CURRENT DEVELOPMENTS IN CORPORATE TAX

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Mark J. Silverman heads Steptoe & Johnson's tax practice. He is a member of The American Law Institute, Tax Advisory Group for the Study of Subchapter C of the Internal Revenue Code. He was formerly an advisor to the Committee on Ways and Means during their consideration of revisions to the corporate tax provisions of the Internal Revenue Code. He is a Fellow of the American College of Tax Counsel. Mr. Silverman was formerly a Council member of the American Bar Association, Section of Taxation and was formerly Chair of the Corporate Tax Committee. He chaired the Tax Section Task Force on Leveraged Buyouts. Mr. Silverman co-authored the Tax Advisors Planning Series on Financially Troubled Businesses, he was formerly Corporate Tax Editor of The Journal of Taxation, and is a member of the advisory boards of NYU Institute on Federal Taxation, BNA Tax Management, Consolidated Returns Tax Report, M&A Tax Report and Corporate Taxation magazines. Mr. Silverman is on the Editorial Board of The American Journal of Tax Policy, and is on the Board of Trustees of the Southern Federal Tax Institute. Mr. Silverman chairs the ALI-ABA annual consolidated returns program. Mr. Silverman was formerly a member of the Executive Committee of the New York State Bar Association. In addition, he is an Adjunct Professor of Law at Georgetown University Law Center and was formerly attorney-advisor to Judge Samuel B. Sterrett of the United States Tax Court. Mr. Silverman is a frequent speaker on tax matters and has published numerous articles on the subject.

Planning and Transactional Practice
Mr. Silverman focuses on planning and transactional matters. He has extensive experience in structuring acquisitions, mergers, and spin-off transactions for large public corporations, as well as closely held businesses. He has authored a book on the tax consequences of financially troubled businesses and advises corporations on consolidated return issues. Mr. Silverman advises leverage buyout groups, venture capitalists and privately held commercial real estate developers with respect to various transactional matters. He is often called upon to advise the Internal Revenue Service, Treasury Department and the staffs of the Congressional tax writing committees with respect to corporate tax issues.

Tax Policy Practice
A significant part of Mr. Silverman's practice involves the
resolution of tax policy issues before Congress and the Treasury Department. These issues arise in the context of pending or proposed legislation and proposed Treasury Department regulations. Mr. Silverman is currently meeting with members of Congress and their staffs on many of the corporate tax provisions proposed by the Administration and by members of Congress (including corporate spin-offs, financial product provisions, and corporate capital gains).

Audit and Controversy
Mr. Silverman also handles audit and controversy matters. He has extensive experience negotiating with field agents, appeals officers and district counsel in settling significant audit issues. Mr. Silverman frequently prepares technical advice requests and often meets with National Office officials with respect to audit and tax litigation matters.

Recently, Mr. Silverman was successful in convincing the National Office to reverse its position with respect to a technical advice memorandum involving the deduction of environmental clean-up costs.
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CURRENT DEVELOPMENTS IN CORPORATE TAX

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COI Issues
Facts: T, a corporation wholly-owned by individual A, merges into P, a publicly traded corporation, in exchange for $50 and 50 shares of P stock.
Facts: On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, A will receive 40 P shares and $60 cash in exchange for all of the outstanding stock of T. At the end of the day on January 2 of Year 1, the P stock trades for $1 per share. On June 1 of Year 1, the P stock trades for $.25 per share.

Analysis: Under proposed regulations issued August 10, 2004, the merger satisfies the continuity of interest (“COI”) requirements. Under the proposed regulations, whether the transaction satisfies the COI requirement is determined by reference to the value of the P stock as of the end of the day on January 2 of Year 1, the last business day before the first date there is a binding contract to effect the potential reorganization. For COI purposes, the T stock is exchanged for $40 of P stock and $60 cash. Thus, the transaction preserves a substantial part of the value of the proprietary interest in T (40%). Therefore, the transaction satisfies the continuity of interest requirement. See Prop. Treas. Reg. §§ 1.368-1(e)(2), (e)(7)(i).
Continuity of Interest — Contingent Earn-out

Facts: On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract at closing (June 1 of Year 1) A will receive $50 in P shares and $50 cash. In addition, if the future earnings of P meet certain targets, P must pay A an additional $100 on the third anniversary of the closing date (in the same 50/50 proportion).

Issue: Does this transaction satisfy the COI requirements? See Prop. Treas. Reg. §§ 1.368-1(e)(2), (e)(7)(i).
Continuity of Interest — Contingent Earn-out, cont.

- Assume that, at the end of the day on January 2 of Year 1, the P stock trades for $1 per share; at closing, the P stock trades for $1 per share; and on June 1 of Year 4, the P stock trades for $5 per share.

<table>
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<th>Earn-Out</th>
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<td>$50 Cash</td>
<td>$50 Cash</td>
<td>$100 Cash</td>
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<tr>
<td>50 shares x $1=$50</td>
<td>10 shares x $5=$50</td>
<td>60 shares=$100 FMV</td>
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Value of Stock:

- Closing
  - 50 shares x $1=$50
  - 10 shares x $1=$10
  - $60

- Earn-Out
  - 50 shares x $1=$50
  - 10 shares x $5=$50
  - $100

Continuity:

- If shares are valued on the earn-out date: $100/$200=50%
- If shares are valued at contract/closing: $60/$160=37.5%
Step Transaction and COBE Issues
Asset Transfers to Corporations

Facts: T merges into P and T shareholders exchange their T stock for P stock. P transfers the T assets to S, which immediately transfers them to S1.
Asset Transfers To Non-Controlled Corporations

Facts: T merges into P and T shareholders exchange their T stock for P stock. P transfers the T assets to Y in exchange for 50% of the stock of Y, and unrelated X transfers cash to Y in exchange for 50% of the stock of Y.
Asset Transfers To Non-Controlled Corporations

Facts: P owns all of the stock of X and Y. X merges into Y. Y transfers the X assets to newly formed N in exchange for 50% of the stock of N, and unrelated M transfers assets to N in exchange for 50% of the stock of N.
COBE and Drop-Down of Assets Following Tax-Free Reorganization; Example 1

**Facts:** P owns more than 80 percent of the stock of S1 and S2. P acquires T in tax-free reorganization qualifying under section 368(a)(1)(B) ("B" reorganization). Immediately after the reorganization, P contributes 50 percent of the T stock to S1 and 50 percent of the T stock to S2.

**COBE and Drop-Down of Asset Following Tax-Free Reorganization; Example 2**

**Facts:** P owns more than 80 percent of the stock of S1 and S2. T merges into P in tax-free reorganization qualifying under section 368(a)(1)(C) (“C” reorganization). Immediately after the reorganization, P contributes 50 percent of the T assets to S1 and 50 percent of the T assets to S2. S1 and S2 form S3, and S1 and S2 each contribute to S3 their respective 50 percent of T assets in exchange for 50 percent of the S3 stock.

COBE and Drop-Down of Asset Following Tax-Free Reorganization; Example 3

Facts: S acquires all of the T assets in the merger of T into S. In the merger, the T shareholders receive P stock and cash. Pursuant to the plan of reorganization, S transfers all of the T assets to PRS, a partnership in which S owns a 33 1/3 percent interest. S does not perform active and substantial management functions as a partner with respect to PRS' business.

Analysis: Under Prop. Treas. 1.368-2(k), the transaction, which otherwise qualifies as an “A” reorganization by reason of section 368(a)(2)(D), is not disqualified by the transfer of T assets from S to PRS because S has an ownership interest in PRS immediately after the transfer, S is a member of the qualified group and is treated as conducting the business of PRS under §1.368-1(d)(4)(iii), and the transaction satisfies the COBE requirements of §1.368-1(d). See Prop. Treas. Reg. 1.368-2(k)(3), ex. 5.
Continuity of Business Enterprise: Cross-Chain Transfers

**Facts**: P owns 100% of the stock of S. T, an unrelated corporation, merges into S, with the T shareholders receiving P stock for their T stock. Immediately thereafter, S transfers the T assets to X.
Continuity of Business Enterprise: Cross-Chain Transfers

Facts: P owns 100% of the stock of S. T, an unrelated corporation, merges into S, with the T shareholders receiving P stock for their T stock. Immediately thereafter, S transfers the T assets to X in exchange for cash.
Cross-Chain Transfers: COBE vs. Step Transaction

Facts: P owns 100% of the stock of S and X. X owns 100% of the stock of Y. T, an unrelated corporation, merges into S, with the T shareholders receiving P stock for their T stock. Immediately thereafter, S transfers the T assets to Y.
Facts: Pursuant to a plan of reorganization, X merges into S, P’s newly formed wholly owned subsidiary, in a transaction that is intended to qualify as a reorganization under sections 368(a)(1)(A) and 368(a)(2)(D). S continues the historic business of X. As part of the reorganization plan, P then transfers the S stock to S1, P’s pre-existing wholly owned subsidiary. Without regard to P’s transfer of the S stock to S1, X’s merger into S qualifies as a reorganization under sections 368(a)(1)(A) and 368(a)(2)(D).

Analysis: Prop. Treas. Reg. § 1.368-2(k) confirms that the merger X into S is not disqualified by the transfer of S stock to S1 following the merger.
Facts: A, an individual, owns 100 percent of T, a state X corporation. A also owns 100 percent of P, a state Y corporation. First, pursuant to plan of reorganization, T transfers all of its assets to P in exchange for consideration consisting of 70 percent P voting stock and 30 percent cash. Second, T liquidates, distributing the P voting stock and cash to A. Third, P transfers all of the T assets to S, a preexisting, wholly owned subsidiary of P, in exchange for S stock.

Result: The transaction qualifies as a “D” reorganization even though P does not retain the assets of T. Prop. Treas. Reg. § 1.368-2(k) confirms this result.
Facts: P and T are manufacturing corporations organized under the laws of state A. S, P’s newly formed wholly owned subsidiary, merges into T in a statutory merger under the laws of state A. In the merger, P exchanges its voting stock for 90% of the T stock, and tenders cash for the remaining 10% of T stock. As part of the merger plan, T sells 50% of its operating assets to X, an unrelated corporation, for cash. T retains the sales proceeds. Without regard to the requirement that T hold substantially all of the assets of T and S, the merger satisfies all the other requirements applicable to reorganizations under sections 368(a)(1)(A) and 368(a)(2)(E).
Push-up of Assets To a Corporation Following Tax-Free Reorganization

Facts: P owns 100 percent of S. S merges into T in a reverse triangular merger qualifying under section 368. Immediately after the merger of S into T, T distributes to P less than substantially all of its assets.

Result: Under Prop. Treas. Reg. § 1.368-2(k), the reorganization is not disqualified by the transfer of less than substantially all T assets from T to P.

Alternative 1: Same facts as above, except T merges into S in a forward triangular merger and S distributes substantially all of the T assets to P.

Alternative 2: Same facts as alternative 1, except S liquidates into P.
Push-up of Assets to Partnership Following Tax-Free Reorganization

Facts: P owns 80 percent of S and PRS. PRS owns the remaining 20 percent of S. T merges into S in a merger qualifying under section 368(a)(1)(A) by reason of section 368(a)(2)(D). Immediately after the merger of T into S, S distributes to PRS less than substantially all of T’s assets in redemption of 5 percent of the stock of S owned by PRS.

Results: Under Prop. Treas. Reg. § 1.368-2(k), the reorganization is not disqualified by the transfer of T assets from S to PRS.
Facts: Domestic corporation D conducts Business X and Business Y; D’s assets are equally divided between the two businesses. Domestic corporation A, which is unrelated to D, conducts Business X. A wishes to acquire D's Business X, but not D's Business Y. Accordingly, D and A undertake the following transaction: First, D transfers its Business X assets to C, a newly formed domestic corporation, in exchange for 100 percent of the stock of C. Second, D distributes the C stock to the D shareholders. Third, A acquires all of the assets of C in exchange solely for voting stock of A. Fourth, C liquidates.

Issue: Whether A’s acquisition of C’s assets satisfies the substantially all requirement of section 368(a)(1)(C)?

Ruling: C should be considered independently from D in determining whether A’s acquisition of C qualifies as a reorganization under section 368. Accordingly, the acquisition by A of all the properties held by C immediately after the distribution by D satisfies the substantially all requirement of section 368(a)(1)(C).

Note: The result is different if D contributes business Y to C, D distributes the C stock to the D shareholders, and D transfers the X assets to A in exchange for A stock. See Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1937).
**Facts:** A is the sole shareholder of Corporation X, an Alabama corporation. On Date 1, X changes its state of incorporation to Delaware and its name to T Corporation in a reorganization intended to qualify under section 368(a)(1)(F). Immediately after the reorganization (on Date 2), A sells 100 percent of the T stock to Z for cash.

**Issue:** Is COI satisfied? On August 12, 2004, the IRS and Treasury issued proposed regulations stating that the application of the COI requirements to a “F” reorganization is not required to protect the policies underlying the reorganization provisions. *See* Prop. Treas. Reg. § 1.368-2(m)(2). In addition, the proposed regulations provide that related events that precede or follow a transaction or series of transactions that constitutes a “mere change in corporate form” will not cause that transaction or series of transactions to fail to qualify as a “F” reorganization. *Prop. Treas. Reg. § 1.368-2(m)(3)(ii).*
“Mere Change” Requirements

• Proposed regulations issued by Treasury and the IRS on August 12, 2004, provide that, to qualify as a “F” reorganization, a transaction must result in a “mere change in identity, form, or place of organization of one corporation.” Prop. Treas. Reg. § 1.368-2(m).

• A transaction constitutes a “mere change” only if the following four requirements are satisfied. See Prop. Treas. Reg. § 1.368-2(m)(1)(i)(A)-(D).
  – All of the stock of the resulting corporation, including stock issued before the transfer, must be issued in respect of stock of the transferring corporation.
  – There must be no change in the ownership of the corporation in the transaction, except a change that has no effect other than that of a redemption of less than all the shares of the corporation.
  – The transferring corporation must completely liquidate in the transaction.
  – The resulting corporation must not hold any property or have any tax attributes (including those specified in section 381(c)) immediately before the transfer.
**Facts:** P and T are widely held manufacturing corporations organized under the laws of state A. T has only voting common stock outstanding, none of which is owned by P. P seeks to acquire all of T’s outstanding stock. For valid business reasons, the acquisition will be effected by a tender offer for at least 51% of T’s stock, to be acquired solely for P voting stock, followed by a merger of S, P’s newly formed wholly owned subsidiary, into T. Pursuant to the tender offer, P acquires 51% of T’s stock from T’s shareholders for P voting stock. P then forms S which merges into T in a statutory merger under the laws of state A. In the merger, P’s S stock is converted into T stock and each of the T shareholders holding the remaining 49 percent of the outstanding T stock exchanges its shares of T stock for a combination of consideration, two-thirds of which is P voting stock and one-third of which is cash. Assume (i) that the tender offer and merger are treated as an integrated acquisition by P of all of the T stock, and (ii) that all nonstatutory requirements under sections 368(a)(1)(A) and 368(a)(2)(E), and all statutory requirements under section 368(a)(2)(E), other than the requirement that P acquire control of T in exchange for its voting stock, are satisfied. Assume the same facts, except what if S initiates the tender offer for T stock and, in the tender offer, acquires 51% of the T stock for P stock provided by P?
**King Enterprises Transaction**

**Facts:** The shareholders of T exchange all of their T stock for consideration consisting of 50% P voting stock and 50% cash. Immediately following the exchange, and as part of the overall plan, P causes T to merge upstream into P. The transaction should qualify as an “A” reorganization. See King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-26, 2001-23 I.R.B. 1 (May 11, 2001).
**Rev. Rul. 2001-46 - Situation 1**

**Facts:** P owns all of the stock of S, a newly formed wholly owned subsidiary. Pursuant to an integrated plan, P acquires all of the stock of T, an unrelated corporation, in a statutory merger of S into T, with T surviving. In the merger, the T shareholders exchange their stock for consideration of 70% P voting stock and 30% cash. Immediately thereafter, T merges upstream into P.

**Result:** If the acquisition were viewed independently from the upstream merger of T into P, the result should be a QSP of T stock followed by a section 332 liquidation. See Rev. Rul. 90-95, 1990-2 C.B. 67. However, because step transaction principles apply, see King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969), the transaction is treated as a single statutory merger of T into P under section 368(a)(1)(A). P acquires the T assets with a carry-over basis under section 362, and P may not make a section 338 election for T.

**Note:** On July 8, 2003, the Service issued new final and temporary regulations that permit taxpayers to turn off the step transaction doctrine and to make a section 338(h)(10) election in the transaction described above. See Treas. Reg. § 1.338-3(c)(1)(i), (2) and Temp. Treas. Reg. § 1.338(h)(10)-1T.
The new temporary 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) . . . ” Temp. Treas. Reg. § 1.338(h)(10)-1T(c)(2).

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.

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 Temp. Treas. Reg. § 1.338(h)(10)-1T(e), Ex. 12 & 13.

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.

The regulations are effective for stock acquisitions occurring on or after July 8, 2003.
**Facts:** Same facts as in Situation 1, except that the T shareholders receive solely P stock in exchange for their T stock, so that the merger of S into T, if viewed independently of the upstream merger of T into P, would qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

**Result:** Step transaction principles apply to treat the transaction as a merger of T directly into P.

**Note:** The taxpayers cannot change this result under the new section 338 regulations because, standing alone, P’s acquisition of T does not constitute a qualified stock purchase.
**King Enterprises Transaction - Variation**

**Facts:** Same facts as in Variation 1, except P sells T’s assets to X a third party immediately after the merger of T into P.

**Questions:**
1. Does the Step-Transaction Doctrine apply?
2. What is the result of this transaction for Federal income tax purposes?
**King Enterprises Transaction - Variation**

**Facts:** T currently operates two businesses. T contributes all of its Business 2 assets to C, a newly formed wholly owned subsidiary. T distributes the stock of C to T shareholders in a spin-off. P acquires T from the T shareholders in exchange for P stock. Immediately thereafter, T is liquidated into P.

**Form:** The above steps in form constitute a section 355 transaction, a B reorganization, and a section 332 liquidation.

**Result:** Step transaction principles apply to treat P’s acquisition of T as if: (1) P purchased a portion of T’s assets and (2) T liquidated. See Rev. Rul. 67-274; Elkhorn Coal. Under Rev. Rul. 67-274, P’s acquisition of T is not a valid B reorganization. Because T liquidates into P, Rev. Rul. 67-274 combines the steps and treats the transaction as an acquisition by P of T’s assets in a C reorganization. In this transaction, the acquisition does not qualify as a C reorganization because Elkhorn Coal steps together the spin-off and the acquisition such that P cannot be said to acquire substantially all of T’s assets. Therefore the transaction will be a taxable acquisition and not a tax-free reorganization.

**Issue:** Can P’s acquisition of T be treated as a qualified stock purchase followed by a section 332 liquidation? See Rev. Rul. 2001-46; Treas. Reg. § 1.338-3(c)(1)(i), (2); Temp. Treas. Reg. § 1.338(h)(10)-1T(c)(2), (e).
PLR 200141040--King Enterprises Variation--D Reorganization

Facts:  (1) T makes a tender offer to all of its shareholders to acquire T stock to increase the percentage ownership of T’s largest shareholders
       (2) T’s largest shareholders contribute T stock to Q solely in exchange for Q stock
       (3) Q forms wholly-owned subsidiary Q1 that merges into T, with T surviving the merger. All of T’s remaining shareholders except Q will receive cash for T stock as part of the merger.
       (4) Q will make a Subchapter S election and a QSub election for T, resulting in a deemed liquidation of T.

Result: Four steps of transaction will be collapsed and treated as the transfer by T of “substantially all” of its assets to Q in exchange for Q stock and the assumption by Q of T’s liabilities, followed by the liquidation of T. The transaction will qualify as a “D” Reorganization.
STEP ONE

Additional X Stock

Assets of A’s business

STEP TWO

Public

Y

X

Facts: Individual A owns all of the stock of corporation X and operates a business similar to the business of X through a sole proprietorship. A transfers its sole proprietorship business to X in exchange for additional X stock. A then transfers all of his stock in X to Y in exchange for Y voting stock. Both steps were part of a prearranged plan.

Result: The transfer of A’s sole proprietorship to X in exchange for X stock does not qualify as a section 351 exchange. The Service ruled that because the sole proprietorship was only transferred to X to allow A to transfer those assets to Y tax-free, the transaction should be recharacterized as a transfer by A of the sole proprietorship directly to Y in a transfer to which section 351 does not apply, followed by a transfer of these assets by Y to X, and a separate transfer of X stock by A to Y for Y voting stock.
Rev. Rul. 70-140 (Variation)

**Facts:** Corporation W transfers its Business A assets to Z in exchange for Z stock. Z then merges into Y in exchange for Y voting stock, which is distributed to W. Both steps are part of a prearranged plan.

**Result:** The transfer of business A assets by W to Z for Z stock does not satisfy the requirements of section 351 because the transaction is recharacterized under Rev. Rul. 70-140 as a transfer of the business assets by W directly to Y in exchange for Y voting stock.
**Facts:** Corporation W engages in Businesses A, B, and C. X, an unrelated corporation, also engages in Business A through its wholly-owned subsidiary, corporation Y. The corporations desire to combine their businesses in a holding company structure. Under a prearranged plan, the following transfers take place: (1) W forms Z and contributes its Business A to Z for Z stock; (2) W contributes its Z stock to Y in exchange for Y stock; (3) simultaneously, X transfers $30x to Y in exchange for additional Y stock to meet the capital needs of Business A; and (4) Y transfers the $30x and its Business A to Z, which is now a wholly-owned subsidiary of Y. After the transfers, W owns 40% of Y stock and X owns 60% of Y stock.

**Result:** W’s transfer of Business A to Z for Z stock (Transfer 1) qualifies as a tax-free exchange under section 351, notwithstanding the subsequent transfers. Unlike Rev. Rul. 67-274, Rev. Rul. 2001-26, and Rev. Rul. 2001-46, the Service did not recharacterize the steps of the transaction, but instead adhered to the form of the transfers. Transfer 1, Transfers 2 and 3, and Transfer 4 are treated as three successive tax-free exchanges under section 351. See Rev. Rul. 77-448. The Service distinguished Rev. Rul. 70-140 on the basis that the transfer of Business A to Z was not necessary for the parties to have structured the transaction in a tax-free manner. Rev. Rul. 2003-51 appears limited to section 351 transactions.
**Rev. Rul. 2003-51 (Variation)**

**Facts:** Corporation W engages in Businesses A, B, and C. X, an unrelated corporation, also engages in Business A through its wholly-owned subsidiary, corporation Y. Individual A has Business A assets. Under a prearranged plan, the following steps take place: (1) W and A form Z. W contributes its Business A to Z for 60% of the Z stock and A contributes its Business A assets and cash to Z for 40% of the Z stock; (2) W contributes its Z stock (60%) to Y in exchange for Y stock; (3) simultaneously, X transfers cash to Y in exchange for additional Y stock to meet the capital needs of Business A; and (4) Y transfers the cash and its Business A to Z for additional Z stock. After the transfers, W owns 40% of Y stock and X owns 60% of Y stock. Y owns 75% of Z stock and A owns 25% of Z stock.

**Result:** Under the reasoning of Rev. Rul. 2003-51, W’s transfer of Business A and A’s transfer of Business A assets and cash to Z for Z stock (Transfer 1) should qualify as a tax-free exchange under section 351, notwithstanding the subsequent transfers. Query whether under Rev. Rul. 2003-51, Transfers 2 and 3 (combined) and Transfer 4 would be treated as separate exchanges? If so, Transfers 2 and 3 would be a tax-free exchange under section 351, but Transfer 4 would not be a tax-free exchange under section 351 because Y does not satisfy the control test. Is this inconsistent with Rev. Rul. 70-140?
Application of Rev. Rul. 70-140 to
Facts of Rev. Rul. 2003-51


Result: Under Rev. Rul. 70-140, the transaction would be recharacterized as follows: (1) W contributes Business A to Y for Y stock; (2) simultaneously, X contributes $30x to Y for additional Y stock; and (3) Y contributes Business A and $30x to Z for Z stock, with Z becoming a wholly-owned subsidiary of Y. Steps 1 and 2 qualify as a tax-free exchange under section 351 and Step 3 qualifies as a tax-free exchange under section 351.
Merrill Lynch v. Commissioner

**Step One:** MLL contributes certain retained assets to Merlease that MLC does not want to sell to Inspiration.

**Step Two:** MLL sells Merlease cross-chain to a sister subsidiary, MLAM, in a section 304 transaction.

**Step Three:** MLL distributes the gross sale proceeds to MLCR as a dividend.

**Step Four:** MLCR sells MLL to Inspiration, an unrelated third party.
Merrill Lynch v. Commissioner

Position of Merrill Lynch: Under the consolidated return regulations in effect during 1986, Merrill Lynch took the position that the cross-chain sale of Merlease and the dividend to MLCR should be treated as a deemed redemption under section 304 subject to dividend treatment under section 301. Merrill Lynch argued that the transaction did not qualify for sale or exchange treatment under section 302 due to the fact that MLL’s interest in Merlease was not terminated at the time of the cross-chain sale. Therefore, Merrill Lynch claimed that MLCR was entitled to a step-up in its basis in its MLL stock to the extent of the dividend and recognized a loss on its sale of MLL stock to Inspiration.

Decision of Tax Court: The Tax Court ruled that the cross-chain sale, dividend, and sale of MLL to Inspiration were steps in a plan to terminate MLL’s ownership of Merlease and the section 304 redemption was therefore subject to sale or exchange treatment because it represented a complete termination of MLL’s interest in Merlease under section 302(b)(3). The Court concluded that the cross-chain sale and sale of MLL to Inspiration represented a “firm and fixed” plan to terminate MLL’s interest in Merlease for purposes of determining whether the section 304 redemption should be treated as a sale or exchange or a dividend. See Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); Niedermeyer v. Commissioner, 62 T.C. 280 (1974). In reaching its decision, the Court focused on the fact that the complete plan to sell MLL was presented to Merrill Lynch’s board of directors only four days after the cross-chain sale and while the sale was not finalized, it was sufficiently mature at that time that a tax reserve for the transaction was established.
Insolvency
And
Liability Issues
Situation 1: Corporation P owns 100 percent of the stock of Subsidiary FS, an entity organized under the laws of Country X that operates a manufacturing business. FS is an “eligible entity” under Treas. Reg. § 301.7701-3(a) and, prior to July 1, 2003, FS is treated as a corporation for federal tax purposes (under section 7701(a)(3)). On December 31, 2002, the stock of FS was not worthless. On July 1, 2003, P files a check-the-box election for FS, changing the classification of FS from a corporation to a disregarded entity for federal tax purposes effective as of that date. At the close of the day immediately before the effective date of the election, the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, exceeds the sum of its liabilities. However, at that time, the fair market value of FS's assets, excluding intangible assets such as goodwill and going concern value, does not exceed the sum of its liabilities. After the change in entity classification election is effective, FS continues its manufacturing operations.

