the information necessary to enable brokers to satisfy their reporting obligations under Regulations section 1.6043-4(b).

Sign Here ▶ Signature of officer | Date | Title

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

A reporting corporation must file Form 8806 to report an acquisition of control or a substantial change in the capital structure of a domestic corporation that occurred after December 4, 2005. The reporting corporation or any shareholder is required to recognize gain (if any) under section 367(a) and its regulation as a result of the transaction.

Definitions

Acquisition of Control of a Corporation

Generally, an acquisition of control of a corporation (first corporation) occurs if, in a transaction or series of related transactions:

- Before an acquisition of stock of the first corporation (directly or indirectly) by the second corporation, the second corporation does not have control of the first corporation;
- After the acquisition, the second corporation has control of the first corporation;
- The fair market value of the stock acquired in the transaction and in any related transactions as of the date or dates on which such stock was acquired is $100 million or more;
- The shareholders of the first corporation receive stock or other property pursuant to the acquisition; and
- The first corporation or any shareholder of the first corporation is required to recognize gain (if any) under section 367(a) and the regulations, as a result of the transaction.

Control. Control means the ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock.

Substantial Change in Capital Structure of a Corporation

A corporation has a substantial change in capital structure if it has a change in capital structure and the amount of any cash and the fair market value of any other property (including the value of any stock) provided to the shareholders of such corporation pursuant to the change in capital structure, as of the date or dates on which the cash or other property is provided, is $100 million or more. Generally, a corporation has a change in capital structure if:

1. The corporation in a transaction or series of transactions:

- Merges, consolidates, or otherwise combines with another corporation or transfers all or substantially all of its assets to one or more corporations;
- Transfers all or part of its assets to another corporation in a Title 11 or similar case and, in pursuance of the plan, distributes stock or securities of that corporation; or
- Changes its identity, form, or place of organization; and

2. The corporation or any shareholder is required to recognize gain (if any) under section 367(a) and the regulations, as a result of the transaction.

Receipt of property. A shareholder is treated as receiving property (or as having property provided to it) related to an acquisition of control or a substantial change in capital structure if a liability of the shareholder is assumed in the transaction and, as a result of the transaction, an amount is realized by the shareholder from the sale or exchange of stock.

Reporting Corporation

A reporting corporation is a corporation whose stock was acquired in an acquisition of control or that had a substantial change in its capital structure.

Acquiring Corporation

The acquiring corporation is any corporation that acquired control of the reporting corporation or received assets from the reporting corporation pursuant to a substantial change in capital structure of the reporting corporation.

Who Must File

A reporting corporation is required to file Form 8806 if the reporting corporation or any shareholder is required to recognize gain (if any) as a result of the application of section 367(a) to the transaction.

If the reporting corporation transfers all or substantially all of its assets to an acquiring corporation in a transaction that constitutes a substantial change in the capital structure of the reporting corporation and the reporting corporation does not file Form 8806, then the acquiring corporation must file Form 8806. If neither corporation files Form 8806, both corporations are jointly and severally liable for any applicable penalties. *See Penalties for Failure To File* below.

Corporations Not Required To File

Do not file Form 8806:

- For transactions that were properly reported under section 6043(a); or
- If the reporting corporation reasonably determines that all of its shareholders who receive cash, stock, or other property related to the acquisition of control or substantial change in capital structure are exempt recipients under Regulations section 1.6043-4(b)(5).

When To File

File Form 8806, within 45 days after the transaction, or if earlier by January 5th of the calendar year following the year in which the acquisition of control or substantial change in capital structure occurred.

Where To File

Mail Form 8806 to:

Internal Revenue Service
Large and Midsize Business Division
Attention: PFTS
1111 Constitution Ave., NW
Washington, DC 20224

Penalties for Failure To File

Caution: *Form 8806 and all Forms 1099-CAP, Changes in Corporate Control and Capital Structure, required to be filed under Regulations sections 1.6043-4(a) and (b) will be considered as one return for purposes of the failure to file penalty under section 6652(l).*

If a correct Form 8806 is not filed by the due date of the corporation's income tax return, including extensions, it may be penalized $500 for each day the return is late, up to a maximum of $100,000. The penalty will not be imposed if the corporation can show that the failure to file on time was due to reasonable cause. Corporations that file late must attach a statement explaining the reasonable cause. Additional penalties may apply under sections 7203, 7206, and 7207.

Note. Failure to file also includes the requirement to file on magnetic media as required by section 6011(e) and Regulations section 1.6011-2.

Information Returns Regarding Shareholders

A corporation required to file Form 8806 also must file Form 1099-CAP for certain shareholders of record who receive cash or other property (including stock) in exchange for their stock in the reporting corporation due to the acquisition of control or the substantial change in capital structure. See Form 1099-CAP for more information.