Situation 2: Same facts as in Situation, except that at the close of the day immediately before the effective date of the election, the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, does not exceed the sum of its liabilities.
**Rev. Rul. 2003-125 (Cont.)**

**Holding:** When an election is made to change the classification of an entity from a corporation to a disregarded entity, the shareholder of such entity is allowed a worthless security deduction under section 165(g) if the fair market value of the assets of the entity, including intangible assets such as goodwill and going concern value, does not exceed the entity's liabilities such that on the deemed liquidation of the entity the shareholder receives no payment on its stock.

**Situation 1:** Because the aggregate value of FS’s tangible and intangible assets ($1,050,000) exceeds FS’s liabilities ($1,000,000) immediately before the effective date of the P’s check-the-box election for FS, the stock of FS is not worthless on that date. Accordingly, because P receives at least partial payment on its FS stock in the deemed liquidation of FS. As a result, section 332 applies to the deemed liquidation and no loss is allowable to P.

**Situation 2:** Because the aggregate value of FS’s tangible and intangible assets ($950,000) does not exceed FS’s liabilities ($1,000,000) immediately before the effective date of the P’s check-the-box election for FS, the stock of FS is worthless. Accordingly, section 332 does not apply because P does not receive any payment on its FS stock in the deemed liquidation of FS. The deemed liquidation is an identifiable event that fixes P's loss with respect to the FS stock and, therefore, P is allowed a worthless security deduction under section 165(g) for its 2003 tax year. Also, depending on the facts, FS's creditors, including P, may be entitled to a deduction for a partially or wholly worthless debt under sections 165 or 166.
Rev. Rul. 2003-125 clarifies that:

• Where a worthless stock deduction is claimed upon the liquidation of a corporation and the stock did not become worthless in a prior tax year, the standard for determining worthlessness is whether the shareholders receive payment for their stock. See H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986).

• A shareholder receives no payment for its stock in a liquidation if, at the time of the liquidation, the fair market value of the corporation's assets is less than the corporation's liabilities.

• The value of intangible assets, including goodwill and going concern, is included in determining the fair market value of the entity’s assets immediately before the deemed liquidation.

• Certain facts, such as (i) the continuation of the corporation's business after a liquidation without a substantial infusion of capital, and (ii) the revenues of that business following the liquidation exceed the amount required to service debt that existed immediately prior to the liquidation, may suggest that at the time of liquidation the fair market value of the liquidating entity's assets, including goodwill and going concern value, exceeded the sum of its liabilities.
Rev. Rul. 2003-125 clarifies that (cont.):

• Nevertheless, depending on the facts, the parent could claim a bad debt deduction and a worthless stock deduction where its wholly owned subsidiary owes a bona fide indebtedness to its parent corporation that exceeds the fair market value of its assets and the subsidiary transfers all of its assets to the parent in partial satisfaction of its indebtedness. This may be true even where the parent continues the business formerly conducted by the subsidiary. See Rev. Rul. 70-489, 1970-2 C.B. 53, amplifying Rev. Rul. 59-296, 1959-2 C.B. 87.

• If a shareholder receives no payment for its stock in a liquidation of the corporation, neither section 331 nor section 332 applies to the liquidation.

• The fact that a shareholder receives no payment for its stock in a liquidation of the corporation demonstrates that such shareholder's stock is worthless.

• The liquidation is an identifiable event that fixes the loss with respect to the stock for purposes of a worthless stock deduction under section 165(g).

Facts: On January 1, year 1, T issues debt instruments with a stated maturity date of January 1, year 12. On the issue date, the debt instruments provide for a market rate of interest and are securities within the meaning of section 354. T has outstanding one class of common stock. On January 1, year 10, T merges into P in a transaction that qualifies as a reorganization under § 368(a)(1)(A). In the merger, T shareholders exchange their T stock for P stock. Also in the merger, the T security holders exchange their T securities for P debt instruments with terms identical to those of the T securities (including the maturity date), except that the interest rate is changed. The modification of the interest rate is a significant modification under Treas. Reg. § 1.1001-3.

Ruling: In Rev. Rul. 2004-78, the Service ruled that the P debt instruments issued by P in exchange for the T securities were securities under section 354. The Service acknowledged that the P debt with a term of two years generally would not qualify as a security. However, because the P debt instruments were issued in the reorganization in exchange for T securities and bore the same terms (other than interest rate) as the T securities, the P debt instruments represented a continuation of the T security holder’s investment in T in substantially the same form. Therefore, the P debt instruments exchanged for T securities were securities under section 354.
Acquisition of Related Party Indebtedness—Rev. Rul. 2004-79: Situation 1

**Facts:** On January 1, Year 1, P issued debt that provides for monthly interest payments of $80,000 payable at the end of each month and a principal payment of $10,000,000 on its stated maturity date of December 31, Year 4. The $80,000 monthly interest payments are qualified stated interest payments within the meaning of Treas. Reg. § 1.1273-1(c). S has only one class of stock outstanding, all of which is owned by P. On January 1, Year 2, S purchases all of the P indebtedness from A, an individual not related to S under Treas. Reg. § 1.108-2(d)(2), for cash in the amount of $9,500,000. On that date, the adjusted issue price of the P indebtedness is $10,000,000. On January 1, Year 3, S distributes all of the P indebtedness it holds to P. At the time of this distribution, the fair market value of the P indebtedness is $9,250,000. During Year 3, S makes no other distributions to P. P and S do not join in filing a consolidated return for Years 1 through 3. At all times, the fair market value of P’s assets exceeds the amount of its liabilities. At the end of Year 3, S has earnings and profits in the amount of $20,000,000.
Rev. Rul. 2004-79: Situation 1, continued

• Analysis

– Under section 108(e)(4), S’s purchase of the P indebtedness is treated as P’s acquisition of that indebtedness because P and S have a relationship specified in section 267(b)(3). Thus, S’s acquisition of the P indebtedness results in the realization by P of income from the discharge of indebtedness. P realizes $500,000 of income from the discharge of indebtedness (the adjusted issue price of the indebtedness ($10,000,000) less S’s basis in the indebtedness on the acquisition date ($9,500,000)).

– The P indebtedness is treated as new indebtedness issued by P to S in year 2. The new indebtedness is deemed issued with an issue price equal to S’s adjusted basis in the indebtedness ($9,500,000). The $500,000 excess of the stated redemption price at maturity of the indebtedness ($10,000,000) over its deemed issue price ($9,500,000) is OID.

– The P indebtedness is property for purposes of the corporate distribution provisions. Therefore, S’s distribution of the P indebtedness to P is a distribution of property described in section 301. The amount of such distribution is the fair market value of the property distributed, $9,250,000. The distribution in its entirety is treated as a dividend to P because as of the end of Year 3 S has earnings and profits in excess of the amount of the distribution.

– Additionally, because the distribution of the P indebtedness to P extinguishes the indebtedness, it is repurchased within the meaning of Treas. Reg. § 1.61-12(c)(2), and P is treated as having repurchased its indebtedness for an amount equal to the fair market value of the indebtedness, $9,250,000. Accordingly, under Treas. Reg. § 1.61-12(c)(2)(ii), P realizes income from the discharge of indebtedness in an amount equal to $397,868, the excess of the adjusted issue price of the P indebtedness ($9,647,868) over the amount of the distribution ($9,250,000).

– Under section 311(a), S does not recognize the loss inherent in the P indebtedness on the distribution of the P indebtedness. As a result of the distribution, pursuant to section 312(a), S's earnings and profits are reduced by its adjusted basis in the P indebtedness distributed, $9,647,868.

Facts: Same facts as situation 1, except that at the time S distributes the P indebtedness to P, the fair market value of the P indebtedness is $10,050,000.

Analysis: In Situation 2, the tax consequences of S’s purchase of the P indebtedness are generally the same as in Situation 1.

In Year 3, the amount of the distribution of the P indebtedness determined pursuant to section 301(b) and treated as a dividend under section 301(c) is $10,050,000.

Additionally, P is treated as having repurchased its indebtedness for the same amount.

Under Treas. Reg. § 1.163-7(c), P is generally entitled to an interest deduction in an amount equal to the $402,132 excess of the amount of the distribution ($10,050,000) over the adjusted issue price of the P indebtedness ($9,647,868).

Under section 311(b), S recognizes gain as if it sold the indebtedness to P for an amount equal to its $10,050,000 fair market value. Thus, S recognizes gain in an amount equal to $402,132, the excess of the fair market value of the indebtedness distributed ($10,050,000) over S’s adjusted basis in the indebtedness distributed ($9,647,868).

Under sections 312(a) and (b), S’s earnings and profits must be increased by $402,132, the excess of the fair market value of the indebtedness distributed ($10,050,000) over S’s adjusted basis in the indebtedness distributed ($9,647,868), and reduced by the fair market value of the indebtedness distributed, $10,050,000.
S Corporation Issues
Adjustments to NUBIG To Cure Duplicated Gain

**Year 1**
- Asset #1 = $50 gain
- Asset #2 = $40 loss
- Asset #3 = $40 gain
- Y's Asset = $40 gain

**Year 2**
- X sells Asset #1, recognizing $50 of gain
- X makes a QSub election for Y (thereby liquidating Y)
- X has net unrealized built-in gain equal to $40 on Y's sole asset

**Year 3**
- X sells Y's asset, recognizing $40 of gain

**Facts:** In year 1, corporation X elects to be treated as an S corporation but does not make a QSub election for Y, X's wholly owned subsidiary. On that date, X owns three assets. Asset #1 has built-in gain of $50. Asset #2 has built-in loss of $40. Asset #3 has built-in gain of $40. Thus, X's NUBIG equals $50. Asset #3 consists of all the stock of Y, which owns one asset with built-in gain of $40. In Year 2, X sells Asset #1, recognizing $50 of gain. In year 2, X also makes a QSub election for Y (thereby liquidating Y). X has net unrealized built-in gain equal to $40 on Y's sole asset. In year 3, X sells Y's asset, recognizing $40 of gain. Accordingly, X's total section 1374 tax equals $90 -- $50 from Asset #1 and $40 from Y's asset.

**Issues:** X should pay section 1374 tax on no more than $50 of recognized built-in gain. The remaining $40 of recognized built-in gain subject to section 1374 tax reflects a duplication of built-in gain. To eliminate this duplication problem, Prop. Treas. Reg. § 1.1374-3 would require X, with respect to all taxable years ending on or after the date of the QSub election, to reduce its Original NUBIG by the amount of built-in gain X had in the stock of Y on the date of X's conversion to an S corporation ($40). In addition, the proposed regulations would require X to increase its NUBIG by any built-in loss X had in the Y stock on the date of X's conversion to an S corporation. The proposed regulations will apply only to taxable years beginning on or after the date they are published as final regulations. Thus, even if the proposed regulations are finalized in 2004, they will not be effective until 2005 for calendar-year S corporations. Accordingly, X still will be required to pay section 1374 tax on $90 of recognized built-in gain in 2004. This result could be corrected if the regulations were issued as temporary regulations applicable to all taxable years beginning on or after the date of publication of the temporary regulations or to transactions occurring on or after the date that the regulations are published.
Adjustment to NUBIG for Built-In Gain in Eliminated C Corporation Stock

Facts: X is a C corporation that wholly owns another C corporation, Y. X decides to convert to an S corporation and to preserve Y as a wholly owned corporate subsidiary. On the effective date of X’s S election, X has a NUBIG of $15,000. Among the assets held by X on such date is all of Y’s stock, which has a fair market value of $33,000 and an adjusted basis of $18,000. On March 1 of the fifth year after X’s conversion to an S corporation, X sells an asset that it owned on the date of conversion and, as a result, recognizes $10,000 of RBIG. Effective June 1 of the same year, X elects under Section 1361 to treat Y as a QSub. The election is treated as a transfer of Y’s assets and liabilities to X in a liquidation to which Sections 332 and 337(a) apply. See Treas. Reg. § 1.1361-4(a). Assume for such year that X has no other RBIG or RBIL, and its taxable income limitation under Section 1374(d)(2)(A)(ii) is $50,000.

Tax Consequences: Under Prop. Treas. Reg. § 1.1374-3(b)(1), X’s NUBIG is adjusted to account for the elimination of the Y stock in the liquidation. X’s NUBIG is decreased by $15,000. Accordingly, X’s NUBIG is $0 for the taxable year of the liquidation. Because X’s NUBIG has been reduced to $0, the $10,000 of RBIG previously recognized in the same taxable year is no longer subject to tax under Section 1374. See Section 1374(b)(1), (c)(2), (d)(2); Prop. Treas. Reg. § 1.1374-3(c) ex. 2.
Adjustment to NUBIG for Built-In Loss Eliminated in C Corporation Stock

Facts: X is a C corporation that owns 10 percent of the outstanding stock of another C corporation, Y. X decides to convert to an S corporation. On the effective date of X’s S election, X has a negative NUBIG of $5,000. Among the assets held by X on such date is 10 percent of Y’s stock, which has a fair market value of $18,000 and an adjusted basis of $33,000. On March 1 of the fifth year after X’s conversion to an S corporation, X sells an asset that it owned on the date of conversion and, as a result, recognizes $8,000 of RBIG. Effective June 1 of the same year, Y transfers all of its assets and liabilities to X in exchange for voting stock of X in a transaction that meets the definition of a reorganization in Section 368(a)(1)(C). Assume for such year that X has no other RBIG or RBIL, and its taxable income limitation under Section 1374(d)(2)(A)(ii) is $50,000.

Tax Consequences: Under Prop. Treas. Reg. § 1.1374-3(b)(1), X’s NUBIG is adjusted to account for the elimination of the Y stock in the reorganization. The NUBIG is increased by $15,000. Accordingly, X’s NUBIG is $10,000 for the taxable year of the reorganization. Because X’s NUBIG has been increased to $10,000, the $8,000 of RBIG previously recognized in the same taxable year becomes subject to tax under Section 1374. See Section 1374(b)(1), (c)(2), (d)(2); Prop. Treas. Reg. § 1.1374-3(c) ex. 3.
Adjustment to NUBIG for Built-In Gain in Eliminated C Corporation Stock – Exception for Prior Gain Recognition

**Facts:** X is a C corporation that wholly owns another C corporation, Y. X decides to convert to an S corporation. On the effective date of X’s S election, X has a NUBIG of $30,000. Among the assets held by X on such date is all the outstanding stock of Y, which has a fair market value of $45,000 and an adjusted basis of $10,000. Y has no current or accumulated earnings and profits. On April 1 of the third year after X’s conversion to an S corporation, Y distributes $18,000 to X, $8,000 of which is treated as gain to X from the sale or exchange of property under Section 301(c)(3). That $8,000 gain constitutes RBIG under Section 1374(d)(3), and it results in $8,000 of NRBIG taxable to X in such third year. Effective June 1 of the fifth year after X’s conversion to an S corporation, Y transfers all of its assets and liabilities to X in a liquidation to which Sections 332 and 337(a) apply.

**Tax Consequences:** Under Prop. Treas. Reg. § 1.1374-3(b)(1), X’s NUBIG is adjusted to account for the elimination of the Y stock in the liquidation. Under this rule, X’s NUBIG presumably is decreased to negative $5,000. Cf. Prop. Treas. Reg. § 1.1374-3(c) ex. 3. However, one of the exceptions to the general rule of the proposed regulations applies. Under Prop. Treas. Reg. § 1.1374-3(b)(2)(i), the amount of the decrease to NUBIG is limited to the amount of built-in gain X had in the Y stock on the date of conversion that has not resulted in RBIG during the recognition period. Since X recognized earlier in the recognition period $8,000 of the built-in gain it had in the Y stock at conversion, the amount of the decrease to X’s NUBIG is decreased from $35,000 to $27,000. Therefore, as a result of the liquidation of Y, X’s NUBIG decreases from $30,000 to $3,000, and X’s NUBIG limitation decreases from $22,000 to $0. See Section 1374(c)(2); Prop. Treas. Reg. § 1.1374-3(c) ex. 4.
Facts: X owns 100 percent of the stock of S, a corporation that X has elected to treat as a QSub. X is an Alabama corporation as well as a S corporation. X merges with and into U, a Delaware corporation, in a transaction qualifying as a reorganization under section 368(a)(1)(F). The shareholders of X own 100 percent of the stock of U and U is eligible to be a S corporation under section 1361(b)(1).

Issues: Does S’s QSub election terminate as a result of the “F” reorganization? In Rev. Rul. 2004-85, the Service ruled that the QSub election does not terminate as a result of the “F” reorganization because U is treated as a continuation of X. See Section 381; Rev. Rul. 64-250.
**Rev. Rul. 2004-85: Situation Two**

**Facts:** Y is a S corporation that owns 100 percent of the stock of S, a corporation that Y has elected to treat as a QSub. Y (whether by sale or reorganization under section 368(a)(1)(A), (C), or (D)) transfers Y’s assets, including all of its S stock, to M, a S corporation, in a transaction that is not a reorganization under section 368(a)(1)(F).

**Issues:** Rev. Rul. 2004-85 holds that, since the transfer does not qualify as a reorganization under section 368(a)(1)(F), M is not treated as Y would have been treated if there had been no sale or reorganization. Accordingly, Y’s QSub election for S does not carry over to M, thereby causing the termination of the QSub election. If M makes a QSub election for S, effective immediately following the termination of S’s QSub election, then M’s deemed transfer of the assets of S in exchange for the stock of S and the immediate liquidation of S as a consequence of the QSub election are disregarded for federal income tax purposes. See Treas. Reg. §§ 1.1361-4(b)(3)(ii) and 1361-5(b)(3), Ex. 9. There will be no period between the termination of S’s QSub election and the deemed liquidation of S during which S is a C corporation. However, if M does not make a QSub election for S, effective immediately following the termination of S’s QSub election, then the transaction will be treated as a transfer of the assets of S to M, followed by M’s contribution of S’s assets to S in exchange for S stock. See Treas. Reg. § 1.1361-5(b)(3), Ex. 9.

**Facts:** Corporation ("P") wholly owns a limited liability company ("S") that has elected to be treated as an association taxable as a corporation. P transfers (by sale, reorganization under section 368(a)(1)(A), (C), (D), or (F), or otherwise) all of the membership interests in S to another person.

**Issues:** In Rev. Rul. 2004-85, the Service ruled that the transfer of the membership interests in S does not terminate S's election to be classified as an association because S makes the election to classify itself as an association under the "check-a-box" regulations (rather than P), the transfer of the membership interests in S does not terminate S's election to be classified as an association.
Intra-Group Asset and Stock Transactions
Facts: Corporation P owns all the stock of Corporation S and Corporation T. P, S, and T are members of a consolidated group. As part of an integrated plan, S purchases all the stock of T from P for cash and T completely liquidates into S. Assume that if T had sold its assets directly to S and T had completely liquidated into P, the transaction would have qualified as a reorganization under § 368(a)(1)(D) of the Internal Revenue Code.

Issues: In Rev. Rul. 2004-83, the Service ruled that step transaction principles apply to treat this transaction as a merger of T into S under section 368(a)(1)(D). In addition, Rev. Rul. 2004-83 provides that the result would be no different if P, S, and T were not members of a consolidated group. In the Service’s view, no policy exists that would require section 304 to apply where section 368(a)(1)(D) would otherwise apply.
Basic Structure

P

X

Z

Y
Basic Structure Continued

This example examines the tax consequences of asset and stock transfers within a consolidated group.

**Alternative 1: Asset Sale**

1. Z sells its assets to Y.

2. Y takes a cost basis in the assets.

**Alternative 2: Stock Sale**

1. X sells Z stock to Y.

2. Y takes a cost basis in Z stock. Z retains historic basis in its assets.

**Alternative 3: Asset Sale and Liquidation**

1. Z sells its assets to Y and Z liquidates into X.

2. The transaction appears to constitute a D reorganization. Under Treas. Reg. § 1.1502-13(f)(3)(ii), the boot is treated as received in a separate transaction under Section 302 rather than Section 356.
Basic Structure Continued

**Alternative 4: Stock Sale and Liquidation**

1. X sells the Z stock to Y and Z liquidates into Y.

2. The treatment of the transaction is the same as described above in Alternative 3.

**Alternative 5: Asset or Stock Transfer**

1. Z transfers its assets to Y for no consideration (or X transfers the Z stock to Y for no consideration).

2. Z is deemed to transfer its assets to Y in a Section 351 transaction, followed by a distribution of the Y stock to X and then to P.

3. Alternatively, Z is deemed to distribute its assets to X and then to P followed by a contribution of the assets by P to Y.

4. In the first case, there is deferred gain (loss) on the Y stock. In the second case, there is deferred gain (loss) on the Z assets.
Alternative 1: Asset Sale and Liquidation

Z sells its assets to Y and Z liquidates into X.
Alternative 2: Stock Sale and Liquidation

X sells the Z stock to Y and Z liquidates into Y.
Boot in D Reorganization Continued

Results

The transactions both appear to constitute D reorganizations. Under Treas. Reg. § 1.1502-13(f)(3)(ii), the boot is treated as received in a separate transaction under Section 302 rather than Section 356.

Issues

1. Is the redemption taxed as a distribution?

2. If so, do we look to the E&P of Z, Y or both Z and Y in measuring the amount of the dividend?

3. Is the dividend eliminated?

4. Does the distribution of the dividend impact stock basis?

5. If E&P is not available, how is the transaction taxed?
Facts: S2 transfers all its assets to S1 for cash. Shortly thereafter, S2 merges into a single-member LLC.
**Rev. Rul. 69-617**

**Facts:** P owns all of the stock of S and X. S merges into P pursuant to state law. P then transfers all of the assets received from S to X.
Rev. Rul. 69-617 (Variation)

Facts: P owns all of the stock of S and X. S merges into P pursuant to state law. P then transfers 50% of the assets received from S to X. Although this transaction appears to raise “liquidation/reincorporation” issues, private letter rulings allow the partial drop of S’s assets to X following the Section 368(a)(1)(A) reorganization. See, e.g., PLR 9222059 (Jun. 13, 1991); PLR 9422057 (Mar. 11, 1994); PLR 8710067 (Dec. 10, 1986). These rulings rely on Rev. Rul. 69-617 and treat the transaction as a merger followed by a Section 368(a)(2)(C) drop of assets. At least one ruling would allow a double-drop of S’s assets following the reorganization. See PLR 9222059 (Jun. 13, 1991).
Rev. Rul. 69-617 &
The New Bausch & Lomb Regulations

Facts: P owns all of the stock of S and X. S liquidates, distributing all of its assets to P. P then transfers some of the assets received from S to X. Can this transaction be treated under the analysis of Rev. Rul. 69-617 as a C reorganization followed by a drop of assets under Section 368(a)(2)(C), given the new Bausch & Lomb regulations? See Treas. Reg. Section 1.368-2(d)(4). What if X were a newly formed corporation?
**Rev. Rul. 69-617 (Variation) & The New Bausch & Lomb Regulations**

**Facts:** P owns all of the stock of S, X, Y, and Z. S merges into an LLC created by P, causing a deemed liquidation of S for tax purposes. LLC then transfers 1/3 of S’s historic assets to X, Y, and Z respectively. (P will be treated as transferring such assets to X, Y, and Z for tax purposes).
Proposed Anti-Basis Shifting Regulations
Facts: H and W, husband and wife, each own half of the stock of X. X has accumulated e&p of $100,000. Both have a basis in their X stock of $50,000. X redeems all of H’s X stock for $100,000 and does not file a section 302(c) waiver.

Result: Under section 318 and section 302(d), the redemption of stock from H is a dividend rather than a payment in exchange for stock under section 302(a). Immediately after the redemption, under Treas. Reg. §1.302-2(c), W is deemed to hold the remaining stock with a basis of $100,000.
Current Basis Shifting Rule: Treas. Rev. Rul. 71-563

Facts: A, an individual, owned all the stock of X. C, A’s son, owned all of the outstanding stock of Y. A sold 25 percent of its stock in X to Y for cash.

Result: Rev. Rul. 71-563 states that, under section 304(a)(1), the sale is treated as a contribution by A of the stock of X to the capital of Y and a distribution to A by Y in redemption of its stock. Because the deemed redemption is governed by section 302(d), the cash received is taxable as a dividend to A. Furthermore, the ruling reasons that, because A owns no stock in Y directly after the transaction, the basis of the X stock should be added to the basis of the remaining stock of X that A continues to own after the transaction.
Facts: A and B are shareholders of Corporation Y. A and B are related. Corporation Y has accumulated e&p. A is a foreign taxpayer, not subject to U.S. tax. Corporation Y redeems A’s Corporation Y stock.

Result: As a result of the application of the attribution rules of section 318, the redemption of stock from A is a dividend rather than a payment in exchange for stock under section 302(a). B takes the position, under Treas. Reg. §1.301-2(c), that the basis of A’s redeemed stock is added to the basis of stock held by B. B then sells its Corporation Y stock and claims a loss.
Proposed Anti-Basis Shifting Regulations

• Summary of provisions

  – The proposed regulations delete Treas. Reg. §1.302-2(c), which allows, in the case of a redemption treated as a dividend, a redeemed shareholder’s basis in his or her redeemed shares to be transferred to shares owned by a related shareholder.

  – Under the proposed regulations, the basis in the redeemed shares remains with the redeeming shareholder.

  • The basis in the redeemed shares is treated as a loss recognized on a disposition of the redeemed stock on the date of the redemption.
    – The character, source, and amount of the loss is fixed on the date of the redemption.

  • However, the redeemed shareholder is not permitted to take such loss into account except upon the occurrence of certain events (discussed on the next slide).

  • The suspended loss likely will be subject to section 382.
Proposed Anti-Basis Shifting Regulations

• Summary of provisions, continued

  – The redeemed shareholder can take the loss into account on the earliest of two dates:

    • The “final inclusion date”
      – The date on which the redeemed shareholder satisfies the provisions of section 302(b)(1), (2), or (3); or
      – The date on which there is no later date on which the redeemed shareholder could recognize the loss.

    • The “accelerated inclusion date”
      – The date, other than the final inclusion date, on which the redeemed shareholder must take into account gain from an actual or deemed sale or exchange of some or all of his or her remaining shares in the redeeming corporation.
Proposed Anti-Basis Shifting Regulations

• Summary of provisions, continued
  – The proposed regulations incorporate these concepts into the consolidated return regulations applicable to inter-company stock transfers and redemptions.

  • Apparently, under the proposed regulations, Treas. Reg. §1.1502-32 applies only to the basis in those shares that are redeemed by one group member from another group member, and not the redeemed member’s basis in all of its redeeming group member shares.

  • This can create an excess loss account in the redeemed shares.
    – Such excess loss account is treated as income recognized on a disposition of the redeemed stock on the date of the redemption.
      » The character, source, and amount of this income is fixed as of the date of the redemption.
      » However, the redeemed shareholder is not permitted to take such income immediately into account.
    – The redeeming shareholder must take the income into account on either the “final inclusion date” or the “accelerated inclusion date” as those concepts are incorporated into Treas. Reg. §1.1502-19.
**Anti-Basis Shifting Rules: Prop. Treas. Reg. §1.302-5, example 1**

**Facts:** A and B, husband and wife, each own 100 shares (50%) of the stock of Corp. X as a capital asset. A purchased his X shares on February 1, Year 1, for $200. On December 31, Year 1, corporation X redeems all of A’s X stock for $300. At the end of Year 1, X has e&p of $200. In connection with the redemption transaction, A does not file an agreement described in section 302(c)(2) waiving the application of the family attribution rules. The redemption proceeds are treated under section 301(c)(1) as a dividend to the extent of X’s e&p of $200, and under section 301(c)(2) as a recovery of basis in the amount of $100. On July 1, Year 2, B sells all of her shares of corporation X stock to G, her mother.

**Result:** Under Prop. Treas. Reg. §1.302-5, an amount equal to A’s remaining basis in the X stock is treated as a loss recognized on a disposition of the redeemed stock on December 31, Year 1. When B sells her shares to G, A no longer owns, actually or constructively, any shares of X stock. If the facts that existed at the end of July 1, Year 2, had existed immediately after the redemption, A would have been treated as having received a distribution in part or full payment in exchange for the redeemed stock pursuant to section 302(a). Therefore, July 1, Year 2, is the final inclusion date and, on that date, A is permitted to take into account the loss of $100 attributable to his basis in the redeemed X stock. Because that loss is treated as having been recognized on a disposition of the redeemed stock on the date of the redemption, December 31 of Year 1, such loss is treated as a short-term capital loss.
Anti-Basis Shifting Rules: Prop. Treas. Reg. §1.302-5, example 3

**Facts:** Corp. Y has 200 shares of common stock outstanding. L owns 150 shares of Y stock and has owned the stock for several years. The remaining 50 Y shares are owned by K, L’s father. In Year 1, Y redeems 50 shares of L’s Y stock, which have a basis of $75, for $200. At the end of Year 1, Y’s e&p exceeds $200. The redemption of L’s stock is treated as a distribution to which section 301 applies. L recognizes dividend income of $200. In Year 4, L sells 25 of his remaining shares of Y stock, which have a basis of $50, to K for $100 and recognizes $50 of long-term capital gain.

**Result:** Under Prop. Treas. Reg. §1.302-5, an amount equal to L’s basis in the redeemed Y stock, $75, is treated as a loss recognized on a disposition of the redeemed stock in year 1. Year 4, when L sells 25 shares of Y stock to K, is not the final inclusion date because L does not satisfy the criteria of section 302(b)(1), (2), or (3) at the end of such day. However, the sale date is an accelerated loss inclusion date because, on that date, L recognizes gain of $50 on a disposition of stock of Y, the redeeming corporation. Thus, in year 4, L is permitted to take into account $50 of the loss attributable to his basis in the redeemed Y stock. The remaining $25 of such loss is taken into account on the earlier of the final inclusion date or the next accelerated loss inclusion date (to the extent of gain recognized).
**Anti-Basis Shifting Rules: Prop. Treas. Reg. §1.304-2, example 2**

**Facts:** Corp. X and Corp. Y each have outstanding 200 shares of stock, all of which are owned by H. H has a basis in his X stock of $60 and in his Y stock of $30. X has $80 of e&p and Y has $80 e&p. H sells his 200 shares of X stock to Y for $150.
Results:

- Because H is in control of both X and Y and receives property from Y in exchange for his X stock, H’s sale of 200 shares of X stock to Y is subject to section 304(a)(1). H is treated as receiving $150 as a distribution in redemption of Y stock.
- Because H actually owns 100 percent of X before the sale, and is treated as owning 100 percent of X after the sale, the proceeds of the deemed redemption are treated as a distribution to which section 301 applies.
- Therefore, H is treated as transferring the X stock to Y in exchange for Y stock in a section 351 transaction.
  - Y’s basis in the X stock acquired is equal to the basis that H had in the X stock surrendered.
  - H takes a basis of $60 in the Y stock he is treated as receiving in the deemed section 351 exchange.
- That Y stock is then treated as redeemed by Y for $150.
  - Under section 302, that redemption is treated as a distribution to which section 301 applies because H owns directly 100% of Y both before and after the redemption of the Y stock that was deemed issued.
  - Thus, the deemed redemption proceeds are treated as a distribution to which section 301 applies.
  - Pursuant to Prop. Treas. Reg. § 1.304-6(a), H is treated as receiving a dividend of $150 ($80 from the current and accumulated e&p of Y and then $70 from the current and accumulated earnings and profits of corporation X).
- An amount equal to the basis in the Y stock that H is deemed to receive and that is deemed redeemed, $60, is treated as a loss recognized on a disposition of the stock deemed redeemed on the date of the deemed redemption and is taken into account under rules set forth in Prop. Treas. Reg. §1.302-5.
- H’s basis in the 200 shares of Y stock that H owned before the sale and continues to own immediately after the sale remains $30.
Anti-Basis Shifting Rules:
Cash Dividend v. Redemption/Dividend

Situation 1
Cash Dividend

Facts: X is a public corporation with 1000 shareholders, each holding 100 shares.
Y corporation is a public shareholder of X. Each share has a fair market value and
basis of $1. X has a value of $100,000. In Year 1, X earns income of $100,000 (after
tax) and the value of X increases to $200,000. In Year 1, X pays a pro-rata dividend of
$1 per share ($100,000 total). In Year 2, Y sells 1 share for $1.

Result: In Year 1, Y receives dividend income of $100 and a dividends received deduction of
$70 (70% of $100). Y’s basis in its 100 shares of X remains at $100. In Year 2, Y
recognizes no gain or loss on the sale of the single share of X stock.
**Anti-Basis Shifting Rules:**
**Cash Dividend v. Redemption/Dividend**

**Situation 2**
Redemption/Dividend

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**Facts:**
X is a public corporation with 1000 shareholders, each holding 100 shares. Y corporation is a public shareholder of X. Each share has a fair market value and basis of $1. X has a value of $100,000. In Year 1, X earns $100,000 (after tax) and the value of X increases to $200,000. In Year 1, X redeems, on a pro rata basis, 50 shares of X stock from each shareholder for $2 per share ($100,000 total). In Year 2, Y sells 1 share of X for $2.

**Result:**
In Year 1, Y has dividend income of $100 and a dividends received deduction of $70. Under Prop. Treas. Reg. § 1.302-5(a), Y has a recognized loss in the amount of $50 (equal to the basis of the redeemed shares), which is suspended, and Y’s basis in its remaining 50 shares is $50 ($1 per share). In Year 2, Y recognizes a $1 gain on the sale of the one share of X stock, and may take into account the entire $50 suspended loss. See Prop. Treas. Reg. § 1.302-5(b)(3); Rev. Rul. 76-385.
**Anti-Basis Shifting Rules: Non-Consolidated Dividend Distributions Prop. Treas. Reg. §1.302-5**

**Facts:** P is the sole shareholder of S and owns 1,000 shares of S stock. P has a basis in its shares of S stock of $1000. S has a fair market value of $1000 and has accumulated and current e&p of $200. S distributes $100 to P. The dividend is not an extraordinary dividend for purposes of section 1059.

**Result:** The distribution is treated as a dividend. P receives a dividends received deduction under section 243. P is not required to reduce its basis in its shares of S stock on account of the dividend. After the dividend, S has a fair market value of $900. P still has a basis of $1000 in its S stock. Accordingly, after the distribution, P has a built-in loss of $100 in its P stock.

**Facts:** P is the sole shareholder of S and owns 1,000 shares of S stock. P has a basis in its shares of S stock of $1000. S has a fair market value of $1000 and has accumulated and current e&p of $200. S redeems 100 shares of P’s stock in exchange for $100.

**Result:** The redemption is treated as a dividend. P receives a dividends received deduction under section 243. Under Prop. Treas. Reg. §1.302-5, an amount equal to P’s basis in the redeemed Y stock, $100, is treated as a loss on a disposition of the redeemed stock. However, that loss is suspended until P satisfies the criteria of section 302(b)(1), (2), or (3) with respect to its remaining S stock. After the redemption, S has a fair market value of $900. P has a $900 basis in its remaining S shares. Therefore, P has no built-in loss in its S shares and a $100 suspended loss.

Facts: P is the sole shareholder of S and owns 1,000 shares of S stock. P has a basis in its shares of S stock of $100. S has a fair market value of $1000 and has accumulated and current e&p of $200. S distributes $100 to P. The dividend is not an extraordinary dividend for purposes of section 1059.

Result: The distribution is treated as a dividend. P receives a dividends received deduction under section 243. P is not required to reduce its basis in its shares of S stock on account of the dividend. After the dividend, S has a fair market value of $900. P still has a basis of $100 in its S stock. Accordingly, after the distribution, P has a built-in gain of $800 in its P stock.

**Facts:** P is the sole shareholder of S and owns 1,000 shares of S stock. P has a basis in its shares of S stock of $100. S has a fair market value of $1000 and has accumulated and current e&p of $200. S redeems 100 shares of P’s stock in exchange for $100.

**Result:** The redemption is treated as a dividend. P receives a dividends received deduction under section 243. Under Prop. Treas. Reg. §1.302-5, an amount equal to P’s basis in the redeemed Y stock, $10, is treated as a loss on a disposition of the redeemed stock. However, that loss is suspended until P satisfies the criteria of section 302(b)(1), (2), or (3) with respect to its S stock. After the redemption, S has a fair market value of $900. P has a $90 basis in its remaining S shares and a $10 suspended loss. Therefore, P’s built in gain in its shares of S stock equals $810.
**Anti-Basis Shifting Rules: Consolidated Dividend Distributions Prop. Treas. Reg. §1.302-5**

**Facts:** P is the sole shareholder of S and owns 1,000 shares of S stock. P and S file consolidated returns. P has a basis in its shares of S stock of $1000. S has a fair market value of $1000. S distributes $100 to P.

**Result:** The distribution is treated as a dividend. Under Treas. Reg. § 1.1502-13(f)(2)(ii), P does not include the $100 in income. Under Treas. Reg. § 1.1502-32, P reduces its basis in its S stock by $100. P thus has a $900 basis in its S shares. After the distribution, S has a fair market value of $900. P has no built in gain in its shares of S stock.

**Facts:** P is the sole shareholder of S and owns 1,000 shares of S stock. P and S file consolidated returns. P has a basis in its shares of S stock of $1000. S has a fair market value of $1000. S redeems 100 shares of P’s stock (with an aggregate basis of $100) in exchange for $100.

**Result:** The distribution is treated as a dividend. Under Treas. Reg. § 1.1502-13(f)(2)(ii), P does not include the $100 in income. Under Treas. Reg. § 1.1502-32, P reduces its basis in the redeemed S stock by $100 (to $0). P has a $900 basis in its remaining S shares. After the distribution, S has a fair market value of $900. P has no built-in-gain in its shares of S stock and no suspended gain.

- Under the new anti-basis shifting rules, the Treas. Reg. §1502-32 basis adjustment rules apparently apply only with respect to redeemed shares. Query whether this is appropriate.

**Facts:** P is the sole shareholder of S and owns 1,000 shares of S stock. P and S file consolidated returns. P has a basis in its shares of S stock of $1000. S has a fair market value of $2000. S distributes $200 to P.

**Result:** The distribution is treated as a dividend. Under Treas. Reg. § 1.1502-13(f)(2)(ii), P does not include the $200 in income. Under Treas. Reg. § 1.1502-32, P reduces its basis in its S stock by $200. P thus has an $800 basis in its S shares. After the distribution, S has a fair market value of $1800. P has a $1000 built in gain in its shares of S stock.

**Facts:** P is the sole shareholder of S and owns 1,000 shares of S stock. P and S file consolidated returns. P has a basis in its shares of S stock of $1000. S has a fair market value of $2000. S redeems 100 shares of P’s stock (with an aggregate basis of $100) in exchange for $200.

**Result:** The distribution is treated as a dividend. Under Treas. Reg. § 1.1502-13(f)(2)(ii), P does not include the $200 in income. Under Treas. Reg. § 1.1502-32, P reduces its basis in the redeemed S stock by $200 (the amount of the distribution), resulting in a $100 ELA in the redeemed S stock. The ELA is immediately recognized as gain (suspended). P has a $900 basis in its remaining S shares. After the distribution, S has a fair market value of $1800. P has a $900 built in gain in its shares of S stock and $100 of suspended gain.
Current Basis Rule for Intercompany Mergers: Treas. Reg. §1.1502-13(f)(7) example 3

**Facts:** P forms S and B by contributing $200 to the capital of each. During Years 1 through 4, S and B each earn $50, and under §1.1502-32 P adjusts its basis in the stock of each to $250. (See §1.1502-33 for adjustments to earnings and profits.) On January 1 of Year 5, the fair market value of S’s assets and its stock is $500, and S merges into B in a tax-free reorganization. Pursuant to the plan of reorganization, P receives B stock with a fair market value of $350 and $150 of cash.

**Result:** The merger of S into B is a transaction to which Treas. Reg. §1.1502-13(f)(3) applies. P is treated as receiving additional B stock with a fair market value of $500 and, under section 358, a basis of $250. Immediately after the merger, $150 of the stock received is treated as redeemed, and the redemption is treated under section 302(d) as a distribution to which section 301 applies. Because the $150 distribution is treated as not received as part of the merger, section 356 does not apply and no basis adjustments are required under section 358(a)(1)(A) and (B). Because B is treated under section 381(c)(2) as receiving S’s earnings and profits and the redemption is treated as occurring after the merger, $100 of the distribution is treated as a dividend under section 301 and P’s basis in the B stock is reduced correspondingly under Treas. Reg. §1.1502-32. The remaining $50 of the distribution reduces P’s basis in the B stock. Section 301(c)(2) and Treas. Reg. §1.1502-32. Under Treas. Reg. §1.1502-13(f)(2)(ii), P’s $100 of dividend income is not included in gross income. Under Prop. Treas. Reg. §1.302-2(c), proper adjustments are made to P’s basis in its B stock to reflect its basis in the B stock redeemed, with the result that P’s basis in the B stock is reduced by the entire $150 distribution.

**Facts:** P forms S and B by contributing $200 to the capital of each. During Years 1 through 4, S and B each earn $50, and under §1.1502-32 P adjusts its basis in the stock of each to $250. (See §1.1502-33 for adjustments to earnings and profits.) On January 1 of Year 5, the fair market value of S’s assets and its stock is $500, and S merges into B in a tax-free reorganization. Pursuant to the plan of reorganization, P receives B stock with a fair market value of $350 and $150 of cash.

**Result:** The merger of S into B is a transaction to which paragraph Treas. Reg. §1.1502-13(f)(3) applies. P is treated as receiving additional B stock with a fair market value of $500 and, under section 358, a basis of $250. Immediately after the merger, $150 of the stock received is treated as redeemed, and the redemption is treated under section 302(d) as a distribution to which section 301 applies. Because the $150 distribution is treated as not received as part of the merger, section 356 does not apply and no basis adjustments are required under section 358(a)(1)(A) and (B). Because B is treated under section 381(c)(2) as receiving S’s earnings and profits and the redemption is treated as occurring after the merger, $100 of the distribution is treated as a dividend under section 301 and P's basis in the B stock is reduced correspondingly under Treas. Reg. §1.1502-32. Under Treas. Reg. § 1.1502-13(f)(2)(ii), P’s $100 of dividend income is not included in gross income. Accordingly, P has a $75 excess loss account in the redeemed stock. That excess loss account is treated as income recognized on a disposition of the redeemed stock on the date of the redemption and is taken into account under the rules of Treas. Reg. §1.1502-19(b)(5).

Facts: Pursuant to a plan to acquire S₂’s assets, Acquiring contributes $500 to a newly formed, wholly owned subsidiary, Newco. Pursuant to the plan, S₂ transfers all of its assets to Newco in exchange for $500 and then liquidates (distributing the $500 sale proceeds to S₁).

Mechanics. Under Treas. Reg. §§ 1.1502-13(f)(3) and (f)(7) ex. 3, the merger and liquidation would be treated as:

• Newco is treated as issuing Newco stock worth $500 to S2 in exchange for S2’s assets in a “D” reorganization;
• S2 is treated as distributing Newco’s stock to S1 in a liquidating distribution pursuant to section 354; and
• Newco is treated as redeeming its stock from S1 in exchange for a $500 cash payment.

Current Basis Rules

Basis adjustments

Stock of Newco: S1’s basis in the Newco stock deemed redeemed is:
• Reduced by the amount of the distribution ($500);
• This reduction creates a $300 “theoretical ELA.”
• However, under Treas. Reg. §1.302-2(c) this ELA is shifted to Acquiring. Acquiring’s basis in its Newco stock is reduced by $300.
• Thus, Acquiring should have a built-in gain of $300 in its Newco stock after the merger and liquidation.

Stock of S1. P’s basis in its S1 stock is:
• Decreased by $500 to reflect a tier-up of S1’s reduction in basis in its redeemed Newco stock;
• Increased by $500 to reflect the S1’s receipt of $500 from Newco; and
• Increased by $300 to take into account S1’s ELA shifted to Acquiring.

Stock of Acquiring: P’s basis in its Acquiring stock is:
• Reduced by $300 to reflect the tier-up of Acquiring’s reduction to its basis in its Newco Stock.

Proposed Basis Rules

Basis=$300
Plus $300 suspended basis increase

$300 ELA

Basis=$600

Stock of Newco: S1’s basis in the Newco stock deemed redeemed is:
• Reduced by the amount of the distribution ($500).
• This reduction creates a $300 ELA, which results in S1’s immediate recognition of $300 of gain (suspended).
• Acquiring’s basis in its Newco stock is unchanged.

Stock of S1. P’s basis in its S1 stock is:
• Decreased by $500 to reflect a tier-up of S1’s reduction in basis in its redeemed Newco stock; and
• Increased by $500 to reflect the S1’s receipt of $500 from Newco.
• When S1 takes its suspended $300 gain into account, P’s basis in its S1 stock will increase by $300 to $600.

Stock of Acquiring:
• P’s basis in its Acquiring stock is unchanged.
New Proposed Basis Determination Regulations
Stock Basis Determinations – Prop. Treas. Reg. § 1.358-1&2

- On April 29, 2004, the Service issued proposed regulations under section 358, which provide guidance for determining the basis of stock or securities received in certain tax-free transactions.
- The proposed regulations adopt a tracing method (rather than an averaging method) for determining basis in tax-free reorganizations.
- Accordingly, the proposed regulations require taxpayers to determine the basis of stock or securities received in the transaction by reference to the basis of the specific stock or securities surrendered in exchange therefor or to which a disposition of stock relates (i.e., in a transaction to which section 355 applies).
- Such a rule ensures the continued application of Treas. Reg. § 1.1012-1(c), which allows taxpayers owning more than one lot or block of stock to identify the particular lot or block of stock that the taxpayer is selling or otherwise transferring.
Stock Basis Determinations – Prop. Treas. Reg. § 1.358-1&2 (Continued)

• The proposed regulations make minor amendments to current Treas. Reg. § 1.358-1 by deleting from paragraph (a) references to former sections 371 and 374 and adding paragraph (c) (regarding effective dates).

• The proposed regulations substantially amend current Treas. Reg. § 1.358-2 by revising paragraphs (a)(1) & (2), removing paragraphs (a)(3)-(5), revising paragraphs (b)(1) & (c), and adding paragraph (d).

• The proposed regulations are not effective until the date they are published as final regulations in the Federal Register.
Stock Basis Determination (Continued); Allocation of Basis -- Prop. Treas. Reg. § 1.358-2


• If a shareholder or security holder surrenders a share of stock or a security in an exchange to which section 354, 355, or 356 applies, the basis of each share of stock or security received in the exchange is determined by reference to the particular stock or security exchanged therefor (as adjusted under Treas. Reg. §1.358-1).

• If more than one share of stock or security is received in exchange for one share of stock or one security, the basis of the surrendered stock or security is allocated to the stock or securities received in exchange therefor in proportion to the fair market value of such stock or securities.

• If one share of stock or security is received in exchange for more than one share of stock or security (or a fraction thereof), the basis of surrendered stock or securities is allocated to the stock or security received in a manner that reflects, to the greatest extent possible, that a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price.
Stock Basis Determination (Continued);
Allocation of Basis -- Prop. Treas. Reg. § 1.358-2


• If a shareholder or security holder receives stock or securities in a distribution to which section 355 applies (or so much of section 356 as relates to section 355), but does not surrender any stock or security in exchange therefor, the basis of each share of stock or security of the distributing corporation, as adjusted under Prop. Treas. Reg. § 1.358-1, is allocated between the share of stock or security of the distributing corporation with respect to which the distribution is made and the share or shares of stock or securities (or allocable portions thereof) received with respect to the share of stock or security of the distributing corporation in proportion to their fair market values.

• If one share of stock or security is received in respect of more than one share of stock or security or a fraction of a share of stock or security is received, the basis of each share of stock or security of the distributing corporation must be allocated to the shares of stock or securities received in a manner that reflects that, to the greatest extent possible, a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price.
Designation of Stock or Securities - Prop. Treas. Reg. § 1.358-2(a)(2)(iii)

- If a shareholder or security holder is not able to identify the stock or security received in exchange for (or distributed with respect to) a particular stock or security, the shareholder or security holder may designate the historic stock or security to which the new stock or security relates, provided that:
  - The designation is consistent with the terms of the exchange or distribution, and
  - The designation is made on or before the first date on which the basis of a share of stock or security received is relevant (i.e., when such shares or securities are sold or otherwise transferred).

- Such designation is binding for purposes of determining the Federal tax consequences of any sale or transfer of, or distribution with respect to, the shares or securities received.

- If the shareholder or security holder fails to make a designation, upon the sale or other transfer of the stock or security received, such shareholder or security holder will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired.
Stock Basis Determination (Continued);
Allocation of Basis -- Prop. Treas. Reg. § 1.358-2

Other Rules

- The aforementioned rules do not apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 351 and section 354 or section 356, if, in connection with the exchange, the shareholder or security holder exchanges property for stock or securities in an exchange to which neither section 354 nor 356 applies or liabilities of the shareholder or security holder are assumed. Prop. Treas. Reg. § 1.358-2(a)(2)(iv).


- The term “securities” means securities (including, where appropriate, fractional parts of securities) that are not “other property” under section 356. _Id._

- Current Treas. Reg. § 1.358-2(b), which applies to transactions governed by section 351 or section 361, is amended to provide that the term “stock” refers only to stock that is not “other property” for purposes of those sections, and the term “securities” refers only to securities that are not “other property” for purposes of those sections.
Stock Basis Determination (Continued); Example 1

Facts: F, an individual, acquired 20 shares of T stock on Date 1 for $3 each and 10 shares of T stock on Date 2 for $6 each. On Date 3, P acquires the assets of T in a reorganization under section 368(a)(1)(A). Pursuant to the terms of the plan of reorganization, F receives 2 shares of P stock for each share of T stock. Therefore, F receives 60 shares of P stock. Pursuant to section 354, F recognizes no gain or loss on the exchange. F is not able to identify which shares of P stock are received in exchange for each share of T stock.

Analysis: Under Prop. Treas. Reg. § 1.358-2(a)(2), F has 40 shares of P stock, each of which has a basis of $1.50 and are treated as having been acquired on Date 1. F has 20 shares of P, each of which has a basis of $3 and is treated as having been acquired on Date 2. On or before the date on which the basis of a share of P stock received becomes relevant, F may designate which of the shares of P have a basis of $1.50 and which have a basis of $3.

See Prop. Treas. Reg. § 1.358-2(c) Ex. 1.
Stock Basis Determination (Continued); Example 2

**Facts:** F, an individual, purchased 10 shares of T stock on Date 1 for $2 per share and 10 shares of T stock on Date 2 for $5 per share. On Date 3, P acquires the stock of T in a reorganization under section 368(a)(1)(B). Pursuant to the terms of the reorganization, F receives one share of P stock for every 2 shares of T stock. Pursuant to section 354, F recognizes no gain or loss on the exchange. F is not able to identify which portion of each share of P stock is received in exchange for each share of T stock.

**Analysis:** Under Prop. Treas. Reg. § 1.358-2(a)(2), F has 5 shares of P stock each of which has a basis of $4 and is treated as having been acquired on Date 1 and 5 shares of P stock each of which has a basis of $10 and is treated as having been acquired on Date 2. On or before the date on which the basis of a share of P stock received becomes relevant, F may designate which of the shares of P have a basis of $4 and which have a basis of $10.