Specific Instructions

Employer identification number (EIN). An EIN must be included for each corporation identified. An EIN is not required if the corporation does not have, and is not otherwise required to have, an EIN.

Common parent of the reporting corporation. If the reporting corporation was a subsidiary member of a consolidated group immediately prior to the reportable transaction, complete lines 2a and 2b.

Common parent of the acquiring corporation. If the acquiring corporation was a subsidiary member of a consolidated group at the time of the change in control or substantial change in capital structure, complete lines 4a and 4b.

Part IV–Consent Election

A reporting corporation may elect to consent to the IRS publication (on the IRS website and/or an IRS publication) of information included on this form, to be limited to the name and address of the corporation, the date of the transaction, a description of the shares affected by the transaction, and the amount of cash and the fair market value of any property provided to shareholders in exchange for a share. See Regulations section 1.6043-4(a)(2).

Corporations that elect to consent to such publication are not required to file Form 1099-CAP with respect to shareholders that are clearing organizations, or to furnish Form 1099-CAP to such organizations. See Regulations section 1.6043-4(b)(1) and (4).

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

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

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

Recordkeeping . . . . 6 hr., 42 min.
Learning about the law or the form . . . . 2 hr., 10 min.
Preparing and sending the form to the IRS . . 2 hr., 23 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6406, Washington, DC 20224. **Do not** send this form to this address. Instead see *Where To File* on page 2.

ATTACHMENT E
(Forms 1096 and 1099-CAP)

Do Not Staple 6969

Form **1096**
Department of the Treasury
Internal Revenue Service

Annual Summary and Transmittal of U.S. Information Returns

OMB No. 1545-0108

2011

FILER'S name

Street address (including room or suite number)

City, state, and ZIP code

Name of person to contact	Telephone number ( )
Email address	Fax number ( )

For Official Use Only

1 Employer identification number	2 Social security number	3 Total number of forms	4 Federal income tax withheld $	5 Total amount reported with this Form 1096 $

6 Enter an "X" in only one box below to indicate the type of form being filed.

7 If this is your **final return**, enter an "X" here . . . . ▶ ☐

W-2G 32	1097-BTC 50	1098 81	1098-C 78	1098-E 84	1098-T 83	1099-A 80	1099-B 79	1099-C 85	1099-CAP 73	1099-DIV 91	1099-G 86	1099-H 71	1099-INT 92
☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

1099-K 10	1099-LTC 93	1099-MISC 95	1099-OID 96	1099-PATR 97	1099-Q 31	1099-R 98	1099-S 75	1099-SA 94	3921 25	3922 26	5498 28	5498-ESA 72	5498-SA 27
☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

Return this entire page to the Internal Revenue Service. Photocopies are not acceptable.

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ▶ **Title ▶** **Date ▶**

Instructions

Reminder. The only acceptable method of filing information returns with Enterprise Computing Center—Martinsburg (ECC—MTB) is electronically through the FIRE system. See Pub. 1220, Specifications for Filing Forms 1097, 1098, 1099, 3921, 3922, 5498, 8935, and W-2G Electronically.

Purpose of form. Use this form to transmit paper Forms 1097, 1098, 1099, 3921, 3922, 5498, and W-2G to the Internal Revenue Service. Do not use Form 1096 to transmit electronically. For electronic submissions, see Pub. 1220.

Caution. If you are required to file 250 or more information returns of any one type, you must file electronically. If you are required to file electronically but fail to do so, and you do not have an approved waiver, you may be subject to a penalty. For more information, see part F in the 2011 General Instructions for Certain Information Returns.

Who must file. The name, address, and TIN of the filer on this form must be the same as those you enter in the upper left area of Forms 1097, 1098, 1099, 3921, 3922, 5498, or W-2G. A filer is any person or entity who files any of the forms shown in line 6 above.

Preaddressed Form 1096. If you received a preaddressed Form 1096 from the IRS with Package 1096, use it to transmit paper Forms 1097, 1098, 1099, 3921, 3922, 5498, and W-2G to the Internal Revenue Service. If any of the preprinted information is incorrect, make corrections on the form.

If you are not using a preaddressed form, enter the filer's name, address (including room, suite, or other unit number), and TIN in the spaces provided on the form.

When to file. File Form 1096 as follows.

- With Forms 1097, 1098, 1099, 3921, 3922, or W-2G, file by February 28, 2012.
- With Form 5498, file by May 31, 2012.