See Prop. Treas. Reg. § 1.358-2(c) Ex. 4.
Stock Basis Determination (Continued); Example 3

**Facts:** F, an individual, purchased 5 shares of D stock for $4 per share on Date 1 and 5 shares of D stock for $8 per share on Date 2. D owns all of the outstanding stock of C. The fair market value of the stock of D, excluding the stock of C, is $900. The fair market value of the stock of C is $900. In a distribution to which section 355 applies, D distributes all of the stock of C pro rata to its shareholders. No stock of D is surrendered in connection with the distribution. In the distribution, F receives 2 shares of C stock with respect to each share of D stock. Pursuant to section 355, F recognizes no gain or loss on the receipt of the shares of C stock. F is not able to identify which share of C stock is received in respect of each share of D stock.

**Analysis:** Under Prop. Treas. Reg. § 1.358-2(a)(2), because F receives 2 shares of C stock with respect to each share of D stock, the basis of each share of D stock is allocated between such share of D stock and two shares of C stock in proportion to the fair market value of those shares. Therefore, each of the 5 shares of D stock acquired on Date 1 will have a basis of $2 and each of the 10 shares of C stock received with respect to those shares will have a basis of $1. In addition, each of the 5 shares of D stock acquired on Date 2 will have a basis of $4 and each of the 10 shares of C stock received with respect to those shares will have a basis of $2. On or before the date on which the basis of a share of C stock received becomes relevant, F may designate which of the shares of C have a basis of $1 and which have a basis of $2.

**See** Prop. Treas. Reg. § 1.358-2(c) Ex. 7.
Stock Basis Determination (Continued); Example 4

**Facts:** F owns 100 percent of Corporation X. On Date 1, X transfers 100 percent of the X stock and Asset to Y solely in exchange for Y stock. After the transaction, F owns 81 percent of Y. The transaction qualifies under both section 351 and 354.

**Analysis:** Because F received stock in Y in a transaction that qualifies under both section 351 and section 354, the new proposed regulations do not apply to determine F’s basis in its Y stock.

Stock Basis Determination (Continued); Example 5

Facts: In a transaction qualifying under section 351, A forms Corporation X and contributes to X Asset 1, with a value of $100 and a basis of $10, and Asset 2, with a value of $10 and a basis of $100, solely in exchange for 100 percent of the stock of X.

- Is A’s basis in its X stock blended?

- The new proposed regulations do not apply to this transaction?
Merger Transactions Involving Disregarded Entities
Multiple Disregarded Entities

Facts: Corporation P is the sole member of LLC-1 and LLC-2, both of which do not elect to be taxed as associations. LLC-1 and LLC-2 form LLC-3, with each taking a 50 percent membership interest.
Merger of Corporation
Into Single-Member LLC

Facts: Corporation P owns all of the stock of S Corporation and all of the membership interests in LLC. LLC does not elect to be taxed as an association. S is merged into LLC pursuant to Delaware General Corporation Law section 264 (which permits the merger or consolidated of a Delaware corporation with an LLC). Pursuant to the merger, all of S’s assets and liabilities are transferred to LLC, and S’s separate corporate existence ceases. See P.L.R. 9822037 (Feb. 27, 1998).
Sale of All of the Membership Interests

Facts: P owns all of the outstanding interests in LLC, which is treated as a disregarded entity for tax purposes. The fair market value of LLC’s assets is $100, and their adjusted basis is $50. P sells all of the outstanding membership interests in LLC to X, an unrelated party, for $100.
Sale of Less than All of the Membership Interests

Facts: P owns all of the outstanding interests in LLC, which is treated as a disregarded entity for tax purposes. The fair market value of LLC’s assets is $100, and their adjusted basis is $50. P sells 50 percent of the outstanding membership interests in LLC to X, an unrelated party, for $50.

What are the results if, instead of selling the interests to X, P sells 50 percent of the LLC’s interests in a public offering?
Deemed Liquidation and Asset Sale of CFC; Dover Corp. v. Commissioner

Facts: P owns 100 percent of CFC1, which engages in business 1. CFC1 owns 100 percent of CFC2, which engages in business 2. CFC1 and CFC2 are controlled foreign corporations incorporated in the United Kingdom. On Date 1, CFC1 checks-the-box for CFC2, which results in a deemed section 332 liquidation of CFC2. Immediately thereafter, CFC1 sells all of the assets of business 2 (i.e., CFC2 assets) to X for cash.

Overlap Between Automatic and Elective Changes In Classification

Facts: P owns all of the outstanding interests in LLC, which is treated as a disregarded entity for tax purposes. On January, 1, 1998, P sells 50 percent of the outstanding membership interests in LLC to X, an unrelated party. P and X elect to treat the entity as an association effective January 1, 1998. See Treas. Reg. § 301.7701-3(f)(4), Ex. 1.
B Reorganization

Facts: P forms a wholly owned LLC. LLC does not elect to be taxed as an association and is, thus, treated as a disregarded entity. LLC acquires T stock from the T shareholders in exchange for P voting stock.
C Reorganization

Facts: P forms a wholly owned LLC, which is treated as a disregarded entity, with P voting stock. P wants LLC to acquire T in a tax-free reorganization. T has assets worth $100 and has recourse liabilities of $30. LLC transfers its shares of P voting stock to T in exchange for all of T’s assets and liabilities. T distributes all of the P voting stock to it’s shareholders in complete liquidation.
Merger Into LLC

Facts: P forms a wholly owned LLC. LLC is treated as a disregarded entity. T merges into LLC pursuant to a state statutory merger, with the T shareholders receiving P voting stock. See Former Prop. Treas. Reg. § 1.368-2(b)(1).
Merger Into LLC - Alternative 1

Facts: T forms a wholly owned LLC and contributes all of its assets and liabilities to LLC. LLC is treated as a disregarded entity. T then merges into P, with the T shareholders receiving P voting stock.
Facts: T merges into P, with the T shareholders receiving P voting stock. P then forms a wholly owned LLC and contributes all of the T assets and liabilities to LLC. LLC is treated as a disregarded entity.
Merger Into LLC - Alternative 3

Facts: P forms a wholly owned LLC. LLC is treated as a disregarded entity. T merges into P, with the T shareholders receiving P voting stock. P directs that all of T’s assets and liabilities be transferred directly to LLC.
Merger Into LLC - Alternative 4

Facts: T forms a wholly owned subsidiary, HC, and HC forms a wholly owned LLC. LLC is treated as a disregarded entity. T merges into LLC, with the T shareholders receiving HC stock. HC then merges into P, with the HC shareholders receiving P voting stock.
Facts: T owns all of the interests of LLC. LLC is treated as a disregarded entity. LLC operates a business. LLC merges into P pursuant to a state statutory merger. See Former Prop. Treas. Reg. § 1.368-2(b)(1).
Temporary Section 368 Regulations
Tax-Free Statutory Merger of Corporation into Disregarded Entity

- The IRS recently issued temporary regulations under Section 368 (Treas. Reg. § 1.368-2T(b)(1)) under which the merger of a target corporation into a disregarded entity will qualify as a tax-free statutory merger under Section 368(a)(1)(A) if certain conditions are satisfied. The temporary regulations were issued on January 23, 2003 (REG-126485-01) and replaced proposed regulations issued on November 15, 2001.

- The temporary regulations clarified certain aspects of the 2001 proposed regulations by providing additional examples. The 2001 proposed regulations replaced proposed regulations that were issued on May 16, 2000 (REG-106186-98). The 2000 proposed regulations, which were withdrawn, provided that neither the merger of a disregarded entity into a corporation nor the merger of a target corporation into a disregarded entity qualified as a tax-free statutory merger under Section 368(a)(1)(A).

- The IRS changed its position from the 2000 proposed regulations based upon comments arguing that not permitting the merger of a target corporation into a disregarded entity to qualify as an A reorganization was inconsistent with the general treatment of a disregarded entity as a division of its owner for federal tax purposes.

- The temporary regulations reflect the change in the position of the IRS through the adoption of a new definition of the term “statutory merger or consolidation,” as used in Section 368(a)(1)(A), for purposes of transactions involving disregarded entities.
Temporary Section 368 Regulations
Tax-Free Statutory Merger of Corporation into Disregarded Entity
Continued

• Under the temporary regulations, the IRS does not intend for the requirement that “all of the assets” of one or more transferor units be transferred in the statutory merger or consolidation to be interpreted in the same manner as the “substantially all” requirement of Sections 368(a)(1)(C), 368(a)(1)(D), 368(a)(2)(D), and 368(a)(2)(E). The “all of the assets” test is included to ensure that divisive transactions do not qualify as statutory mergers or consolidations under Section 368(a)(1)(A). See Treas. Reg. § 1.368-2T(b)(1)(iv), Ex. 1.

• The temporary regulations do not require a statutory merger or consolidation to be effected pursuant to “corporation laws” to qualify as a tax-free reorganization under Section 368(a)(1)(A). Instead, a transaction may qualify as a reorganization under Section 368(a)(1)(A) even if it is undertaken pursuant to laws other than the corporation law of the relevant jurisdiction.

• The temporary regulations do not provide for tax-free treatment under Section 368(a)(1)(A) for transactions where a corporation merges into a disregarded foreign entity.
Temporary Section 368 Regulations
Definition of Terms

- The following terms are defined in Treas. Reg. § 1.368-2T(b)(1)(i) for purposes of the definition of the term “Statutory merger or consolidation” under Section 368(a)(1)(A).

- **Disregarded Entity**--A disregarded entity is a business entity (as defined in Treas. Reg. § 301.7701-2(a)) that is disregarded as an entity separate from its owner for Federal tax purposes. Examples of disregarded entities include a domestic single member LLC that does not elect to be classified as a corporation for federal tax purposes, a qualified REIT subsidiary, and a corporation that is a qualified subchapter S subsidiary (QSub). Treas. Reg. § 1.368-2T(b)(1)(i)(A).

- **Combining Entity**--A combining entity is a business entity that is a corporation that is not a disregarded entity. Treas. Reg. § 1.368-2T(b)(1)(i)(B).

- **Combining Unit**--A combining unit is comprised solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for federal tax purposes.
Temporary Section 368 Regulations
Statutory Merger or Consolidation Generally

Treas. Reg. § 1.368-2T(b)(1)(ii)

For purposes of Section 368(a)(1)(A), a “statutory merger or consolidation” is a transaction effected pursuant to the laws of the United States or a State or the District of Columbia, in which, as a result of the operation of such laws, the following events occur simultaneously at the effective time of the transaction--

(A) All of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and

(B) The combining entity of each transferor entity ceases its separate legal existence for all purposes.
Temporary Section 368 Regulations
Statutory Merger or Consolidation Involving Disregarded Entities

Treas. Reg. § 1.368-2T(b)(1)(iii)

A transaction effected pursuant to the laws of the United States or a State or the District of Columbia in which any of the assets and liabilities of a combining entity of a transferor unit become assets and liabilities of one or more disregarded entities of the transferee unit is not a statutory merger or consolidation within the meaning of Section 368(a)(1)(A) unless such combining entity, the combining entity of the transferee unit, such disregarded entities, and each business entity through which the combining entity of the transferee unit holds its interests in such disregarded entities is organized under the laws of the United States or a State or the District of Columbia.
Temporary Section 368 Regulations

Merger of Target into Disregarded Entity

**Facts:** P and T are domestic corporations and LLC is a domestic limited liability company. LLC is wholly owned by P. LLC is treated as a disregarded entity. P and LLC are a combining unit and T is a combining entity. T merges into LLC under state statutory merger law, with the T shareholders receiving P voting stock. The transaction qualifies as a tax-free A reorganization under Treas. Reg. § 1.368-2T(b)(1)(ii). See Treas. Reg. § 1.368-2T(b)(1)(iv), ex. 2.
Temporary Section 368 Regulations

Merger of Target and LLC into Separate Disregarded Entities

**Facts:** P and T are domestic corporations and LLC₁, LLC₂, and LLC₃ are domestic limited liability companies. LLC₁ and LLC₂ are wholly owned by P. LLC₃ is wholly owned by T. The LLCs are treated as disregarded entities. P, LLC₁, and LLC₂ are a combining unit and T and LLC₃ are a combining unit. T merges into LLC₁ under state statutory merger law, with the T shareholders receiving P voting stock. LLC₃ merges into LLC₂ under state statutory merger law. The transaction qualifies as a tax-free A reorganization under Treas. Reg. § 1.368-2T(b)(1)(ii). See Treas. Reg. § 1.368-2T(b)(1)(iv), ex. 2.
Temporary Section 368 Regulations
Merger Preceded by Distribution

**Facts:** P and T are domestic corporations. LLC is a domestic limited liability company. LLC is wholly owned by P and is treated as a disregarded entity. T operates two unrelated businesses, business R and business Q, each of which represents 50 percent of the value of the assets of T. P desires to acquire and operate business R, but not business Q. Pursuant to a single plan, T sells business Q to X, which is unrelated to P or T, in a taxable transaction, and then distributes the proceeds of the sale to its shareholders. T then merges into LLC under state statutory merger law, with T shareholders receiving P voting stock. The transaction qualifies as a tax-free A reorganization under Treas. Reg. § 1.368-2T(b)(1)(ii). The fact that the transaction would not satisfy the “substantially all” requirement applicable to certain other types of reorganizations is not material because it satisfies the “all of the assets” requirement of Treas. Reg. § 1.368-2T. See Treas. Reg. § 1.368-2T(b)(1)(iv), ex. 8.
Temporary Section 368 Regulations
Merger of Target into Transitory Disregarded Entity

Facts: P and T are domestic corporations and LLC is a domestic limited liability company. LLC is wholly owned by P. LLC is treated as a disregarded entity. P and LLC are a combining unit and T is a combining entity. T merges into LLC under state statutory merger law, with the T shareholders receiving P voting stock. Immediately after the merger, LLC merges into P as part of a plan that included the first merger. The transaction qualifies as a tax-free A reorganization under Treas. Reg. § 1.368-2T(b)(1)(ii). The principles of Rev. Rul. 72-405, which would treat a similar transaction involving a transitory subsidiary as a C reorganization rather than as an A reorganization, do not apply to this transaction because the merger of LLC into P does not alter the identity of P as the tax owner of the former assets of LLC, and the second merger is therefore disregarded. See Preamble to Treas. Reg. § 1.368-2T(b)(1).
Facts: R, P and T are domestic corporations and LLC is a domestic limited liability company. LLC is wholly owned by P. LLC is treated as a disregarded entity. P and LLC are a combining unit and T is a combining entity. T merges into LLC under state statutory merger law, with the T shareholders receiving R voting stock. The transaction qualifies as a tax-free A reorganization under Treas. Reg. § 1.368-2T(b)(1)(ii) if the transaction also meets the requirements of Section 368(a)(2)(D).

Merger of Target into Disregarded Entity Owned by Partnership

**Facts:** P, LLC, and T are domestic entities. LLC is wholly owned by P, a partnership under state law. LLC is treated as a disregarded entity. T merges into LLC under state statutory merger law, with the T shareholders receiving P partnership interest. The transaction does not qualify as a tax-free reorganization because neither P nor LLC qualifies as a combining entity and P and LLC are not a combining unit under Treas. Reg. § 1.368-2T(b)(1)(i)(B). See Treas. Reg. § 1.368-2T(b)(1)(iv), ex. 5.
Temporary Section 368 Regulations

Merger of Target with Subsidiary into Disregarded Entities

P

100%

LLC

P Voting Stock

Merger

T

100%

T1

Facts: LLC is treated as a disregarded entity. T merges into LLC under state statutory merger law, with the T shareholders receiving P voting stock. P and LLC are a combining unit. T is a combining entity. The transaction qualifies as a tax-free A reorganization under Treas. Reg. § 1.368-2T(b)(1)(ii).

Note: T1 is a combining entity, but is not a part of T’s combining unit, as defined by Treas. Reg. § 1.368-2T(b)(1)(i)(C), for purposes of the “all of the assets” test of Treas. Reg. § 1.368-2T(b)(1)(ii). What if T1 distributed a portion of its assets to its shareholders prior to the merger?
**Temporary Section 368 Regulations**

**Merger of Corporation into Disregarded Entity in Exchange for Interests in the Disregarded Entity**

**Facts:** P and T are domestic corporations and LLC is a domestic limited liability company. LLC is wholly owned by P. LLC is treated as a disregarded entity. T merges into LLC under state statutory merger law, with the T shareholders receiving interests in LLC. After merger, LLC is not disregarded as an entity separate from P and is treated as a partnership under state law. The transaction does not qualify as a tax-free A reorganization because assets of T do not become assets of a combining unit. LLC cannot be a combining entity as a partnership and thus is not part of a combining unit. See Treas. Reg. § 1.368-2T(b)(1)(iv), ex. 7.

Temporary Section 368 Regulations

Merger of Target S Corp. that owns a QSub into Disregarded Entity

**Facts:** P is a domestic corporation. LLC is a domestic limited liability company. LLC is wholly owned by P and is treated as a disregarded entity. S is a domestic S corporation. QSub is a qualified S corporation subsidiary wholly owned by S and is treated as a disregarded entity. P and LLC are a combining unit and S and QSub are a combining unit. S merges into LLC under state statutory merger law, with the S shareholders receiving P voting stock. The merger qualifies as a tax-free A reorganization under Treas. Reg. § 1.368-2T(b)(1)(ii). Immediately after the merger, QSub no longer qualifies as a qualified S corporation subsidiary. As a result, QSub is treated as transferring its assets to LLC and LLC is treated as transferring such assets to a new corporation. See Treas Reg. § 1.1361-5(b)(3), ex. 9. The deemed transfer of the assets of QSub in exchange for QSub stock does not cause the transaction to fail to qualify as a statutory merger or consolidation. See Section 368(a)(2)(C); Treas. Reg. § 1.368-2T(b)(1)(iv), ex. 3.
Temporary Section 368 Regulations

Merger of Disregarded Entity into Corporation

**Facts:** P and T are domestic corporations and LLC is a domestic limited liability company. LLC is wholly owned by P. LLC is treated as a disregarded entity. P and LLC are a combining unit and T is a combining entity. LLC merges into T under state statutory merger law. The transaction does not qualify as a tax-free A reorganization under Treas. Reg. § 1.368-2T(b)(1)(ii) because all of assets and liabilities of the combining unit of P and LLC do not become assets of T and LLC is not a combining entity. See Treas. Reg. § 1.368-2T(b)(1)(iv), ex. 6.
Temporary Section 368 Regulations

Divisive Mergers

Facts: P, LLC1, LLC2, and T are domestic entities. LLC1 and LLC2 are wholly owned by P and are treated as disregarded entities. T merges into LLC1 and LLC2 under state statutory merger law, with the T shareholders receiving P stock. The transaction qualifies as a tax-free A reorganization because P, LLC1, and LLC2 are a combining unit, and all of the assets and liabilities of T are transferred to that combining unit, and T ceases to exist.
Temporary Section 368 Regulations

Definition of Statutory Merger or Consolidation

Facts: P and T are domestic corporations and LLC is a domestic limited liability company. LLC is wholly owned by P. LLC is treated as a disregarded entity. P and LLC are a combining unit and T is a combining entity. T distributes assets to its shareholders and then merges into LLC under state statutory merger law, with the T shareholders receiving P voting stock. The transaction qualifies as a tax-free A reorganization under Treas. Reg. § 1.368-2T(b)(1)(ii). The requirement that T transfer all of its assets in the statutory merger is not intended to impose a substantially all requirement.
Temporary Section 368 Regulations

Mergers Involving U.S. vs. Foreign Disregarded Entities

Facts: LLCs are treated as disregarded entities. T merges into P’s U.S. LLC under state statutory merger law, with the T shareholders receiving P voting stock. P and its LLCs are a combining unit. T and its LLCs are a combining unit. The transaction should qualify as a tax-free A reorganization under Treas. Reg. § 1.368-2T(b)(1)(ii).

Note: If T merged into P’s foreign LLC, or T’s assets and liabilities were split between P’s U.S. and foreign LLCs, the transaction would not qualify as tax-free A reorganization under Treas. Reg. § 1.368-2T(b)(1)(iii).
Temporary Section 368 Regulations

Merger of Target into U.S. LLC followed by Transfer of Assets to Foreign LLC

Facts: T merges into P’s U.S. LLC under state statutory merger law, with the T shareholders receiving P voting stock. P and its LLCs are a combining unit. T and its LLCs are a combining unit. In a separate transaction following the merger, P’s U.S. LLC transfers T assets and liabilities to P’s foreign LLC.

Does this transaction still qualify as a tax-free statutory merger under Treas. Reg. § 1.368-2T(b)(1)(ii)? What if T’s assets and liabilities were instead contributed to a wholly-owned foreign LLC of P’s U.S. LLC?
Temporary Section 368 Regulations
Merger of Target into U.S. LLC Wholly-Owned by Foreign LLC

Facts: T merges into P’s U.S. LLC under state statutory merger law, with the T shareholders receiving P voting stock. P holds its interest in its U.S. LLC through a wholly-owned foreign LLC. This transaction does not qualify as a tax-free statutory merger under Treas. Reg. § 1.368-2T(b)(1)(iii).
Temporary Section 368 Regulations
Merger of Target into U.S. LLC Wholly-Owned by U.S. Sub

Facts: P wholly owns Foreign LLC, which owns S, a domestic corporation, which in turn owns U.S. LLC. The LLCs are treated as disregarded entities. T merges into S’s U.S. LLC under state statutory merger law, with the T shareholders receiving P voting stock. S and its U.S. LLC are a combining unit and T is a combining unit. The transaction should qualify as a tax-free triangular reorganization under Treas. Reg. § 1.368-2T(b)(1)(ii) if transaction also meets the requirements of section 368(a)(2)(D), because all business entities through which S, the combining entity of the transferee unit, holds its interests in the transferee disregarded entity are domestic entities.
Loss Disallowance Rules
P, the common parent of a consolidated group, owns all of the stock of S with a basis of $100. S earns $30, net of taxes (which $30 could be ordinary income or gain on the disposition of an asset). P’s basis in the stock of S increases to $130 pursuant to Reg. §1.1502-32.
LDR Background
Reg. §1.1502-32 -- Investment Adjustments

P contributes $1000 to newly formed S. S uses the $1000 to purchase a parcel of land from X. The land appreciates to $2500 and S sells the land to Y for $2500, generating $1500 of gain and causing P’s basis in S to increase to $2500 (disregarding taxes). P thereafter sells the S stock for $2500 (the amount of cash S had from the sale of the land) and recognizes no gain or loss.
P purchases the stock of S for $1000 from X. S’s only asset is land with a value of $1000 and a tax basis of $0. P causes S to sell the land to Y for its fair market value of $1000, generating $1000 of gain and causing P’s basis in the S stock to increase to $2000 (disregarding taxes). P subsequently sells the S stock for its fair market value of $1000 and generates a $1000 loss that is attributable to the recognition of the built-in gain inherent in S’s land (i.e., the excess of the fair market value of the land over its tax basis in S’s hands).
P purchases the stock of S for $1000 from X. S has two assets, a machine (wanted asset) and land (unwanted asset), each of which has a fair market value of $500 and a tax basis of $0. P causes S to dividend the machine to P, causing (i) S to recognize $500 of gain, (ii) P to take a basis of $500 in the machine and (iii) P’s basis in the stock of S to increase by $500 (at the time S’s $500 gain is taken into income, disregarding taxes) and decrease by $500 by reason of the distribution of the machine worth $500 (a net adjustment of $0; P’s basis in S stock remains $1000). P subsequently sells the stock of S to Y for its fair market value of $500 and recognizes a $500 loss.
P contributes $1000 to newly formed S. S loses $900 of the $1000, generating a $900 NOL that is not absorbed by the P group. P sells the stock of S to Purchaser for its fair market value of $100, recognizing a $900 loss. S is allocated a $900 NOL from the P group. What is the result under Reg. §1.1502-20?
Loss Disallowance Rules -- Background

• LDR was originally enacted for two reasons, only the first of which was described in Notice 87-14 (which indicated that guidance would be forthcoming).
  – To protect the Repeal of the General Utilities Doctrine (“GU Repeal”).
    • “Son-of-mirrors” transaction permitted taxpayers to avoid GU Repeal. The drafters believed that “wasting assets” with inherent built-in gain and positive investment adjustments attributable to those assets (“PIAs”) raised son of mirrors concerns.
  – Loss Duplication, which is arguably inconsistent with the single entity principle of consolidated returns.
History of the Extremely Controversial Loss Disallowance Rules

- January 6, 1987: Notice 87-14 indicates that forthcoming guidance will (i) protect GU Repeal by preventing son of mirrors transactions and (ii) be retroactive to the date of the notice.

- March 9, 1990: Temp Reg. §1.1502-20T disallowed all losses with respect to stock of consolidated subsidiaries (simple but much too harsh and not justifiable) and Reg. §1.337(d)-1T adopted a tracing regime for certain transition periods.


- September 13, 1991: Reg. §1.337(d)-1, Reg. §1.337(d)-2 and Reg. §1.1502-20 (permit deductible losses with respect to stock of consolidated subsidiaries in certain fact patterns; Reg. §1.1502-20 held invalid in Rite Aid (at least in part).
P purchases the stock of S and elects under the Section 338(h)(10) to treat the acquisition as a deemed asset acquisition. Consequently, S’s asset basis presumably equals fair market value at the time of the acquisition. P subsequently sells the stock of S to an unrelated party and recognizes a $20 loss (which loss was also inherent in S’s assets). Under Reg. §1.1502-20, the $20 loss was disallowed. The taxpayer challenged the result. Although the taxpayer lost in the Claims Court, the Court of Appeals for the Federal Circuit reversed the Claims Court and declared Reg. §1.1502-20 invalid (at least as it relates to duplicated losses).
Rite Aid, Notice 2002-11 and Square D

- July 6, 2001 -- Court of Appeals for the Federal Circuit reversed the June 2000 Claims Court decision in Rite Aid and held that Reg. §1.1502-20 is invalid (at least to the extent it relates to duplicated losses) under the following rationale:
  - a deductible loss is permitted under §165 on the sale of subsidiary corporation stock by another corporation if those corporations file separate returns.
  - no problem is created by the filing of consolidated returns and, consequently, the IRS and Treasury do not have the authority to promulgate regulations to deny the deduction for the stock loss.

- January 31, 2002 -- Treasury and the IRS issued Notice 2002-11, which announced:
  - their decision not to seek cert. from the U.S. Supreme Court with respect to Rite Aid (presumably because there was no split in the circuits).
  - the government will not continue to litigate Reg. §1.1502-20 in the “interests of sound tax administration.”
  - Reg. §1.337(d)-2 would be amended and substituted for Reg. §1.1502-20.

- February 7, 2002, the IRS reportedly conceded a case against Square D Co. (which involved the positive investment adjustment factor of Reg. §1.1502-20).
Rite Aid - Analysis of Court of Appeals for Federal Circuit

- The Federal Circuit determined validity under the following analysis despite the broad language of §1502:
  - In the absence of a problem created from the filing of consolidated returns, the Secretary is without authority to change the application of other tax code provisions to a group of affiliated corporations filing a consolidated return. (See American Standard).
  - This standard may call into question the validity of numerous other consolidated regulations.
CONSIDERATION SHOULD BE GIVEN TO WHETHER ANY OF THE FOLLOWING ARE POTENTIALLY INVALID CONSOLIDATED RETURN REGULATIONS UNDER THE RITE AID RATIONALE

- Reg. §1.1502-13(c) -- matching rule to the extent related to attributes and holding period
- Reg. §1.1502-13(f)(3) -- boot in intercompany reorganizations
- Reg. §1.1502-13(f)(6) -- parent stock loss disallowance rule
- Reg. §1.1502-13(g) -- intercompany obligations
- Reg. §1.1502-13(h) -- intercompany transaction anti-avoidance rules
- Reg. §1.1502-17(c) -- anti-avoidance rule regarding method of accounting
- Reg. §1.1502-19 -- excess loss accounts
- Reg. §1.1502-20 -- to the extent related to other than duplicated loss
- Reg. §1.1502-30(b)(3) -- stock basis following triangular reorganizations and excess loss accounts
- Reg. §1.1502-31-- stock basis after group structure change
CONSIDERATION SHOULD BE GIVEN TO WHETHER ANY OF THE FOLLOWING ARE POTENTIALLY INVALID CONSOLIDATED RETURN REGULATIONS UNDER THE RITE AID RATIONALE (Continued)

• Reg. §1.1502-33(e) -- E&P eliminated upon deconsolidation
• Reg. §1.1502-33(f) -- E&P replication in parent following group structure change
• Reg. §1.1502-34 -- special aggregation rules regarding stock ownership
• Prop. Reg. §1.1502-55(g) -- AMT stock basis
• Reg. §1.1502-80(b) -- non-applicability of section 304 to intercompany transactions
• Reg. §1.1502-80(c) -- deferral of section 165 loss
• Reg. §1.1502-80(d) -- non-applicability of section 357(c) to intercompany transactions
• Reg. §1.1502-80(e) -- non-applicability of section 165(e)(5) to intercompany obligations
• Reg. §1.1502-80(f) -- non-applicability of section 1031 to intercompany transactions
• Reg. §1.1502-91(h)(4) -- exchanged basis property
Legislative Proposal to Limit Impact of *Rite Aid*

- As part of the Jobs and Growth Reconciliation Tax Act of 2003, the Senate introduced legislation that would have amended section 1502 to limit the decision in *Rite Aid*. However, this legislative proposal was removed from the final version of the bill passed by Congress and signed by the President. However, this proposal is likely to be revisited in future legislation.

- Under the legislative proposal, section 1502 would be amended by adding the following new sentence:

  > In prescribing such regulations, the Secretary may prescribe rules applicable to corporations filing consolidated returns under section 1501 that are different from other provisions of this title that would apply if such corporations filed separate returns.

- The Senate bill also provided that notwithstanding the above amendment, the duplicated loss factor of Treas. Reg. § 1.1502-20(c)(1)(iii), which was invalidated by the court in *Rite Aid*, shall be construed as being inapplicable to the factual situation in *Rite Aid*; i.e., denying a loss on the disposition of subsidiary stock to the extent such loss may be duplicated outside the consolidated group.

- The Technical Explanation of the 2003 Senate bill prepared by the Senate Finance Committee explains that the reason for the provision is the Finance Committee’s concern that the language of the *Rite Aid* opinion may lead taxpayers to challenge other consolidated return regulations that prescribe a result that is different from the separate return result. It also states that the provision in no way prevents or invalidates the approaches Treasury has announced it will apply in lieu of Treas. Reg. § 1.1502-20.
IRS Response to *Rite Aid* - Notice 2002-11

- January 31, 2002, Treasury issued Notice 2002-11 announcing:
  - Decision not to seek certiorari from Supreme Court.
  - Would not litigate §1.1502-20 in the “interests of sound tax administration,” but view Rite Aid as limited in scope
  - Due to interrelationship among the 3 LDR factors, §1.337(d)-2 would be amended and substitute for §1.1502-20.

- February 7, 2002, IRS conceded *Square D Co.* (a case involving positive investment adjustment factor)
IRS Response to *Rite Aid*

- **March 7 Guidance**
  - §1.1502-20 Removed
  - New Temp. Reg. §1.337(d)-2T Added
  - The new regulations are generally effective for dispositions of stock occurring on or after March 7, 2002.
  - Temp. Reg. §1.1502-20T allows taxpayers three choices for prior years

- **May 31 Guidance**
  - Amended new Temp. Reg. §1.337(d)-2T and new Temp. Reg. §1.1502-20T in response to several questions raised concerning the interpretation and application of the new temporary regulations.
  - The amendments are effective May 31, 2002.
Temp. Reg. §1.1502-20T

- Provides sellers with three choices for losses on dispositions of subsidiary stock recognized prior to March 7, 2002
  - Can apply Treas. Reg. §1.1502-20 in its entirety
  - Can apply Treas. Reg. §1.1502-20 without regard to the loss duplication factor
  - Can apply Temp. Reg. §1.337(d)-2T
- Taxpayers can pick any of the three alternatives for each separate disposition of subsidiary stock (deal by deal election)
- Taxpayers make election by filing a statement with an original return for a year that includes any date on or before 3/7/02 or with an amended return filed by the due date of the return for the taxable year that includes 3/7/02 (a -20(c) statement is not required).
Temp. Reg. §1.1502-20T

• If, pursuant to an election under Temp. Reg. §1.1502-20T(i), the loss on the disposition of subsidiary stock is increased, but the year of the disposition (or the year to which such loss would have been carried back or carried forward) is closed, to the extent that the absorption of such excess loss in such year would have affected the tax treatment of another item (e.g., another loss that was absorbed in such year) that has an effect in an open year, the election will affect the treatment of such other item.

• If (i) a subsidiary of the consolidated group (the disposing member) recognized a loss on the disposition of stock of a lower-tier subsidiary member of the group, (ii) the loss was disallowed under Treas. Reg. §1.1502-20, and (iii) as a result, a group member’s basis in the stock of the disposing member was reduced pursuant to Treas. Reg. §1.1502-32 because the disallowed loss was treated as a noncapital, nondeductible expense, then to the extent that all or some portion of the disallowed loss is allowed as a result of an election under Temp. Reg. §1.1502-20T(i), but such loss would have been properly absorbed or expired in a closed year, the basis in the stock of the disposing member may be increased for purposes of determining the group’s or the shareholder-member’s Federal income tax liability for all open years.
### Reg. §1.337(d)-2
- Loss on stock of consolidated subsidiary allowed to the extent taxpayer establishes that the loss is not attributable to recognition of built-in gain on the disposition of an asset (“BIG”).
- Basis reduction on deconsolidation of share except to the extent the taxpayer establishes the basis is not attributable to BIG.
- Complete (but not partial) disposition to unrelated party or worthlessness can give rise to deductible loss.
- No loss reattribution.
- Netting of gain and loss blocks of stock not permitted.
- Taxpayer must file allowed loss statement.
- Effective Date - Generally applies to dispositions and deconsolidations on or after 11/19/90 to the extent not subject to Reg. §1.1502-20.

### Reg. §1.337(d)-2T
- Loss on stock of consolidated subsidiary allowed to the extent taxpayer establishes that the loss is not attributable to recognition of BIG.
- Basis reduction on deconsolidation of share except to the extent the taxpayer establishes the basis is not attributable to BIG.
- Complete or partial disposition or worthlessness can give rise to deductible loss.
- No loss reattribution.
- Netting of gain and loss blocks of stock permitted.
- Taxpayer must file allowed loss statement.
- Effective Date - Generally applies to dispositions and deconsolidations on or after 3/7/02; elective applicability for prior transactions.

### Reg. §1.1502-20
- Loss on stock of consolidated subsidiary allowed to the extent loss is not attributable to:
  - (i) extraordinary gain dispositions,
  - (ii) positive investment adjustments, or
  - (iii) duplicated loss.
- Basis reduction on deconsolidation of share except to the extent basis not attributable to LDR Factors.
- Complete or partial disposition or worthlessness can give rise to deductible loss.
- Loss reattribution generally permitted to extent of disallowed loss.
- Netting of gain and loss blocks of stock permitted.
- Taxpayer must file allowed loss statement.
- Rules regarding successors, anti-avoidance and investment adjustments and E&P.
- Effective Date - Elective applicability generally to dispositions and deconsolidations after 2/1/91 and before 3/7/02.

### Reg. §1.1502-20 “Lite”
- Loss on stock of consolidated subsidiary allowed to the extent loss is not attributable to:
  - (i) extraordinary gain dispositions and
  - (ii) positive investment adjustments ((i) and (ii), collectively “Lite LDR Factors”).
- Basis reduction on deconsolidation of share except to the extent basis not attributable to Lite LDR Factors.
- Complete or partial disposition or worthlessness can give rise to deductible loss.
- Loss reattribution generally permitted to extent of disallowed loss.
- Netting of gain and loss blocks of stock permitted.
- Taxpayer must file allowed loss statement.
- Rules regarding successors, anti-avoidance and investment adjustments and E&P.
- Effective Date - Elective applicability generally to dispositions and deconsolidations on or after 2/1/91 and before 3/7/02.
P purchases all of the stock of S for $110. At that time, S has two assets, Asset 1, which has a basis of $0 and a fair market value of $50 and Asset 2, which has a basis of $0 and a fair market value of $60. Subsequently, S sells Asset 2 to Y for $60, causing P’s basis in the S stock to increase to $170 (disregarding taxes). In addition, S earns $80 of operating income, causing S’s fair market value to increase to $190 and P’s basis in the S stock to increase to $250 (disregarding taxes). Subsequently, the value of S declines to $100 and P sells all of the stock of S to Z for $100. How much of P’s $150 loss would be disallowed under Reg. §1.1502-20 assuming S has no duplicated loss? Compare the results under Reg. §1.1502-20 “Lite”. Compare the results under Reg. §1.337(d)-2T. How would the answer change if S also had a $30 NOL carryover?
Temp. Reg. §1.337(d)-2T

• The regulations largely employ the rules in current Reg. §1.337(d)-2
  – Losses on subsidiary stock are disallowed except to the extent that seller establishes that the loss is not attributable to built-in gain
  – “Built-in gain” includes only gain on the disposition of an asset that is already “reflected” in the basis of the stock
    * Under a tracing regime, built-in gain is gain that is inherent in the asset when the stock is acquired
    * Under the Service’s recent interpretation, built-in gain is gain attributable (directly or indirectly, in whole or in part) to any excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share (directly or indirectly, in whole or in part).
  – To claim the loss, taxpayers must file a “1.337(d)-2T Statement” with their return

• Two key changes from current Reg. §1.337(d)-2 are (i) the selling group is no longer required to dispose of its entire interest in subsidiary, and (ii) gain and loss from certain dispositions of stock may be netted.
Interpreting Treas. Reg. § 1.337(d)-2T

- Treas. Reg. § 1.337(d)-2T generally provides that a loss on the sale of subsidiary stock is disallowed, and subsidiary stock basis is reduced to (but not below) FMV, except to the extent the taxpayer can establish that the loss is not attributable to the recognition of built-in gain on the disposition of an asset.

- Under Treas. Reg. § 1.337(d)-2T(c)(2), gain is built-in gain to the extent it is attributable (directly or indirectly, in whole or in part) to any excess of value over basis that is reflected, before the disposition of the asset, in the basis of the share (directly or indirectly, in whole or in part).

- Traditionally, practitioners interpreted Treas. Reg. § 1.337(d)-2T as implementing a tracing rule for determining whether a loss on the sale of subsidiary stock was attributable to the recognition of built-in gain on the disposition of an asset. Thus, if outside basis equaled inside basis on the date the subsidiary entered the group (e.g., in the case of a QSP with a section 338(h)(10) election), no loss on the subsequent disposition of the subsidiary stock would be disallowed.

- At the ABA conference in May of 2004, members of the Internal Revenue Service explained that Treas. Reg. § 1.337(d)-2T does not implement a tracing rule; instead, the regulation creates a rule based on stock and asset basis conformity.

- The National Office has instructed the Field to apply Treas. Reg. § 1.337(d)-2T as follows:
Application of Treas. Reg. § 1.337(d)-2T by the Field

- Gain will not be treated as reflected in subsidiary stock basis where inside/asset basis equals or exceeds outside/stock basis (i.e., where there is basis conformity).

- Gain will be treated as reflected in subsidiary stock basis to the extent of any basis disconformity (i.e., excess of stock basis over assets basis)

- Gain will be treated as built-in gain to the extent of the lesser of:
  - The sum of all gains (net related expenses) recognized on asset dispositions while the subsidiary is a member of the group, and
  - The amount of basis disconformity, computed as the excess, if any, of:
    - The share’s basis, over
    - The share’s proportionate interest in the subsidiary’s net asset basis

- Loss will be treated as attributable to recognized built-in gain only to the extent of:
  - The excess, if any, of positive adjustments made to the share under Treas. Reg. § 1.1502-32, over
  - Negative adjustments made to the share under Treas. Reg. § 1.1502-32

* For purposes of this outline, the interpretation discussed above is referred to as the “Service’s May 2004 interpretation”
Treas. Reg. § 1.337(d)-2T;
The Service’s May 2004 Interpretation Example

**Facts:** SH owns all the stock of T. T owns one asset (Asset 1) with a basis of $0 and a value of $100. On Date 1, P purchases 100 percent of the T stock for $100. On Date 2, P contributes $1 to T, and T purchases Asset 2. The $1 contribution increases P’s basis in T stock by $1 (to $101). Prior to Date 3, the value of Asset 1 declines to $0, and the value of Asset 2 increases to $100. On Date 3, T sells Asset 2 to an unrelated third party for $100, recognizing a $99 gain on the transaction. This gain results in an upward basis adjustment of $99 in P’s T stock. Thus, P has a $200 basis in T stock. Later in Date 3, P sells all of its T stock to an unrelated third party for $100.

**Issue:** What is the result under the a tracing regime? What is the result under the Service’s May 2004 interpretation?
Facts: In Year 1, P buys 100 percent of the stock of T, which owns 100 percent of the stock of TS1. TS1 owns 100 percent of the stock of TS2. TS2 owns 100 percent of the stock of TS3, which owns 100 percent of the stock of FS4, a foreign subsidiary. On the date of P’s acquisition of the T stock, FS4 owns a built in gain (“BIG”) asset. In Year 4, FS4 sells the BIG asset to a third party, which generates subpart F income. In Year 7, P sells 100 percent of the T stock to a third party.

How do you trace the basis adjustment?

What is the result under the Service’s May 2004 interpretation?
Temp. Reg. §1.337(d)-2T

Issues Regarding Whether Gain is Built-in Gain from the “Disposition of an Asset” that Gives Rise to a Disallowed Loss

– Income from oil and gas interests, timber, etc.

– Sale of stock of a CFC at a gain, which gain is characterized as a dividend under Section 1248

– Distributions with respect to stock outside of a consolidated return that are taxed under Section 301(c)(3)

– Application of the Service’s May 2004 interpretation

(Note that similar issues arise under Section 382(h), Section 384 and Section 1374)
Facts: P acquired all of the stock of T from an unrelated party for $100. At that time, T owned a manufacturing plant with an aggregate tax basis of $0 and a value of $100. During Years 1 and 2, T’s plant manufactures widgets, generating income of $100. At the end of this period, the plant’s useful life is at an end and P sells its stock of T for $100.

- What is the result under the tracing regime?
- What is the result under the Service’s May 2004 interpretation?
Facts: Same example except that T’s plant has a basis of $200. Following the acquisition, the plant generated $100 in income after depreciation deductions. P then sells its stock of T for $100.

- What is the result under the tracing regime?
- What is the result under the Service’s May 2004 interpretation?
**Wasting Asset; Example**

**Year 1**

- **A**: Business 1: AB=$100, FMV=$300
- **B**: Business 2: AB=$200, FMV=$200
- **P**: 100% of T stock for $500

- **S**: T Stock

**Year 2**

- **A**: T sells Business 1 for $300 (gain of $200) and incurs $200 of loss from Business 2
- **P**: AB=$500
- **S**: Sale of Bus. 1
- **T**: NOL = $200

**Year 3**

- **A**: AB=$500
- **P**: Sale of T stock
- **S**: T

**Facts:** In Year 1, P buys 100 percent of the stock of T for $500. At the time of P’s acquisition of T, T operates two businesses: Business 1, with assets having an adjusted basis of $100 and a fair market value of $300, and Business 2, with assets having an adjusted basis of $200 and a fair market value of $200. In Year 2, T sells Business 1 for $300 (recognizing a gain of $200) and incurs $200 of loss from the operations of Business 2. In Year 3, P sells 100 percent of the T stock for $300.

- What is the result under the tracing regime?
- What is the result under the Service’s May 2004 interpretation?
• Subject to a binding contract exception, losses cannot be reattributed with respect to dispositions of subsidiary stock that occur on or after March 7, 2002.

• If a disposition of subsidiary stock occurred before March 7, 2002, the selling consolidated group may (i) continue to apply existing Reg. §1.1502-20 in its entirety, (ii) elect to apply Reg. §1.1502-20 “Lite”, which is Reg. §1.1502-20 without regard to the duplicated loss factor (which may cause an increase in allowable loss with respect to subsidiary stock and a consequent reduction of the amount of the reattributed losses), or (iii) elect to apply Reg. §1.337(d)-2T (which will preclude the selling group’s ability to reattribute losses with respect to that disposition).

• The election to apply existing Reg. §1.1502-20, Reg. §1.1502-20 “Lite”, or Reg. §1.337(d)-2T with respect to dispositions prior to March 7, 2002 is made on a transaction by transaction basis (i.e., there is no consistency requirement for multiple dispositions).
LOSS REATTRIBUTION -- PRIOR PERIODS

- To be eligible to reattribute losses with respect to a disposition occurring prior to March 7, 2002, a selling consolidated group must have filed a valid Reg. §1.1502-20(g) election to reattribute losses with respect to that disposition in the year of that disposition.
  - If the selling consolidated group elects to determine the allowable loss with respect to a disposition pursuant to Reg. §1.1502-20 “Lite”, it cannot revoke an earlier election under Reg. §1.1502-20(g) to reattribute losses with respect to that disposition.
  - The amount of the reattributed losses with respect to that disposition will be reduced however, to the extent they exceed the greater of (i) the disallowed loss as recomputed under Reg. §1.1502-20 “Lite” and (ii) the amount of the reattributed losses the selling consolidated group absorbed in closed years.
  - If the selling consolidated group elects to determine allowable loss with respect to that disposition pursuant to Reg. §1.337(d)-2T, the amount of losses treated as reattributed is the greater of (i) zero and (ii) the amount of the reattributed losses the selling consolidated group absorbed in closed years.
- To the extent a selling consolidated group’s reattributed losses with respect to a disposition are reduced by reason of the elective applicability of Reg. §1.337(d)-2T or Reg. §1.1502-20 “Lite”, the previously reattributed excess losses are reallocated to the target subsidiary, and are subject to applicable limitations (such as §382, §384 and the SRLY rules).
LOSS REATTRIBUTION -- PRIOR PERIODS

• If a selling group’s reattributed losses are reduced by reason of the elective applicability of Reg. § 1.337(d)-2T or Reg. §1.1502-20 “Lite” to a prior disposition (and, consequently, reallocated to the target subsidiary), such selling group may cede to the target subsidiary any part of the §382 limitation that such selling group had previously elected to apportion to itself with respect to that loss (this would generally apply if the selling consolidated group (or loss subgroup included in the selling consolidated group) previously had a §382 ownership change).
  – Any portion of the §382 limitation so ceded by the selling consolidated group is treated as having been ceded effective as of the date the target subsidiary ceased to be a member of the selling consolidated group or loss subgroup, as the case may be.
  – Any portion of the §382 limitation intended to be ceded by the selling consolidated group must be ceded by such group at the time it elects to apply Reg. §1.337(d)-2T or Reg. §1.1502-20 “Lite”, as the case may be.

• Prior to filing its return for the year that includes March 7, 2002, the parent of the selling consolidated group must notify the target subsidiary (and the entity that was the common parent of the acquiring group at the time the subsidiary was acquired from the selling consolidated group, if any) that the amount of the seller’s reattributed losses from the target subsidiary have been reduced (and the amount of allocated § 382 limitation, if any; presumably sellers will negotiate this amount with purchasers and charge a fee for making the election to cede §382 limitation).

• The parent of the selling consolidated group must amend its returns for open years to reflect any reduction in the amount of reattributed losses from the target subsidiary as a result of recomputing the amount of disallowed loss because the selling consolidated group elects to apply Reg. § 1.337(d)-2T or Reg. §1.1502-20 “Lite”, rather than Reg. §1.1502-20, to the prior disposition of the stock of the target subsidiary.
LOSS REATTRIBUTION -- PRIOR PERIODS

• A selling consolidated group’s election to reattribute losses with respect to a prior disposition of a target subsidiary is binding on the target subsidiary and, consequently, the target subsidiary cannot avail itself of the losses reattributed to the seller under Reg. §1.1502-20 or Reg. §1.1502-20 “Lite”, as the case may be.
  – The target subsidiary is permitted to use the reattributed losses (subject to applicable limitations), however, to the extent the amount of such losses reattributed to the seller is reduced because the selling group recomputes its disallowed loss pursuant to Reg. §1.337(d)-2T or Reg. §1.1502-20 “Lite”.
  – Reattributed losses are deemed to have been waived if they expired before they became available to the target subsidiary (or, if such losses have not previously expired, the target subsidiary may elect to waive them under Reg. §1.1502-32(b)(4) in the year that such subsidiary receives notice from the seller that such losses have been reallocated to such subsidiary; if the seller fails to notify the target subsidiary, the losses will be deemed waived).

• A selling consolidated group’s election to recompute its disallowed loss with respect to the disposition of a subsidiary under Reg. §1.337(d)-2T or Reg. §1.1502-20 “Lite” must be made on the selling consolidated group’s return for a taxable year that includes any date on or before March 7, 2002 (or, if later, the year a subsidiary’s stock is disposed of pursuant to the binding contract transition rule), or with an earlier filed amended return.
P sells the stock of S to X for a $150 loss that was disallowed under Reg. § 1.1502-20 (S has a $100 NOL carryover and recognized $50 of built-in gains while it was owned by P and, consequently, $100 of the stock loss was disallowed under the “duplicated loss” factor and $50 was disallowed because of extraordinary gain dispositions). Pursuant to Reg. § 1.1502-20(g), P was permitted to reattribute to itself all or any portion of S’s loss (to the extent such reattributed loss did not exceed the disallowed stock loss of $100 under Reg. §1.1502-20).

Reg. §1.337(d)-2T contains no similar reattribution concept, but Reg. §1.1502-20 “Lite” does.
Netting of Gain and Loss Blocks of Stock of the Same Subsidiary

P has two blocks of S common stock that P acquired at different times
Block 1 FMV=$200 Basis=$50
Block 2 FMV=$200 Basis=$200

P purchases 50 percent of the stock of S for its then FMV of $50 (“Block 1”). Subsequently, P purchases the remaining 50 percent of S’s stock for its then FMV of $200 (“Block 2”). S subsequently sells an asset to X and recognizes a $100 gain that was inherent in the asset at the time P acquired S’s stock. The recognition of the gain (disregarding taxes) causes P’s basis in the Blocks 1 and 2 to increase to $100 and $250, respectively. P subsequently sells all of the S stock to Y for $300 ($150 of which is allocable to each block of S stock), causing P to recognize a $50 gain on Block 1 and a $100 loss on Block 2.

What is the result under Reg. §1.337(d)-2T (both under the tracing regime and the Service’s May 2004 interpretation), Reg. §1.1502-20, and Reg. §1.1502-20 “Lite”? 178
**Considerations for Selling Consolidated Groups**

- Analyze each disposition of stock of a consolidated subsidiary at a loss that occurred in a taxable year that remains open (and in closed taxable years if there could be (i) a loss carryover to an open tax year, or (ii) an effect on another tax item in an open tax year) to determine which set of LDR rules produces the most favorable result (taking into account any potential payments from purchasers for losses and §382 allocations).

- Purchasers of stock of a domestic corporation from a consolidated group should analyze whether the LDR elections available to the seller could produce tax benefits to any party.

- Elections under Reg. §1.1502-20T for prior dispositions must be filed with the selling consolidated group’s tax return for a year that includes any date on or before March 7, 2002, or with an earlier filed amended return (i.e., one filed prior to the due date of the selling consolidated group’s return that includes March 7, 2002).

- In applying Treas. Reg. §1.337(d)-2T, analyze the results under both the tracing regime and the Service’s May 2004 interpretation.
An uncertainty exists regarding:

- how, if the taxable year of the disposition of subsidiary stock at a loss is closed, but the carryforward year is open, the selling consolidated group makes the election to apply Reg. §1.337(d)-2T or Reg. §1.1502-20 “Lite” to the disposition.
Temp. Reg. §1.1502-20T

Circumstances where a selling consolidated group might conclude it wishes to apply Reg. §1.1502-20 and not Reg. §1.337(d)-2T or Reg. §1.1502-20 “Lite” -- even if that would maximize the amount of the disallowed stock loss.

– the selling consolidated group reattributed NOLs and a capital loss on the subsidiary’s stock would not produce a tax (or economic) benefit equal to that produced by the reattributed NOLs.