Where To File

Send all information returns filed on paper with Form 1096 to the following:

If your principal business, office or agency, or legal residence in the case of an individual, is located in ▼	Use the following three-line address ▼
Alabama, Arizona, Arkansas, Connecticut, Delaware, Florida, Georgia, Kentucky, Louisiana, Maine, Massachusetts, Mississippi, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, Texas, Vermont, Virginia, West Virginia	Department of the Treasury Internal Revenue Service Center Austin, TX 73301

Alaska, California, Colorado, District of Columbia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maryland, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, North Dakota, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Utah, Washington, Wisconsin, Wyoming

Department of the Treasury
Internal Revenue Service Center
Kansas City, MO 64999

If your legal residence or principal place of business is outside the United States, file with the Department of the Treasury, Internal Revenue Service Center, Austin, TX 73301.

Transmitting to the IRS. Group the forms by form number and transmit each group with a separate Form 1096. For example, if you must file both Forms 1098 and 1099-A, complete one Form 1096 to transmit your Forms 1098 and another Form 1096 to transmit your Forms 1099-A. You need not submit original and corrected returns separately. Do not send a form (1099, 5498, etc.) containing summary (subtotal) information with Form 1096. Summary information for the group of forms being sent is entered only in boxes 3, 4, and 5 of Form 1096.

Box 1 or 2. Complete only if you are not using a preaddressed Form 1096. Make an entry in either box 1 or 2; not both. Individuals not in a trade or business must enter their social security number (SSN) in box 2; sole proprietors and all others must enter their employer identification number (EIN) in box 1. However, sole proprietors who do not have an EIN must enter their SSN in box 2. Use the same EIN or SSN on Form 1096 that you use on Forms 1097, 1098, 1099, 3921, 3922, 5498, or W-2G.

Box 3. Enter the number of forms you are transmitting with this Form 1096. Do not include blank or voided forms or the Form 1096 in your total. Enter the number of correctly completed forms, not the number of pages, being transmitted. For example, if you send one page of three-to-a-page Forms 1098 with a Form 1096 and you have correctly completed two Forms 1098 on that page, enter "2" in box 3 of Form 1096.

Box 4. Enter the total federal income tax withheld shown on the forms being transmitted with this Form 1096.

Box 5. No entry is required if you are filing Form 1098-T, 1099-A, or 1099-G. For all other forms, enter the total of the amounts from the specific boxes of the forms listed below.

Form W-2G	Box 1
Form 1097-BTC	Boxes 1a, 1b, 1c, and 1d
Form 1098	Boxes 1 and 2
Form 1098-C	Box 4c
Form 1098-E	Box 1
Form 1099-B	Boxes 2 and 14
Form 1099-C	Box 2
Form 1099-CAP	Box 2
Form 1099-DIV	Boxes 1a, 2a, 3, 8, and 9
Form 1099-H	Box 1
Form 1099-INT	Boxes 1, 3, and 8
Form 1099-K	Box 1
Form 1099-LTC	Boxes 1 and 2
Form 1099-MISC	Boxes 1, 2, 3, 5, 6, 7, 8, 10, 13, and 14
Form 1099-OID	Boxes 1, 2, and 6
Form 1099-PATR	Boxes 1, 2, 3, and 5
Form 1099-Q	Box 1
Form 1099-R	Box 1
Form 1099-S	Box 2
Form 1099-SA	Box 1
Form 3921	Boxes 3 and 4
Form 3922	Boxes 3, 4, and 5
Form 5498	Boxes 1, 2, 3, 4, 5, 8, 9, 10, 12b, 13a, and 14a
Form 5498-ESA	Boxes 1 and 2
Form 5498-SA	Box 1

Final return. If you will not be required to file Forms 1097, 1098, 1099, 3921, 3922, 5498, or W-2G in the future, either on paper or electronically, enter an "X" in the "final return" box.

Corrected returns. For information about filing corrections, see the 2011 General Instructions for Certain Information Returns. Originals and corrections of the same type of return can be submitted using one Form 1096.

7373 ☐ VOID ☐ CORRECTED

CORPORATION'S name, street address, city, state, ZIP code, and telephone no.	1 Date of sale or exchange	OMB No. 1545-1814 **2011** Form **1099-CAP**	**Changes in Corporate Control and Capital Structure**
	2 Aggregate amount rec'd* $		
	3 No. of shares exchanged	4 Classes of stock exchanged	**Copy A For Internal Revenue Service Center** File with Form 1096. For Paperwork Reduction Act Notice, see the **2011 General Instructions for Certain Information Returns.**
CORPORATION'S federal identification no. / SHAREHOLDER'S identification no.			
SHAREHOLDER'S name			
Street address (including apt. no.)	5		
City, state, and ZIP code			
Account number (see instructions)	* The shareholder cannot claim a loss based on the amount in box 2.		

Form **1099-CAP** Cat. No. 35115M Department of the Treasury - Internal Revenue Service

Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page