– the selling consolidated group reattributed NOLs and cannot demonstrate that positive investment adjustments with respect to the subsidiary’s stock are not attributable to recognized built-in gain (which is necessary to have an allowed stock loss under Reg. §1.337(d)-2T (under both the tracing regime and the Service’s May 2004 interpretation)).
A selling consolidated group might conclude it wishes to apply Reg. §1.1502-20 “Lite” if:

- the selling consolidated group had a disallowed loss on the disposition of the subsidiary’s stock by reason of the duplicated loss factor of Reg. §1.1502-20 and a capital loss on the disposition of target subsidiary stock in the year of the disposition would produce a tax benefit for the selling consolidated group.

- the selling consolidated group (i)(a) had a disallowed loss on the disposition of the subsidiary’s stock and (b) previously reattributed NOLs, (ii) could have used the disallowed capital loss, and (iii) is paid a fee to make the election by the disposed subsidiary or its purchaser.
A selling consolidated group might conclude it wishes to apply Temp. Reg. §1.337(d)-2T if:

- the selling consolidated group (i) had a disallowed loss on the disposition of the subsidiary that was attributable to positive investment adjustments or extraordinary gain dispositions, (ii) either (a) is able to prove that the loss is not attributable to the recognition of built-in gain (within the meaning of Reg. §1.337(d)-2T) or (b) could have used the disallowed capital loss, and (iii)(a) did not reattribute NOLs or (b) reattributed NOLs, but the disposed subsidiary or its purchaser will pay the Seller a sufficient amount to induce the Seller to make the election.

- In determining whether to apply Temp. Reg. §1.337(d)-2T, the taxpayer must analyze the results under both the tracing regime and the Service’s May 2004 interpretation.
Amending Waivers of Loss Carryovers after Election to Apply Reg. § 1.1502-20 “Lite” or Reg. 1.337(d)-2T

Waiver Election In General

• Treas. Reg. § 1.1502-32(b)(4) provides that, if a subsidiary has a loss carryover from a separate return limitation year when it becomes a member of a consolidated group, the group may make an election to treat all or any portion of the loss carryover as expiring immediately before the subsidiary becomes a member of the consolidated group. This election permits an acquiring group to avoid the loss of stock basis that otherwise would result if the subsidiary’s loss carryovers were to expire before the group could absorb them. See Treas. Reg. § 1.1502-32(b)(2)(iii).

• The election may be made by identifying either the amount of each loss carryover deemed to expire or the amount of each loss carryover deemed not to expire. Any loss waived under Treas. Reg. § 1.1502-32(b)(4) may be excluded from the selling group’s computation of duplicated losses. Thus, the waiver could have the effect under the prior loss disallowance regulations of increasing the amount of stock loss allowed on the disposition of subsidiary stock.
Amending Waivers of Loss Carryovers after Election to Apply Reg. § 1.1502-20 “Lite” or Reg. 1.337(d)-2T

Amendment of Prior Waivers after Election Under Treas. Reg. § 1.1502-20T(i)

- Prior to promulgation of Treas. Reg. § 1.1502-20T, acquiring and selling groups may have negotiated to have the acquiring group waive loss carryovers in an effort to increase the amount of loss allowed to the selling group. Thus, Treasury and the Service believed that in cases where a selling group elects to apply -20 Lite or Treas. Reg. § 1.337(d)-2T, it was appropriate to permit an acquiring group to amend prior waivers of loss carryovers. On May 7, 2003, Treasury and the Service amended the temporary regulations to provide for the amendment of prior waivers. See Treas. Reg. § 1.1502-32T(b)(4)(vii).

- If a selling group elects to apply -20T Lite or Temp. Treas. Reg. § 1.337(d)-2T, which may have the effect of increasing the loss allowed on the disposition of the subsidiary stock, then the acquiring group may reduce the amount of any loss carryover deemed to expire (or increase the amount of any loss carryover deemed not to expire) as a result of Treas. Reg. § 1.1502-32(b)(4). Treas. Reg. § 1.1502-32T(b)(4)(vii)(A).

- The aggregate amount of loss carryovers that may be treated as not expiring as a result of such an amendment is limited to the amount of the duplicated loss with respect to the subsidiary’s stock. This limitation is intended to ensure that the loss carryovers subject to the amendment did, in fact, increase the amount of the allowed loss.
Amending Waivers of Loss Carryovers after Election to Apply Reg. § 1.1502-20 “Lite” or Reg. 1.337(d)-2T

Avoiding Inadvertent Waivers

- If the acquiring group made its original waiver election by identifying those losses that were deemed not to expire, it may have inadvertently waived those losses that were reattributed to the selling group but revert to the subsidiary as a result of an election to apply -20 Lite or Treas. Reg. § 1.337(d)-2T.

- In such cases, the temporary regulations permit the acquiring group to amend its waiver election to provide that the additional losses are deemed not to expire. Treas. Reg. § 1.1502-32T(b)(4)(vii)(B).
Notice 2002-18

• Proposed regulations (see Prop. Treas. Reg. § 1.1502-35) will prevent groups from obtaining multiple benefits from one economic loss.
  – Consolidated groups will not be permitted to claim (i) a deductible loss from the disposition of stock and (ii) use a loss or deduction attributable the same economic loss.
  – Forthcoming regulations will “defer or otherwise limit utilization of the loss on the stock in such transactions and other transactions that facilitate the group’s utilization of a single loss more than once.”
  – When issued, those regulations will apply retroactively to dispositions of stock (or another asset that reflects the basis of stock) on or after March 7, 2002.

• IRS and Treasury are studying various approaches to implement Notice 2002-18 in a manner that gives “full effect to §337(d) and to reflect the single entity principles of the consolidated return rules.”
P owns all of the stock of S and S1. S1 contributes to S assets with a basis of $100 and a fair market value of $20 in exchange for §1504(a)(4) preferred stock of S with a fair market value of $20. S1 subsequently sells the S §1504(a)(4) preferred stock to X for $20 (S remains a member of the P consolidated group and continues to own the transferred built-in loss asset). What is the result under current law?
Elimination of Duplicated Losses

On March 11, 2003, the IRS issued as temporary regulations Treas. Reg. § 1.1502-35T. The temporary regulations are substantially similar to proposed regulations issued on October 18, 2002. Consistent with Notice 2002-18, the purpose of the temporary regulations is to prevent a consolidated group from obtaining more than one tax benefit from a single economic loss.

The temporary regulations apply with respect to transactions occurring on or after March 7, 2002, but only if such transactions occur during a taxable year the original return for which is due, without regard to extensions, after March 14, 2003.

The proposed regulations consist of two primary rules to accomplish this goal:
(1) a Basis Redetermination Rule and
(2) a Loss Suspension Rule.

The temporary regulations contain a loss expiration rule that applies to situations not within the scope of the Loss Suspension Rule where a group may obtain more than one tax benefit from a single economic loss with respect to the sale of a subsidiary member’s stock when the stock of the subsidiary becomes worthless or the subsidiary member does not have a separate return year after the transaction.

The temporary regulations also contain certain anti-avoidance rules designed to address transactions that are structured to avoid the application of the Basis Redetermination Rule and the Loss Suspension Rule.
The **Basis Redetermination Rule** applies to a transaction where: (1) a member of a consolidated group transfers stock of a subsidiary member that has a basis that exceeds its value immediately prior to such transfer, and the subsidiary member is not deconsolidated; or (2) a subsidiary member is deconsolidated and any share of stock of the subsidiary member held by a member of the group has a basis that exceeds its value immediately prior to deconsolidation.

**Year 1**

- **P**
  - $80
  - 80 shs S stock

**Year 2**

- **P**
  - Asset A
    - A/B = $70
    - FMV = $20
  - 20 new shs S stock

**Year 3**

- **P**
  - Asset A
    - $20
  - Buyer

**Year 4**

- **P**
  - 20 shs S stock
  - $20
  - Buyer

Under prior law, S recognizes a loss of $50 loss on the sale of Asset A. As a result of the loss, P’s basis in the 80 shares of S stock was reduced by $40 to $40. P’s basis in the 20 shares of S stock was reduced by $10 to $60. P then realized a $40 loss on the sale of the 20 shares of S stock. The Basis Redetermination Rule is designed to avoid the “double benefit” of this transaction.
If immediately after a transfer of stock of a subsidiary member that has a basis that exceeds its value, the subsidiary remains a member of the group, then **immediately before** such transfer, the basis in each share of the subsidiary member stock held by members of the group is redetermined as follows:

1) The basis of all of the members of the group in the subsidiary member’s stock is aggregated.

2) The aggregated basis is first allocated to the subsidiary member’s preferred stock, in proportion to, but not in excess of, the value of those shares on the date of the transfer.

3) Any remaining basis is allocated among all common shares of subsidiary member stock held by members of the group in proportion to the value of such shares on the date of the transfer.
Facts: In Year 1, S1 and S2 form S3. S1 contributes $100 to S3 in exchange for all of the S3 common stock. S2 contributes an asset with a basis of $50 and a fair market value of $20 in exchange for all of the preferred stock of S3. In Year 3, S2 sells the preferred stock for $20 and S3 remains a member of the P group.

Result: Under Treas. Reg. § 1.1502-35T(b)(1), the Basis Redetermination Rule applies. S2’s basis in S3 preferred stock is redetermined to be $20 and S2 recognizes no loss on the sale of the S3 preferred stock. S1’s basis in S3 common stock is increased to $130. P’s basis in S1 is increased to $130 and P’s basis in S2 is decreased to $90. See Treas. Reg. § 1.1520-35T(e), Ex. 1.
Treas. Reg. §1.1502-35T
Basis Redetermination Rule --Treatment of ELA

Step 1
Contributes $100 in Exchange for Common Stock

Bank
$500

S1

Step 2
Contributes $100 in Exchange for Preferred Stock

S2

S1 generates $600 of losses resulting in an ELA for P of $500.

Facts: P contributes $100 to S1 in exchange for common stock of S1. S2 contributes $100 to S1 in exchange for preferred stock of S1. S1 borrows $500 from Bank and uses the loan proceeds in its business operations. S1 generates $600 of loss, which creates an ELA for P of $500. S2 sells all of its preferred S1 stock to an unrelated third party for $99.

Issue: How do you determine S2’s basis in the S1 preferred stock under the basis redetermination rule?
Treas. Reg. §1.1502-35T(b)(2)  
Basis Redetermination Rule if Subsidiary is Deconsolidated

If a subsidiary member is deconsolidated from the group, and immediately before such deconsolidation any share of stock of such subsidiary owned by a member of the group has a basis that exceeds its value, then the bases of the shares of the subsidiary held by members of the group are adjusted based upon the “Reallocable Basis Amount.”

The Reallocable Basis Amount equals the lesser of:

- **Built-in loss in all loss shares**—the aggregate of all amounts by which, immediately before the deconsolidation, the basis exceeds the value of a share of the subsidiary member’s stock owned by any member of the group at such time; and

- **Investment adjustments in non-loss shares**—the total of the subsidiary member’s (and any predecessor’s) items of deduction and loss, and the subsidiary member’s (and any predecessor’s) allocable share of items of deduction and loss of all lower-tier subsidiary members, that were taken into account in computing the adjustment to the basis under § 1.1502-32 of any share of stock of the subsidiary member (and any predecessor) held by members of the group immediately before deconsolidation, other than shares that have bases in excess of value immediately before the deconsolidation.
Basis Redetermination Rule if Subsidiary is Deconsolidated

**Reallocation of Basis**—The shares of the subsidiary member held by the members of the group are adjusted in the following manner:

1. The basis of every “loss” share of subsidiary stock owned by a member of the group is reduced, but not below its fair market value, in a manner, that to the greatest extent possible, causes the ratio of the basis to the value of each such share to be the same. The amount of such reduction is not to exceed the **reallocable basis amount**.

2. To the extent of the **reallocable basis amount**, the basis of each share of preferred stock of the subsidiary held by members of the group immediately before the deconsolidation is then increased, but not above such share’s fair market value, in a manner that that causes the ratio of the basis to the value of such share to be the same.

3. Any remaining **reallocable basis amount** is used to increase the basis of all common shares of the subsidiary’s stock held by members of the group immediately before the deconsolidation in a manner that causes the ratio of the basis to the value of such shares to be the same.
Facts: In Year 1, P contributes Asset A to S in exchange for one share of S common stock (CS1). In Years 2 & 3, P contributes $200 to S in exchange for one share of S common stock (CS2), Asset B in exchange for one share of S common stock (CS3), and Asset C in exchange for one share of S common stock (CS4). In Year 4, S sells Asset A and recognizes a $700 loss that is used to offset income of P in Year 4. The basis of each S share is thus reduced by $175. The basis of CS1 is reduced to $725, CS2 has a basis of $25, CS3 has a basis of $125, and CS4 has a basis of $825. In Year 5, P sells CS4 for $200, which deconsolidates S.

Result: Treas. Reg. § 1.1502-35T(b)(2) applies because P’s bases in CS1 and CS4 exceed the value of these shares immediately prior to the sale of S. The reallocable basis amount is $350 (the lesser of the gross loss inherent in the stock of S owned by P immediately before the sale ($1150) and the aggregate amount of S’s items of deduction and loss that were previously taken into account in adjusting the basis of S stock that P did not hold at a loss immediately before the sale ($350)). P’s basis in CS1 is reduced from $725 to $600 and P’s basis in CS4 is reduced from $825 to $600. Then, P’s basis in CS2 is increased from $25 to $250 and in CS3 from $125 to $250. P recognizes a $400 loss on the sale of CS4. See Treas. Reg. § 1.1520-35T(e), Ex. 2.
Under the Loss Suspension Rule, any loss recognized by a member of a consolidated group with respect to the disposition of a share of subsidiary member stock shall be suspended to the extent of the duplicated loss with respect to such share of stock if, immediately after the disposition, the subsidiary is a member of the consolidated group of which it was a member immediately prior to the disposition.

Under prior law, P recognizes a $30 loss on the sale of the 20 shares of S stock, then S recognizes a $30 loss on the sale of Asset A. The Loss Suspension Rule is designed to avoid the “double benefit” of this transaction.
The Duplicated Loss suspended under the Loss Suspension Rule is determined immediately after a disposition and equals the excess, if any, of:

The sum of:
1) The aggregate adjusted basis of the subsidiary member’s assets other than any stock that subsidiary member owns in another subsidiary member; and
2) Any losses attributable to the subsidiary member and carried to the subsidiary member’s first taxable year following the disposition; and
3) Any deductions of the subsidiary member that have been recognized but are deferred under a provision of the Internal Revenue Code;

over, the sum of:
1) The value of the subsidiary member’s stock; and
2) Any liabilities of the subsidiary member that have been taken into account for tax purposes.
Treas. Reg. §1.1502-35T(c)
Treatment of Suspended Loss

• Any loss suspended under the Loss Suspension Rule is treated as a noncapital, nondeductible expense of the member that disposes of the subsidiary member stock incurred during the taxable year that includes the date of the disposition of stock to which the Loss Suspension Rule applies. Consequently, the basis of a higher-tier member’s stock of the member that disposes of subsidiary member stock is reduced by the suspended loss in the year it is suspended.

• **Reduction of Loss**—The amount of any loss suspended pursuant to the Loss Suspension Rule shall be reduced, but not below zero, by the subsidiary member’s (and any successor’s) items of deduction and loss, and the subsidiary member’s (and any successor’s) allocable share of items of deduction and loss of all lower tier subsidiary members, that are allocable to the period beginning on the date of the disposition that gave rise to the suspended loss and ending on the day before the first date on which the subsidiary member is not a member of the group, and that are taken into account in determining consolidated taxable income (or loss) of the group during such period.

• **Limitation on Reduction**—Such reduction shall not exceed the excess of the amount of such items (described above) over the amount of such items that are taken into account in determining the basis adjustments made under § 1.1502-32 to stock of the subsidiary member (or any successor) owned by members of the group. This limitation was not included in the proposed regulations and is designed to prevent the disallowance of a tax loss for an economic loss.
Treas. Reg. §1.1502-35T(c)
Allowance of Suspended Loss

- **Allowance of Loss**—To the extent not reduced, a suspended loss shall be allowed on a return filed by the group of which the subsidiary was a member on the date of the disposition of subsidiary stock that gave rise to the suspended loss for the taxable year that includes the day before (1) the first date on which the subsidiary (or any successor) is not a member of such group, or (2) the date the group is allowed a worthless stock deduction with respect to all of the subsidiary member stock.

- **Statement of Allowed Loss**—A loss is only allowable if a separate statement entitled “ALLOWED LOSS UNDER § 1.1502-35T(c)(5)” is filed with, or as part of, the taxpayer’s return for the year in which the loss is allowable. The statement must contain the name and EIN of the subsidiary the stock of which gave rise to the loss.

- **Limitation on Disallowance of Loss**—The Loss Suspension Rule is not to be applied in a manner that permanently disallows a deduction for an economic loss, provided that such deduction is otherwise allowable. If the application of the Loss Suspension Rule results in such a disallowance, proper adjustment may be made to prevent such disallowance. Whether the Loss Suspension Rule has resulted in such a disallowance is determined on (1) the date on which the subsidiary member (or any successor), the disposition of the stock of which gave rise to a suspended stock loss is not a member of the group, or (2) the date the group is allowed a worthless stock loss with respect to all of such subsidiary member stock owned by members. “Proper adjustment” shall be made by restoring the suspended stock loss immediately before such time.
**Treas. Reg. §1.1502-35T**

**Loss Suspension Rule Example**

**Facts:** In Year 1, P forms S by contributing Asset A in exchange for 100 shares of S common stock. The value of Asset A decreases to $20. In Year 5, P sells 20 shares of S common stock (basis = $20) for $4 and recognizes a $16 loss. In Year 6, S earns $50 and purchases Asset B. In Year 7, S sells Asset B for $40, recognizing a loss of $10 that is absorbed by the P group. In Year 8, P sells the remaining stock of S.

**Result:** When the 20 shares are sold in Year 2, the Loss Suspension Rule of Reg. §1.1502-35T(c) applies. The duplicated loss amount equals $80 ($100 basis in Asset A - $20 value of S stock). As a result, the entire $16 loss is suspended. The suspended loss will be reduced by losses and deductions absorbed by the P group. P’s suspended loss will be reduced by the $10 loss on Asset B, unless P can establish that it is not part of the duplicated loss. To the extent not reduced, the suspended loss will be allowed in Year 8 when S leaves the P group.
**Treas. Reg. §1.1502-35T**  
**Basis Redetermination Rule and Loss Suspension Rule Example**

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<thead>
<tr>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
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<tr>
<td><img src="Year1.png" alt="Diagram" /></td>
<td><img src="Year2.png" alt="Diagram" /></td>
<td><img src="Year3.png" alt="Diagram" /></td>
<td><img src="Year4.png" alt="Diagram" /></td>
<td><img src="Year5.png" alt="Diagram" /></td>
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**Facts:**  In Year 1, P forms S with $80 in exchange for 80 shares of S common stock. In Year 2, P contributes Asset A (basis of $50, value of $20) to S in exchange for 20 shares of S common stock. In Year 3, P sells the 20 shares for $20 and S remains a member of the P group. In Year 4, S sells Asset A for $20, recognizing a $30 loss. In year 5, P sells its remaining S common stock for $80.

**Result:** When the 20 shares are sold in Year 3, under the Basis Redetermination Rule, P’s basis in the 20 shares is reduced by $24 (to $26) and P’s basis in the 80 shares is increased by $24 (to $104). Further, P’s remaining loss of $6 is a duplicated loss and is suspended under Treas. Reg. § 1.1502-35T(c). The sale of Asset A, and recognition of a $30 loss, results in an investment adjustment to the remaining 80 shares of S common stock of $24. The loss also eliminates the $6 suspended loss. Thus, when P sells the 80 shares in Year 5, it has a basis in those shares of $80 and recognizes no loss on the sale.

**See** Treas. Reg. § 1.1520-35T(e), Ex. 3.
Treas. Reg. §1.1502-35T
Basis Redetermination Rule and Loss Suspension Rule Example

Facts: In Year 1, P forms S with $80 in exchange for 80 shares of S common stock. In Year 2, P contributes Asset A (basis of $50, value of $20) to S in exchange for 20 shares of S common stock. In Year 3, P sells the 20 shares for $20 and S remains a member of the P group. In Year 4, S sells Asset A for $45, recognizing a $5 loss. In year 5, P sells its remaining S common stock for $100.

Result: When the 20 shares are sold in Year 3, under Treas. Reg. § 1.1502-35T(b)(2), P’s basis in the 20 shares is reduced by $24 (to $26) and P’s basis in the 80 shares is increased by $24 (to $104). Further, P’s remaining loss of $6 is a duplicated loss and is suspended under Treas. Reg. § 1.1502-35T(c). The sale of Asset A, and recognition of a $5 loss, results in an investment adjustment to the remaining 80 shares of S common stock of $4. As a result, the amount of the suspended loss is reduced by $1 ($5 recognized loss - $4 investment adjustment). Thus, when P sells the 80 shares in Year 5, it has a basis in those shares of $100 and recognizes no loss on the sale. The remaining suspended loss of $5 is allowed in Year 5 when S is deconsolidated.
Facts: In Year 1, P forms S1 with $200 in exchange for S1 common stock. In the same year, S1 forms S2 with $80 in exchange for 80 shares of S2 common stock. In the same year, S2 purchases Asset A for $80. In Year 2, S1 contributes Asset B to S2 with a basis of $50 and a value of $20 in exchange for 20 shares of S2 common stock. In Year 3, S1 sells the 20 shares of common stock for $20. In Year 4, S2 sells Asset B for $45. In Year 5, S2 sells its remaining common stock for $100.

Result: When the 20 shares are sold in Year 3, S1’s basis in the 20 shares of S2 stock is reduced by $24 (to $26) and S1’s basis in the 80 retained shares is increased by $24 (to $104). Further, S1’s loss of $6 is a duplicated loss and is suspended under Treas. Reg. § 1.1502-35T(c). The suspended loss is treated as a noncapital, nondeductible expense of S1 and P’s basis in its S1 stock is reduced by $6 to $194. When S2 sells Asset B for $45, it recognizes a $5 loss, which results in an investment adjustment to the remaining 80 shares of S2 common stock of $4 (to $100). The amount of the suspended loss is reduced by $1 to $5. In Year 5, S1 recognizes no loss on the sale of the remaining 80 shares of S2 stock. The $5 suspended loss is allowed in Year 5. See Treas. Reg. § 1.1520-35T(e), Ex. 4.
Facts: In Year 1, P forms S1 with a contribution of Asset A in exchange 100 shares of S1 common stock. In the same year, S1 contributes Asset A to S2 for 20 shares of S2 common stock and P contributes $80 to S2 for 80 shares of S2 common stock. In Year 3, P sells the 100 shares of S1 common stock for $20, but S2 remains a member of the P group. In Year 4, S2 sells Asset A for $20, recognizing a $30 loss. In Year 5, P sells its S2 common stock for $80.

Result: When P sells the S1 stock, it causes a redetermination of the S1 and S2 stock basis immediately before the disposition under Treas. Reg. § 1.1502-35T(b)(1) based upon the application of Treas. Reg. § 1.1502-35T(b)(4). S1’s basis in its 20 shares of S2 stock is reduced to $26. P’s basis in its 80 shares of S2 stock is increased to $104. Further, the adjustment tiers up under Treas. Reg. § 1.1502-32 to reduce P’s basis in S1 stock from $50 to $26. P’s loss of $6 on the sale of S1 is a duplicated loss and is suspended under Treas. Reg. § 1.1502-35T(c), even though S1 leaves the group, because S2 remains a member. When S2 sells Asset A for $50, it recognizes a $30 loss, which eliminates the suspended $6 loss and results in a negative investment adjustment to P’s remaining 80 shares of S2 common stock of $24 (to $80). When P sells its remaining S2 stock for $80, its basis in the stock is $80 and P recognizes no gain or loss.

See Treas. Reg. § 1.1520-35T(e), Ex. 5.
Facts: In Year 1, P forms S with $80 in exchange for 80 shares of S common stock. In Year 2, P contributes Asset A to S in exchange for 20 shares of S common stock. In Year 3, P contributes the 20 shares to Partnership PS in exchange for a 20 percent capital/profits interest. In Year 4, P sells its partnership interest for $20, recognizing a $30 loss.

Result: P’s transfer of the 20 shares to PS causes a redetermination of basis under Treas. Reg. § 1.1502-35T(b)(1) because the 20 shares are loss shares. P’s basis in the 20 shares is reduced to $26 and P’s basis in the 80 shares is increased to $104. As a result, P’s basis in its partnership interest is $26. P recognizes a $6 loss on the sale of its partnership interest, which is a duplicated loss that is suspended under Treas. Reg. § 1.1502-35T(c). See Treas. Reg. § 1.1520-35T(e), Ex. 6.
Treas. Reg. §1.1502-35T
Ordering Rules

To the extent applicable, the Basis Redetermination Rule, Loss Suspension Rule, and rules of Treas. Reg. § 1.337(d)-2T are applied in the following order:

1. Basis Redetermination Rule (Treas. Reg. § 1.1502-35T(b))

2. Treas. Reg. § 1.337(d)-2T

3. Loss Suspension Rule (Treas. Reg. § 1.1502-35T(c))

Treas. Reg. §1.1502-35T(f)
Worthlessness and
Dispositions Not Followed by Separate Return Years

• **General Rule**—If stock of a subsidiary member is treated as worthless under section 165 (taking into account the provisions of Treas. Reg. § 1.1502-80(c)) or if a member of a group disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year, then:

1. All losses treated as attributable to the subsidiary member under Treas. Reg. § 1.1502-21(b)(2)(iv) are taken into account in computing the taxable income of the group, the subsidiary, and any group of which the subsidiary was previously a member for the taxable year that includes the determination of worthlessness or the disposition and any prior taxable year.

2. Any remaining losses not utilized are treated as expired, but shall not be treated as noncapital, nondeductible expenses for purposes of § 1.1502-32(b)(3)(iii) as of the beginning of the group’s taxable year that includes the determination of worthlessness or the disposition.

• **Special Election**—If stock of a subsidiary member is treated as worthless between March 7, 2002 and March 14, 2003, or if a member of a group disposes of subsidiary member during this period and on the following day the subsidiary is not a member of the group and does not have a separate return year, then the common parent may make an irrevocable election to reattribute to itself all or any portion of the losses treated as attributable to such subsidiary member under Treas. Reg. § 1.1502-21(b)(2)(iv).
Worthlessness and Temp. Reg. §1.1502-35T(f)

Creditors of insolvent S exchange their S debt for all of S’s stock and, simultaneously, P’s stock in S is cancelled. What is the result under Temp. Reg. §1.1502-35T(f): (a) to NOLs allocable to (i) S or (ii) S1 and (b) to built-in losses inherent in the assets of (i) S and (ii) S1?
S, which is insolvent, transfers all of its assets to its creditors in satisfaction of its debt, which entitles P to a worthless stock deduction with respect to its S stock under Section 165 and Reg. §1.1502-80. What is the result under Temp. Reg. §1.1502-35T(f)?
Worthlessness and Temp. Reg. §1.1502-35T(f)

S is insolvent at the time S merges into a disregarded single member LLC wholly owned by P. What is the result under Temp. Reg. §1.1502-35T(f)?
• (g)(1)—**Transfer of share without loss in avoidance**—Transfer of shares to avoid future basis redetermination results in application of basis redetermination rule.

• (g)(2)—**Transfer of loss property in avoidance**—Transfer of loss property under §721 or §351 (to a corporation that is not a member of the group) followed by recontribution to member to avoid basis redetermination or loss suspension results in adjustments to carry out purposes of Treas. Reg. § 1.1502-35T.

• (g)(3)—**Anti-loss reimportation**—If the group recognizes a loss from the sale of subsidiary stock, and the subsidiary is deconsolidated, the subsidiary’s losses cannot be reimported within 10 years of deconsolidation.

• (g)(4)—**Avoidance of recognition of gain**—Transfer of shares of subsidiary stock at a loss that is not significant to avoid or defer recognition of gain by invoking the basis redetermination rules results in the basis redetermination and loss suspension rules not applying.
Consolidated Attribute Issues
Facts. In Year 1, Creditor lends $130 to S1, and the P group incurs a $110 consolidated net operating loss ("CNOL") that is carried over to Year 2 and attributed to each member of the P group as described above under the principles of Temp. Reg. § 1.1502-21T. In Year 2, as a result of S1 becoming insolvent, Creditor discharges S1 from its obligation to repay the loan, which causes S1 to realize $130 of cancellation of indebtedness income ("COD income"). S1 excludes the COD income from its gross income under § 108(a)(1)(B) since S1 remains insolvent after the discharge. At the end of Year 2, in addition to the CNOL, S1 has a $10 basis in the stock of S3 and a $3.33 general business credit carryover. S2 also has a $100 basis in depreciable property. No member makes an election under § 108(b)(5).
Insolvency Example (continued)

Results under New Insolvency Rules: 1.1502-19T, 1.1502-21T, 1.1502-28T, and 1.1502-32T

First Step - Separate Entity Determination. Apply the § 108(a)(1)(B) insolvency exception to the debtor member taking into account only the debtor member’s assets and liabilities. This results in the exclusion of all of S1’s $130 COD income from gross income. Temp. Reg. § 1.1502-28T(a)(1).

Second Step – Reduce Attributes of Debtor Member. Reduce the tax attributes of the debtor member, including consolidated tax attributes attributable to the debtor member, by the amount of the debtor member’s excluded COD income. With respect to S1, this reduces the following attributes in the following order: (i) $80 CNOL, (ii) $3.33 general business credit carryover, and (iii) $10 adjusted basis in S3 stock. Note that an ELA attributable to S3 stock cannot be created under these rules. Overall in this step, $100 of the $130 excluded COD income is applied to reduce tax attributes and, therefore, is taken into account for purposes of adjusting P’s basis in S1 stock. However, note that the reduction in the $3.33 general business credit carryover causes $10 of the excluded COD income to be treated as tax-exempt income, but the reduction of the credit carryover itself does not constitute a noncapital, nondeductible expense. Temp. Reg. §§ 1.1502-28T(a)(2), 1.1502-32T(b)(3)(ii)(C)(1), (3)(iii)(A).

Third Step – Reduce Attributes of Debtor Member Subsidiaries. To the extent the debtor member reduced its basis in the stock of a subsidiary in the second step, such subsidiary is treated as realizing excluded COD income but only for purposes of the tax attribute reduction rules. Since S1’s basis in S3 stock was reduced by $10, S3 is treated as realizing excluded COD income of $10 but only for purposes of the tax attribute reduction rules. The deemed excluded COD income of $10 reduces the $10 CNOL attributable to S3. The realization of the deemed excluded COD income and the absorption of the $10 CNOL are not taken into account for purposes of adjusting S1’s basis in S3 stock or P’s basis in S1 stock. Overall in this step, $0 of the actual $130 excluded COD income is applied to reduce tax attributes. Temp. Reg. §§ 1.1502-28T(a)(3), 1.1502-32T(b)(3)(ii)(C)(1), (3)(iii)(A).
Insolvency Example (continued)

Fourth Step – Reduce Attributes of Members Other Than Debtor Member. To the extent of any remaining excluded COD income, apply such remaining amount to reduce the consolidated tax attributes attributable to members other than the debtor member. The remaining $30 of excluded COD income is applied to reduce the consolidated tax attributes (to the extent they remain) attributable to P, S2, or S3. The $10 CNOL attributable to P and the $10 CNOL attributable to S2 are reduced to $0. Although $10 of excluded COD income remains, it does not reduce S2’s basis in its depreciable property, since Temp. Reg. § 1.1502-28T does not permit the reduction of asset basis of members other than the debtor member (and subsidiary members of the debtor member under the third step). Thus, the remaining $10 of excluded COD income does not reduce tax attributes of any member of the group. Overall in this step, $20 of the $130 excluded COD income is applied to reduce tax attributes and, therefore, is treated as tax-exempt income of S1 for purposes of adjusting P’s adjusted basis in S1 stock. The reduction of the $10 CNOL attributable to S2 is treated as a noncapital, nondeductible expense of S2 for purposes of determining P’s basis in S2 stock. Temp. Reg. §§ 1.1502-28T(a)(4), 1.1502-32T(b)(3)(ii)(C)(1), (3)(iii)(A).

Excess Loss Accounts. If P had a $40 ELA attributable to its S1 stock after the above steps, the $10 of excluded COD income that did not reduce tax attributes would trigger that ELA into income. However, only $10 of the $40 ELA would be taken into income. Under prior rules, the entire $40 ELA would have been taken into income, regardless of the fact that only $10 of excluded COD income triggered the ELA inclusion. Temp. Reg. § 1.1502-19T(b)(1)(ii). Under temporary regulations issued on March 12, 2004, the amount of the ELA required to be taken into income is included in the group’s tax return for the taxable year that includes the date on which the subsidiary realizes excluded COD income. Temp. Treas. Reg. § 1.1502-28T(b)(6)(ii). Under proposed regulations issued that same day, the determination of whether any portion of the ELA must be included in income is made after the determination of taxable income (or loss) for the year during which the member realizes excluded COD income (without regard to whether any portion of an ELA in a share of the subsidiary is required to be taken into account) and any prior years to which the deductions or losses of the subsidiary may be carried, after the reduction of tax attributes (under sections 108, 1017, and Treas. Reg. § 1.1502-28T), and after the adjustment of the basis of the share of subsidiary stock under Treas. Reg. § 1.1502-32. Prop. Treas. Reg. § 1.1502-28T(b)(6)(i).
Consolidated Section 108(b) -- The Question

1. Creditor discharges the debt
2. $50 COD income not taxable under § 108(a)(1)(B)
3. By how much should group reduce the CNOL?
   • § 108(b) refers to the “tax attributes of the taxpayer”
   • How would the Santorum/Conrad bill affect the analysis?

CNOL: $30 attributable to Debtor
      $20 attributable to S2

AB and FMV = $0
Liabilities = $50

P

S2

Debtor

Creditore

$50 loan
1. Disavowing PLR 9121017, FSA 199912007 and ILM 200149008 assert a $50 reduction in the CNOL.

2. Because Debtor is severally liable for the consolidated tax under Treas. Reg. § 1.1502-6, the entire CNOL can be used by and is an attribute of Debtor.

3. United Dominion confirms that there is no such thing as a “separate NOL”; thus, the CNOL is the only identifiable “tax attribute of the taxpayer”.

4. There is no reason to “unbake the cake” other than for apportionment of CNOL to separate return year.
Taxpayer Counterarguments

1. ELA rules provide an appropriate backstop to consolidated attribute reduction
2. Consolidated attribute reduction also appears inconsistent with §1017(b)(3)(D)
3. Existence of only a single CNOL does not resolve determination of “tax attributes of taxpayer”
4. While the cake should not be “unbaked” to separate a single CNOL absent an apportionment event, it is necessary to know portion attributable to member so as to apply investment adjustment rules
5. If there were consolidated attribute reduction, it would still be necessary to know to whom the reduced CNOL is attributable
6. Thus, although the single CNOL is indivisible until an apportionment event, absorption or reduction determined on a member-by-member basis is required to ensure correct amount available for apportionment
Consolidated Section 108(b)

1. New temporary regulations adopt a consolidated approach to section 108(b).
2. The IRS and the Treasury Department stated that a separate entity approach would have been “inconsistent with Congressional intent that income realized from debt discharge generally be deferred and not permanently eliminated.”
3. The IRS and the Treasury Department also stated that a consolidated approach “reflects the principle enunciated by the Supreme Court in United Dominion Indus., Inc. v. United States, 532 U.S. 822 (2001), that, in general, the only net operating loss of a consolidated group or its members for a consolidated return year is the consolidated net operating loss.”
4. The new temporary regulations are effective for discharges of indebtedness occurring after August 29, 2003.
5. These temporary regulations were supplemented by new proposed and temporary regulations issued on March 12, 2004, which provide rules regarding the timing for when any portion of an ELA must be included income. See Temp. Treas. Reg. § 1.1502-28T(b)(6)(ii) and Prop. Treas. Reg. § 1.1502-28T(b)(6)(i). The new temporary regulations are generally effective for discharges of indebtedness occurring after August 29, 2003. The new proposed regulations are effective the date they are published as temporary or final in the Federal Register.
Consolidated Section 108(b)

1. First General Rule: Tax attributes attributable to the debtor member are reduced.
2. Second General Rule: To the extent that the debtor member reduced basis in stock of another member as a result of the first rule, such other member must reduce tax attributes attributable to it in an amount equal to the amount of the stock basis reduction.
3. Third General Rule: To the extent that excluded COD income is not applied to reduce tax attributes attributable to the debtor member and after the application of the Second Rule, such remaining excluded COD income shall be applied to reduce the remaining consolidated tax attributes of the group. However, basis in assets held by other members of the group is not subject to reduction under this rule.
4. Other Rules: The amount of COD income treated as excluded as a result of insolvency is determined only on the basis of the assets and liabilities of the debtor member. The limitation on the amount of basis reduction in section 1017(b)(2) is determined in a similar fashion.
5. Result: The $50 of excluded COD income is applied first to reduce $30 of the $50 CNOL attributable to Debtor. Then, the remainder of the $50 of excluded COD income is applied to reduce the $20 of the $50 CNOL attributable to S2. Accordingly, the P Group is left with a $0 CNOL.

• The Service recently amended Treas. Reg. § 1.1502-28T to include the reduction of tax attributes attributable to members other than the debtor member that (i) arose in a separate return year, or (ii) arose (or treated as arising) in a separate return limitation year to the extent that no SRLY limitation applies to the use of such attributes by the group. Temp. Treas. Reg. § 1.1502-28T(a)(4).

  • The amended attribute reduction rule does not permit a reduction in the basis of non-debtor member assets.

  • The amended attribute reduction rule applies after the application of -28T(a)(2) (reduction in the attributes of the debtor-member) and -28T(a)(3) (reduction in the attributes of subsidiaries of the debtor-member).

  • The amended attribute reduction rule does not apply to the extent that a SRLY limitation applies.

• The amended temporary regulations address a concern that, under the original temporary regulations, taxpayers were required to reduce non-debtor member attributes only to the extent that a SRLY limitation applied.

• The amended temporary regulations are effective for discharges of indebtedness that occur after August 29, 2003, but only if the discharge occurs during a taxable year the return of which is due (without regard to extensions) after December 10, 2003. Temp. Treas. Reg. § 1.1502-28T(d).
The Effect of COD on ELAs

Step 1

P

$100
S Stock

SH

S

$100 Loan

Creditor

A1- AB=$0, FMV=$100
A2- AB=$0, FMV=$100

Step 2

P

A1- FMV=$300
ELA=$200

S

A2- FMV=$99

Creditor

Cancels $1 of the $100 Loan

Facts: P purchases 100 percent of the stock of S for $100, and S becomes part of P’s consolidated group. At the time S is acquired, S has two assets: (i) asset A1, which has an adjusted basis of zero and a FMV of $100, and (ii) asset A2, which has an adjusted basis of zero and a FMV of $100. S has no tax attributes, and $100 debt (owed to Creditor), for which A2 has been pledged as security. Subsequent to P’s acquisition of S, S distributes A1 to P, at a time when the value of A1 has increased to $300. This results in an ELA of $200. At the same time, the value of A2 has decreased to $99, and creditor agrees to cancel $1 of the $100 debt owed by S.

Result: The $1 of COD would be excluded under the insolvency exception, and $1 of the $200 ELA would be triggered since the excluded COD does not reduce attributes (Treas. Reg. § 1.1502-19(c)(1)(iii)(B); Temp. Treas. Reg. § 1.1502-19T(b)(1)(ii)). Prior to Temp. Treas. Reg. § 1.1502-19T(b)(1)(ii), the entire $200 ELA was triggered under these circumstances. See Treas. Reg. § 1.1502-19(b)(1).
On March 12, 2004, the Service issued temporary and proposed regulations that supplement the temporary regulations issued in September of 2003, and that provide rules regarding the timing for when any portion of an ELA must be included income (the “2004 regulations”).

Under the 2004 temporary regulations, the amount of ELA required to be taken into account in income is included in the group’s tax return for the taxable year that includes the date on which the subsidiary realizes excluded COD income. Temp. Treas. Reg. § 1.1502-28T(b)(6)(ii).

Under the 2004 proposed regulations, the determination of whether any portion of the ELA must be included in income is made (i) after the determination of taxable income (or loss) for the year during which the member realizes excluded COD income (without regard to whether any portion of an ELA in a share of the subsidiary is required to be taken into account) and any prior years to which the deductions or losses of the subsidiary may be carried, (ii) after the reduction of tax attributes (under sections 108, 1017, and Treas. Reg. § 1.1502-28T), and (iii) after the adjustment of the basis of the share of subsidiary stock under Treas. Reg. § 1.1502-32. Temp. Treas. Reg. § 1.1502-28T(b)(6)(i).

The 2004 temporary regulations are generally effective for discharges of indebtedness occurring after August 29, 2003, but only if the discharge occurs during a taxable year the original return for which is due (without regard to extensions) after March 12, 2004. The group may elect to apply the regulations to discharges occurring after August 29, 2003, but during a taxable year the original return for which is due (without regard to extensions) before March 12, 2004. The 2004 proposed regulations are effective on the date they are published as temporary or final in the Federal Register.
The Effect of COD on ELAs (continued); Income Issue

• May assets be contributed to an insolvent member of a consolidated group to provide basis reduction and avoid triggering an ELA? See FSA 200135002; PLR 9650019.

• Does reduction of credit under section 108(b) trigger ELA?

⇒ ELA is triggered to extent COD is excluded from gross income and is not tax-exempt income.

⇒ Pursuant to Temp. Treas. Reg. § 1.1502-32T(b)(3)(ii)(C)(1), excluded COD that reduces credits is tax-exempt income despite the fact that it does not result in a negative basis adjustment. Prior rules did not treat excluded COD that reduces credits as tax-exempt income.

• Basis Reduction Rule:

Under Prop. Treas. Reg. § 1.1502-35(f), if a subsidiary (i) leaves the group and does not exist after leaving the group, or (ii) becomes worthless (Treas. Reg. section 1.1502-80(c)), then any consolidated NOL or capital loss attributable to such subsidiary is treated as absorbed immediately prior to such event, and any deemed absorption under Prop. Treas. Reg. § 1.1502-35(f) causes a downward basis adjustment with respect to subsidiary stock (and stock of higher-tier members).
Section 355


**Purpose:** To clarify that the Service will not issue private letter rulings or determination letters that rule upon inherently factual issues in the section 355 context. Specifically, the Service will not determine whether (i) the distribution of controlled stock is carried out for one or more corporate business purposes, (ii) the transaction is used principally as a device, or (iii) the distribution and acquisition are part of a plan under section 355(e).

**Effective Date:** Rev. Proc. 2003-48 is effective for all ruling requests postmarked or received after August 8, 2003. Ruling requests postmarked or received after June 24, 2003 and on or before August 8, 2003 that do not comply with Rev. Proc. 2003-1 and Rev. Proc. 96-30 may be either returned to the taxpayer or treated as being subject to Rev. Proc. 2003-48.

Changes to Rev. Proc. 96-30—New Representations: Rev. Proc. 2003-48 specifically modifies and amplifies Rev. Proc. 96-30 by altering the representations a taxpayer is required to make with respect to a private letter ruling or determination letter request as follows. These representations, in effect, foreclose the possibility of a taxpayer receiving a private letter ruling or determination letter based upon section 355 factual issues.

- **Section 4.01** modifies section 4.04(1) through 4.04(7) and Appendices A and C of Rev. Proc. 96-30 by deleting those sections and adding the following representation: “The distribution of the stock, or stock and securities, of the controlled corporation is carried out for the following corporate business purposes: [list these corporate business purposes]. The distribution of the stock, or stock and securities, of the controlled corporation is motivated, in whole or substantial part, by one or more of these corporate business purposes.”

- **Section 4.02** modifies section 4.05(1) through 4.05(5) of Rev. Proc. 96-30 by deleting those sections and adding the following representation: “The transaction is not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both. See § 355(a)(1)(B).”
Changes to Rev. Proc. 96-30—New Representations (cont.):

- **Section 4.03** amplifies Rev. Proc. 96-30 by adding new section 4.08(12), which requires one of the following representations; the representation may be modified if necessary:

  (i) “There is no acquisition of stock of the distributing corporation or any controlled corporation (including any predecessor or successor of any such corporation) that is part of a plan or series of related transactions (within the meaning of §1.355-7T) that includes the distribution of the controlled corporation stock;”

  (ii) “Each of the following acquisitions of stock of the distributing corporation or any controlled corporation (including any predecessor or successor of any such corporation) is or may be part of a plan or series of related transactions (within the meaning of §1.355-7T) that includes the distribution of controlled corporation stock: [describe acquisitions here]. Taking all of these acquisitions into account, stock representing a 50-percent or greater interest (within the meaning of §355(d)(4)) in the distributing or controlled corporation (including any predecessor or successor of any such corporation) will not be acquired by any person or persons;” or

  (iii) “The distribution is not part of a plan or series of related transactions (within the meaning of §1.355-7T) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest (within the meaning of §355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation)."

Changes to Rev. Proc. 96-30—Additional Requirements and Limitations:

• **Section 4.04** amplifies Rev. Proc. 96-30 by adding new section 4.08(13), which requires taxpayers to file with their ruling request copies of any proxy statements, information statements, or prospectuses filed or prepared in connection with the distribution or any related transaction.

• **Section 4.05** amplifies Rev. Proc. 96-30 by adding new section 4.08(14), which provides: “The Service will not entertain any ruling request regarding a proposed or completed transaction if the Service has previously declined to rule on that transaction (or a similar transaction) because the Service was not satisfied that the distribution met the corporate business purpose requirement, was not a device for the distribution of earnings and profits, or was not part of a plan (or series of related transactions) under § 355(e).”

• **Section 4.06** amplifies Rev. Proc. 96-30 by adding new section 4.08(15), which provides: “The Service will decline a request for a supplemental letter ruling, unless the request presents a significant issue (as defined in section 3.01(29) of Rev. Proc. 2003-3). A change in circumstances arising after the transaction ordinarily does not present a significant issue.”
Facts: Domestic corporation D conducts Business X and Business Y; D’s assets are equally divided between the two businesses. Domestic corporation A, which is unrelated to D, conducts Business X. A wishes to acquire D's Business X, but not D's Business Y. Accordingly, D and A undertake the following transaction: First, D transfers its Business X assets to C, a newly formed domestic corporation, in exchange for 100 percent of the stock of C. Second, D distributes the C stock to the D shareholders. Third, A acquires all of the assets of C in exchange solely for voting stock of A. Fourth, C liquidates.

Issue: Whether A’s acquisition of C’s assets satisfies the substantially all requirement of section 368(a)(1)(C)?

Ruling: C should be considered independently from D in determining whether A’s acquisition of C qualifies as a reorganization under section 368. Accordingly, the acquisition by A of all the properties held by C immediately after the distribution by D satisfies the substantially all requirement of section 368(a)(1)(C).

Note: The result is different if D contributes business Y to C, D distributes the C stock to the D shareholders, and D transfers the X assets to A in exchange for A stock. See Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1937).

**Facts:** Father (“F”), Mother (“M”), Son (“S”), and Daughter (“D”) each own 25 percent of Corporation X, a domestic corporation that has been engaged in the livestock and grain growing businesses for more than five years. S and D, who manage and operate X, disagree over the future direction of X; S wants to expand the livestock business and D wants to expand the grain business. Also, the spouses of S and D dislike one another. To allow each child to develop the business they are most interested in, to further the estate planning goals of F and M, and to preserve family harmony, X transfers the livestock business to newly formed, wholly owned domestic corporation Y and distributes 50 percent of the Y stock to S in exchange for all of S’s stock in X. F and M each receive 25 percent of the Y stock in exchange for one half of their X stock. F and M amend their wills to ensure that S inherits only Y stock and that D inherits only X stock. Apart from the business purpose requirement of Treas. Reg. § 1.355-2(b), the distribution of Y stock meets all of the requirements of section 368(a)(1)(D).

**Ruling:** Although the distribution is intended, in part, to further the estate plans of F and M and to promote family harmony, the business purpose requirement of Treas. Reg. § 1.355-2(b) is satisfied because the distribution eliminates the disagreement between S and D regarding how to develop the future operations of X and allows S and D to devote their undivided attention to the business in which they are most interested.

**Facts:** D is a publicly traded corporation that conducts Businesses A and B directly and Business C through its wholly owned subsidiary C. Business C needs to raise significant capital and D has been advised that the best way to raise the capital is through an initial public offering (“IPO”) of C stock after C has been separated from D; the investment banker believes that spinning off C prior to the IPO will be more efficient than an offering by C or D without first separating the corporations because it would raise the needed capital with significantly less dilution of the existing shareholders’ interests in the combined enterprises. In reliance on the investment banker’s opinion, D distributes the stock of C to its shareholders and prepares to offer the C stock to the public with a target date of six months from the distribution. Following the distribution, market conditions unexpectedly deteriorate to an extent that C and its advisors determine to postpone the IPO. One year after the distribution, conditions have not improved to permit the IPO and C raises the needed capital through the issuance of debentures. Apart from the business purpose requirement of Treas. Reg. § 1.355-2(b), the distribution of C stock meets all of the requirements of section 368(a)(1)(D).

**Ruling:** Although C does not complete the IPO that motivated its separation from D, the business purpose requirement of Treas. Reg. § 1.355-2(b) is satisfied because an unexpected change in market or business conditions following a distribution will not prevent satisfaction of that requirement.
Rev. Rul. 2003-74--Independent Business Purpose

Under Treas. Reg. § 1.355-2(b)

Facts: Distributing (“D”) is a publicly traded corporation that conducts a technology software business. Controlled (“C”) is a wholly owned subsidiary of D that conducts a paper product business. One shareholder, who does not actively participate in the management or operation of D or C, owns eight percent of the D stock. D acquired the paper products business of C five years ago to support D’s software business; the paper products business is smaller and grows at a slower rate than D’s software business. D’s senior management would like to devote more time and effort to growing the software business and would like to focus exclusively on that business, but cannot do so because of the needs of C’s paper products business. The senior management of C believes that its paper business could be more fully developed if less time and effort was spent on D’s software business. Thus, in order to allow D’s management to concentrate on the software business and to alleviate its responsibility with respect to C’s paper business, and in order to allow C’s management to concentrate on the paper business, D distributes the C stock pro rata to the D shareholders. There is no other tax-free transaction that would allow the D and C management to concentrate exclusively on the corporations’ respective businesses. Both D and C expect that the transaction will benefit their respective businesses in a real and substantial way. No officer will serve both D and C. However two of D’s eight directors will hold temporary position on C’s six-member board; one director will serve C for two years and assist with the administrative aspects of the transaction, and the other director, an expert in corporate finance, will serve C for six years and reassure the financial markets by providing a sense of continuity. Neither of these directors will serve as an officer of C. Apart from the business purpose requirement of Treas. Reg. § 1.355-2(b), the distribution of C stock meets all of the requirements of section 355.

Ruling: Although the continuing relationship between Distributing and Controlled evidenced by the two common directors appears inconsistent with the assertion that the software business and the paper products business require independent management teams, this relationship does not conflict with the business purpose for the separation. Accordingly, the distribution of C stock by D to D's shareholders satisfies the corporate business purpose requirement of Treas. Reg. § 1.355-2(b).

**Facts:** Distributing ("D") is a publicly traded corporation that conducts a pharmaceuticals business. Controlled ("C") is a wholly owned subsidiary of D that conducts a cosmetics business. One shareholder, who does not actively participate in the management or operation of D or C, owns six percent of the D stock. D’s pharmaceuticals business is a higher-margin business and grows at a faster rate than C’s cosmetics business; however, both business require substantial capital for reinvestment and research and development. D does all of the borrowing for both D and C and makes all decisions regarding the allocation of capital spending between the businesses. The competition for capital traditionally has prevented both businesses from pursuing development strategies that the management of both businesses believes are appropriate. Moreover, D has had to limit its total expenditures to maintain its credit ratings. Thus, to eliminate the competition for capital, D distributes the C stock pro rata to the shareholders of D. D distributes C stock pro rata to the shareholders of D. There is no other tax-free transaction that would allow the D and C management to concentrate exclusively on the corporations’ respective businesses. D and C expect that the transaction will benefit their respective businesses, and that the cosmetics business will benefit in a real and substantial way by gaining increased control over spending and direct access to capital markets. To facilitate their separation, D and C enter into transitional agreements that relate to information technology, benefits administration, and accounting and tax matters. Other than the tax agreements, each agreement will terminate in two years (absent extraordinary circumstances), but may be extended on arm’s-length terms for a limited period. Following the separation of D and C, there will be no cross-guarantee or cross-collateralization of debt between D and C, and D will enter into an arm’s length agreement with C to loan C working capital for a term of two years. Apart from the business purpose requirement of Treas. Reg. § 1.355-2(b), the distribution of C stock meets all of the requirements of section 355.

**Ruling:** The limited continuing relationship between D and C evidenced by the various administrative agreements and the loan for working capital is not incompatible with the extent of separation contemplated by section 355; except for the tax agreement, the administrative agreements and the loan are transitional and designed to facilitate the separation of the two businesses. Accordingly, the distribution of C stock by D to D’s shareholders satisfies the corporate business purpose requirement of Treas. Reg. § 1.355-2(b).
Facts: Distributing ("D") is a publicly traded corporation that conducts a pesticides business. Controlled ("C") is a wholly owned subsidiary of D that conducts a baby food business. A significant number of potential customers of the baby foods business refuse to buy from Controlled because of its affiliation with Distributing and its pesticides business. Distributing's management consultant has advised Distributing that separating Controlled from Distributing would relieve the baby foods business of the adverse market perception caused by its association with the pesticides business. To solve the market perception problem, Distributing distributes the Controlled stock to Distributing’s shareholders, pro rata. There is no other nontaxable solution to the problem. Sale of the Controlled stock by Distributing would have resulted in recognition of gain. Distributing's directors expect that the baby foods business will benefit in a real and substantial way from the improved market perception produced by the separation.

Ruling: Distributing’s distribution of Controlled stock pro rata to the Distributing shareholders satisfies the business purpose requirement of Treas. Reg. § 1.355-2(b). The fact that section 355 permits a distributing corporation to distribute the stock of a controlled corporation without recognition of gain does not present a potential for the avoidance of Federal taxes under Treas. Reg. § 1.355-2(b). Accordingly, because the distribution is motivated, in whole or substantial part, by one or more corporate business purposes, the distribution does not violate Treas. Reg. § 1.355-2(b)(3), which provides that the business purpose requirement is not satisfied if the purpose can be achieved through a nontaxable alternative transaction, and Distributing is entitled to reject a taxable disposition in favor of a tax-free distribution without violating the business purpose requirement.
Business Expansion

• Bricks and clicks
  • A corporation that previously only sold to customers through retail stores begins to sell over the internet
    • Do the products have to be identical with those in the stores?
    • What if the sales are conducted through an auction process?

• Clicks and clicks
  • A corporation that manufactures computer parts develops/acquires software of know-how that enhances the performance of its (and similar) products
  • A corporation that develops software applications develops/acquires applications that are utilizable in new ways (or by new industries)
  • A corporation that develops software applications develops/acquires a consulting business with respect to its or similar products

• Results of Product Innovation/Industry Expansion
  • A corporation that owns and operates cable systems acquires stations or begins to produce content to show over the network.
  • A corporation that manufactures televisions begins to manufacture DVD players.
  • A corporation that provides long distance telephone service begins also to provide local service. Thereafter, it begins to provide wireless service. That wireless service becomes integrated with the internet and then, in turn, with hand-held devices. In addition, the company begins to manufacture telephones that incorporate its recently developed technology for delivery to customers.
Expansion Doctrine - General

• Treas. Reg. § 1.355-3(b)(3)(ii):

The fact that a trade or business underwent change during the five-year period preceding the distribution (for example, by the addition of new or the dropping of old products, changes in production capacity, and the like) shall be disregarded, provided that the changes are not of such a character as to constitute the acquisition of a new or different business. In particular, if a corporation engaged in the active conduct of one trade or business during that five-year period purchased, created, or otherwise acquired another trade or business in the same line of business, then the acquisition of that other business is ordinarily treated as an expansion of the original business, all of which is treated as having been conducted during that five-year period, unless that purchase, creation, or other acquisition effects a change of such a character as to constitute a new or different business.
Expansion Doctrine - General

• Preamble to final section 355 Regulations (T.D. 8238) (Jan. 5, 1989):

In reexamining the active business requirements, Treasury and the Internal Revenue Service recognized that it is often difficult to determine whether a corporation is conducting a single business, which may be separated under section 355 if it has been actively conducted for five years, or multiple businesses, which may be separated under section 355 only if each has been actively conducted for five years. Correlatively, they recognized that it is difficult to determine whether a corporate expenditure for a new activity constitutes the acquisition or creation of a new business or the expansion of an existing business. Accordingly, it is considered to be appropriate to simplify these determinations.

As in Estate of Lockwood v. Commissioner, 350 F.2d 712 (8th Cir. 1965), the final regulations provide that, for purposes of the five-year active conduct requirement, a new activity in the same line of business as an activity that has been actively conducted by the distributing corporation for the five-year period preceding the distribution ordinarily will not be considered a separate business. As a result, the distribution of a new activity will more easily satisfy the five-year active conduct requirement.
Expansion Doctrine – Examples

• A corporation that owns and operates a department store downtown may acquire a parcel of land in the suburbs and construct a new department store. Treas. Reg. § 1.355-3(c), Example 7.

• A corporation that owns and operates hardware stores in several states may purchase the assets of a hardware store in a state where it had not previously conducted business. Treas. Reg. § 1.355-3(c), Example 8; See also Estate of Lockwood v. Commissioner, 350 F.2d 712 (8th Cir. 1965).

• A corporation that manufactures a product may acquire assets related to the installation or distribution of that product. P.L.R. 199937014 (June 15, 1999); P.L.R. 9621030 (Feb. 23, 1996).

• A corporation may introduce a new product line that complements and advances its current products by incorporating new technological developments. P.L.R. 9646019 (Aug. 16, 1996).
**Rev. Rul. 2003-18**

**Facts:** D has been engaged as an automobile dealer of brand X automobiles for over five years. In Year 1, D acquired a franchise for the sale of brand Y automobiles and purchased the inventories, equipment, and leasehold of a former brand Y automobile dealer. D operated the brand Y business through D’s employees. In Year 3, D transferred all of the assets with respect to the brand X business to C in exchange for the stock of C, and distributed the C stock pro rata to its shareholders.

**Result:** The Service ruled that the acquisition of the brand Y business in Year 1 constituted an expansion, because (i) the product of the brand X business is similar to the product of the brand Y business, (ii) the business activities associated with the brand X business are the same as the business activities associated with the brand Y business, and (iii) the operation of the brand Y business involves the use of the experience and know-how that D developed in the brand X business. *See* Treas. Reg. § 1.355-3(c), Exs. 7, 8; *see also* P.L.R. 9241033 (July 13, 1992). This ruling obsoletes Rev. Rul. 57-190, 1957-1 C.B. 121, which came to a contrary result under the same facts, effective as of January 5, 1989, the effective date of Treas. Reg. § 1.355-3.
**Facts:** D has operated a retail shoe store business under the name “D” since Year 1. D’s business enjoys favorable name recognition, customer loyalty, and other elements of goodwill. In Year 8, D created an Internet web site, which it named D.com to take advantage of its goodwill, and began selling shoes at retail on the web site. In Year 10, D transferred all of the assets with respect to the web site to C in exchange for the stock of C, and distributed the C stock pro rata to its shareholders.

**Result:** The Service ruled that the creation of the web site in Year 8 constituted an expansion, because (i) the product of the retail shoe store and the web site are the same, (ii) the business activities associated with the retail shoe store are the same as those of the web site, and (iii) the operation of the web site draws to a significant extent on D’s existing experience and know-how, and the web site’s success will depend in large measure on the goodwill associated with D’s name, even though the web site’s operation requires some know-how not associated with operating a retail store. See Treas. Reg. § 1.355-3(c), Exs. 7, 8. What if the web site offered specialized shoes or other products that were not offered in the stores? What if the web site sold shoes through an auction process?

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<td>1. Similar Products Sold</td>
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<td>2. Same Business Activities</td>
<td>Present</td>
<td>Present</td>
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<td>3. Use of Experience and Know-How of Existing Business</td>
<td>Present</td>
<td>Partially Present (web site’s operation differs from retail store)</td>
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<td>4. Goodwill Associated with Name of Existing Business</td>
<td>Not Considered</td>
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Example 1: Direct Acquisition of T Assets by D

- D owns a 5-year Widget business operating in State X.
- D acquires T’s 5-year Widget business operating in State Y for cash.
- D operates in States X and Y for two years.
- D contributes T’s business to C, and immediately thereafter spins-off C.
- See Treas. Reg. §1.355-3(b)(3)(ii) (acquisition of trade or business by corporation engaged in same line of business ordinarily treated as an expansion of the original business); Treas. Reg. §1.355-3(c), Ex.(7) (acquisition by distributing through purchase and construction of new retail location, followed by transfer of new store to controlled, satisfies active business requirement); Treas. Reg. §1.355-3(c), Ex. (8) (purchase by distributing of new retail store in state where corporation had not previously conducted any business, followed by transfer of newly acquired assets to controlled; controlled satisfies active business requirements); Estate of Lockwood v. Comm'r, 350 F.2d 712 (8th Cir. 1965) (expansion of distributing’s business into new geographical area by controlled is a good 5-year business; relying on Conf. Rep. No. 2543, at 38 (1954).
Example 2: Acquisition of T Assets by D/Transitory Ownership

(2) T’s State Y Widget Business

D

Cash

T

C

T’s State Y Widget Business

• Same facts as Example 1, except the following:
• D contributes T’s State Y Widget business to C immediately after its acquisition.
• D spins-off C two years after acquiring T’s State Y Widget business.
• Is D’s transitory ownership of T’s business disregarded?
Example 3: Acquisition of T Assets/Cause to be Directed Transfer

Same facts as Example 2, except the following:

- D directs the T assets to be transferred directly from T to C.
- The directed transfer presumably is treated as a transfer to D, followed by a contribution of the assets from D to C. See Rev. Rul. 70-224, 1970-1 C.B. 79.
- See PLR 199937014 (June 15, 1999) (contract for acquisition of assets by parent of distributing corporation and immediate transfer of those assets to newly formed subsidiaries of distributing corporation constitutes expansion of distributing’s business).
Example 4: Acquisition of T Assets Directly by C

- Same facts as Example 2, except D contributes cash to C; C contracts directly with T for the cash acquisition of T’s 5-year Widget business operating in State Y.
- Should the lack of any transitory actual or constructive ownership by D of the T assets, as in the previous examples, preclude satisfaction of the active trade or business analysis? See Athanasios v. Comm’r, T.C. Memo 1995-72 (in litigation, IRS appears to have conceded that controlled’s acquisition of new restaurant constitutes expansion of distributing’s active business).
Example 5: Expansion of Business through Stock Acquisition; Spin-Off of Newly Acquired Corporation

- Same historic facts as Example 1 regarding D’s and T’s respective Widget Business.
- D acquires all of the stock of T from P in a qualified stock purchase; no Section 338 election is made.
- D spins off T two years after its acquisition.
- Should the expansion of business principle trump section 355(b)(2)(D) as it does section 355(b)(2)(C)? Does structure of section 355 and language of section 355(a)(3)(B) suggest that the latter provision is inapplicable with respect to stock acquisitions that precede or give rise to Distributing owning an amount of stock satisfying section 368(c) control?
- See PLR 200109027 (Nov. 30, 2000) (suggesting that expansion of business requirements not met with respect to a stock acquisition).
Example 6: Indirect Expansion of D’s Business through Acquisition of T Stock

- Same historic facts as Example 1 regarding D’s and T’s respective Widget businesses.
- D acquires all of the stock of T from P in a qualified stock purchase; no Section 338 election is made.
- Two years after its acquisition, T is liquidated.
- Immediately thereafter, D contributes its historic State X Widget Business to C and spins off C.
- Should the expansion of business principle apply to D’s acquisition of the State Y Widget business via the liquidation of T?
- See PLR 200109027 (Nov. 30, 2000); cf. Commissioner v. Gordon, 382 F2d 499 (2d Cir. 1967), rev’d on other grounds, 391 U.S. 83 (1968) (implying that a single-entity approach applies to active trade or business analysis); Treas. Reg. §1.355-3(b)(4)(iii) (same, applicable prior to 1987 legislation); Rev. Rul. 78-442, 1978-2 C.B. 143 (transaction qualifies under Section 355 despite recognition of gain upon distributing’s transfer of assets to controlled).
Example 7: Acquisition of T Stock by D with Section 338(h)(10) Election

(1) Same historic facts as Example 1 regarding D’s and T’s respective Widget businesses.

- D acquires all of the stock of T from P in a qualified stock purchase.

- D and P make a Section 338(h)(10) election.

- Acquisition is treated as purchase by New T of all of the Old T assets.

- Should this transaction be treated the same as Example 4?

(2) Recharacterization via a Section 338(h)(10) Election

- D and P make a Section 338(h)(10) election.

- Acquisition is treated as purchase by New T of all of the Old T assets.

- Should this transaction be treated the same as Example 4?
Example 8: Acquisition of T Assets by Holding Company D

- S owns a 5-year Widget business operating in State X.
- D is a holding company and satisfies the active trade or business requirement through its ownership of the stock of S.
- D acquires all of the assets of T’s 5-year Widget business operating in State Y.
- D immediately contributes the T assets to the newly formed C.
- D spins off C two years following the acquisition of the T assets.
- Should the fact that D is not directly engaged in an active trade or business change the outcome of Example 2?
Example 9: Acquisition of T Assets by Holding Company D

Same facts as Example 8, except for the following:

10 days following acquisition of T assets, D makes a retroactive check-the-box election for S effective as of the day before the acquisition.

See Treas. Reg. §301.7701-3(c)(1) (regarding retroactive effectiveness dates for check-the-box elections); PLR 200109027 (Nov. 30, 2000) (merger of existing subsidiaries into disregarded entities satisfies expansion of business test as well as 5% gross assets test).
Revenue Ruling 2002-1

1. D issues D restricted stock and D stock options to D & C employees.
2. C stock is distributed to D shareholders, including D & C employees, in a spin-off transaction. As part of the spin off, prior D stock options are cancelled and replaced with new options to acquire D stock & C stock.
3. Three years later, restrictions lapse on D restricted stock & C restricted stock, and D & C employees exercise their options.

Holding: D will recognize no gain or loss on lapse of restrictions on C stock or its employees exercise of options to buy C stock. Similarly, C will recognize no gain or loss on lapse of restrictions on D stock or its employees exercise of options to buy D stock.
Facts: P, a holding company, has four wholly owned subsidiaries: S1, S2, S3, and S4. The subsidiaries are each actively engaged in a trade or business for purposes of section 355. S3 and S4, however, were acquired in taxable transactions during the past five years. As a result, S3 and S4 are not engaged in qualifying active businesses under section 355(b). S2 merges into an LLC. P then distributes the stock of S1 to its shareholders.
Use of LLCs in Spin-Offs -- Continued

1. Merger

2. Spin-off of S1 to P shareholders

P (Holding)

S1
S2
LLC
S3
S4

Shareholders
Distribution of LLC Interests as a Spin-Off

**Facts:** Individuals A and B own all of the stock of D. D owns all of the interests in LLC, which is disregarded as a separate entity. LLC owns all of the stock of C. D distributes all of the LLC interests to A and B.
Section 355 and the Use of Partnerships

Example 1: 20% Managing General Partner (Revenue Ruling 92-17)

- C is 20% general partner in limited partnership.
- C provides managerial services.
  - C’s officers perform active and substantial management functions including decision making and employee supervision.
Section 355 and the Use of Partnerships

Example 2: Managing Member in Limited Liability Company

- C is sole managing member.
  - C performs all active and substantial management functions for LLC.
- See PLR 200025001 (July 9, 1999).
- Are standards for percentage ownership or management higher for LLC interests than GP interests?
  - For example, what if C is not the sole managing member and has a less than 50% interest in the LLC?
Section 355 and the Use of Partnerships

Example 3: Business Held through Disregarded Entities

- C owns captive state law general partnership through disregarded LLCs.
- See PLR 200007005 (Nov. 1, 1999); PLR 9722018 (Feb. 26, 1997).
Section 355 and the Use of Partnerships

Example 4: 20% Managing General Partner Held Through SM LLC

- C is 20% general partner in limited partnership.
- C’s partnership interest is held through disregarded LLC.
- C provides managerial services as per Rev. Rul. 92-17.
- Does liability shield alter the result? See PLR 20025001.
Section 355 and the Use of Partnerships

Example 5: 1% Managing General Partner & 19% Limited Partner

- C is 1% general partner & 19% limited partner.
- C provides managerial services as per Revenue Ruling 92-17.
- Bifurcated GP/LP established as a liability shield.
Section 355 and the Use of Partnerships

Example 6: 1% Managing General Partner

- C is 1% general partner in limited partnership.
- C provides managerial services as per Revenue Ruling 92-17.
Section 355 and the Use of Partnerships

Example 7: 2% Partner; Affiliate Holds 18% and Management

- S-1 is 2% general partner.
- S-2 is 18% general partner and provides managerial services as per Revenue Ruling 92-17.
- Can S-2’s interest and/or management activities be considered in testing S-1?
- What if C holds its partnership interest through 5 subsidiaries, with each holding a 4% partnership interest?
Section 355 and the Use of Partnerships

Example 8: 50% Partner in General Partnership with Shared Management

- C is 50% partner in general partnership.
- C & P both provide managerial services.
- Can more than one partner treat partnership as a qualifying active business?
- See PLR 200044017.
Section 355 and the Use of Partnerships

Example 9: 40% Partner in General Partnership with Blocking Rights

- C is 40% partner in general partnership.
- P has controlling interest.
- C has blocking rights with respect to material decisions.
- Compare Treas. Reg. §§ 1.368-1(d)(4)(iii)(B) & 1.368-1(d)(5), Examples 9, 10, 11 & 12 (COBE satisfied with 33% interest and no management).
Section 355 and the Use of Partnerships

Example 10: Business Contributed to Partnership during 5-Year Period

- Until six months prior to spin-off, Business X was operated directly by C.
- Six months prior to spin-off, C contributes Business X to Partnership.
- C receives 20% managing general partner interest that satisfies standards of Revenue Ruling 92-17.
- Is C in the same active business before and after the contribution?
- See PLR 200025001 (July 9, 1999).
- What if C recognizes gain when Business X is contributed to P/S?
Section 355 and the Use of Partnerships
Example 11: Section 355 Active Trade or Business

Facts:

P contributes a five year business to P/S that meets the requirements of 355(b) in exchange for an 80% interest in P/S. C contributes a three year business to P/S that does not meet the requirements of 355(b) in exchange for a 20% interest in P/S. C is the managing general partner of P/S.

D wants to spin off C under section 355. Does C satisfy the active trade or business requirement?
Section 355 and the Use of Partnerships
Revenue Ruling 92-17: Variation

Facts: C is a wholly-owned subsidiary of D. D and C have each actively conducted five-year trades or businesses. C then transfers its business into a newly-formed general partnership, GP, and takes a 50% general partnership interest in GP. X, an unrelated corporation, transfers assets into GP and also takes a 50% general partnership interest in GP. Both C and X retain employees and perform activities on behalf of GP as general partners. May D distribute the stock of C tax-free under section 355? See Plus 200044017; 200025001; cf. Rev. Rul. 2002-49.
Section 355 and the Use of Partnerships
Revenue Ruling 2002-49: Situation 1

• D and X jointly perform all active and substantial management functions for LLC through Year 2.
• D purchases the LLC interests of X and Y on the first day of Year 3.
• D exclusively manages LLC from Year 3 through Year 6.
• D causes LLC to distribute 40 percent of the value of its rental properties on the first day of Year 6.
• D then transfers those properties to C, a newly formed subsidiary, and distributes the stock of C.

Holding: The active trade or business requirement is satisfied. In Years 1-2, D satisfies the requirements of Rev. Rul. 92-17, and the acquisition of X and Y’s interests in Year 3 constitutes an expansion.
Section 355 and the Use of Partnerships
Revenue Ruling 2002-49: Situation 2

- D acquires its interest in LLC on the first day of Year 2 by contributing appreciated securities to LLC in a transaction described in Section 721.
- D and X jointly perform all active and substantial management functions for LLC through Year 2.
- D exclusively manages LLC from Year 3 through Year 6.
- D causes LLC to distribute 40 percent of the value of its rental properties on the first day of Year 6.
- D then transfers those properties to C, a newly formed subsidiary, and distributes the stock of C.

**Holding:** The active trade or business requirement is not satisfied because D will be treated as having acquired the business of LLC in a transaction in which gain or loss was recognized.
Section 355 and the Use of Partnerships
Revenue Ruling 2002-49: Variation

Years 1-5

X
Business X

Y
Business Y

Year 6

X
Business X

80%

Y
Business Y

LLC

Year 8

X

Y

Cash
Business Y

• Corporation X has been actively engaged in Business X throughout Years 1-5. Corporation Y has been actively engaged in Business Y throughout Years 1-5.

• On January 1 of Year 6, X and Y form LLC and contribute Businesses X and Y to LLC in exchange for 80% and 20% membership interests in LLC, respectively.

• LLC is treated as a partnership for federal income tax purposes. The exchanges qualify as tax-free under section 721. X and Y have no other assets other than their interests in LLC. X and Y have equal say in making policy decisions and in the overall supervision of LLC (i.e., X and Y both perform management functions with respect to LLC’s businesses described in Rev. Rul. 92-17).

• In Year 8, for valid business reasons, LLC sells Business Y for cash to a person unrelated to X and Y. LLC thereafter continues to operate Business X. LLC uses the cash proceeds from the sale in the operation of Business X.
Section 355 and the Use of Partnerships

Revenue Ruling 2002-49: Variation (Cont.)

• In Year 9, Y’s Parent, D, distributes the stock of Y to D’s shareholders in a transaction intended to qualify as tax-free under section 355.

• Does Y satisfy the active trade or business requirement of section 355?
  • Immediately after the distribution Y performs management functions described in Rev. Rul. 92-17.
  • Business X is actively conducted throughout the 5-year period ending on the date of the distribution.
  • Y acquired its interest in Business X in a transaction in which gain or loss was not recognized.
Facts: D owns 100% of C’s stock. D recapitalizes C’s stock into 100 shares of Class A and 100 shares of Class B. Each share of Class A stock has ten votes. Each share of Class B stock has one vote. Despite the vote disparity, Class A and Class B stock are equal in value. D then sells to the public 40% of the value of C stock, i.e., 80 shares of Class B stock. This leaves D with 1020 out of 1100 votes, or 92% of the vote. D then spins-off C for valid business reasons. See PLR 199935031.
Section 355(e)
Section 355(e)

In General

- Section 355(e) imposes a corporate-level tax on any distribution (i) to which section 355 (or so much of section 356 as relates to section 355) applies, and (ii) that is part of a “plan (or series of related transactions)” pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.

- A plan is presumed to exist with respect to an acquisition that occurs during the four-year period beginning two years before and ending two years after the distribution.
Section 355(e)
Basic Morris Trust Structure

Facts: A publicly traded corporation (“D”) owns all the stock of a controlled corporation (“C”). D has an adjusted basis in its C stock of $100, and the fair market value of its C stock is $150. In order to facilitate an acquisition of D by a third corporation (“P”), D distributes its C stock to its shareholders. Within two years, P acquires all the stock of D in a section 368(a)(1)(B) reorganization.
Section 355(e)
Section 355(e) Applies

1. D PUBLIC
   D
   C

2. D PUBLIC
   D STOCK
   C
   D
   P PUBLIC
   40% P STOCK

3. D PUBLIC
   40%
   C
   P
   60%
   D

Facts: Same facts as in the previous example, but assume further that in the B reorganization the shareholders of D receive 40 percent of the stock of P in exchange for their D stock.
Section 355(e) Inapplicable

Facts: Same facts as the previous example, except that in the B reorganization, the shareholders of D receive 60 percent of the stock of P in exchange for their D shares.
Temporary Section 355(e) Regulations
In General

- On April 26, 2002, the IRS issued new temporary regulations under section 355(e), which provide guidance on the definition of “plan (or series of related transactions).”

- Brief History of Plan Regulations:
  - Proposed and temporary regulations withdrawn April 26, 2002.
  - New proposed and temporary issued April 26, 2002.
Temporary Section 355(e) Regulations
Effective Date

- The new temporary regulations apply to all distributions after April 26, 2002.

- Retroactive Election - Taxpayers may elect to apply the new regulations in whole, but not in part, to a distribution occurring after April 16, 1997, and before April 26, 2002.

- Application of Old Temporary Regulations - If the taxpayer does not elect to apply the new regulations, the 2001 temporary regulations apply to distributions after August 3, 2001 and before April 26, 2002.
Temporary Section 355(e) Regulations
Super Safe Harbor

Temp. Treas. Reg. § 1.355-7T(b)(2) provides that:

In the case of an acquisition (other than a public offering) after the distribution, the distribution and the acquisition can be part of a plan *ONLY IF* there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the 2-year period ending on the date of the distribution.
Temporary Section 355(e) Regulations
Safe Harbors

- **Safe Harbor I** - Acquisition occurring after a distribution is not part of a plan if (a) the distribution was motivated (in whole or in substantial part) by a corporate business purpose other than to facilitate an acquisition of the acquired corporation, and (b) the acquisition occurs more than 6 months after the distribution and there was no agreement* concerning the acquisition or a similar acquisition during a period beginning 1 year before the distribution and ending 6 months after the distribution.

- **Safe Harbor II** - Acquisition occurring after a distribution is not part of a plan if (a) the distribution was not motivated by business purpose to facilitate the acquisition or a similar acquisition, (b) the acquisition occurs more than 6 months after the distribution and there was no agreement* concerning the acquisition or a similar acquisition during a period beginning 1 year before the distribution and ending 6 months after the distribution, and (c) no more than 25 percent of acquired corporation stock was either acquired or subject to an agreement* for 1 year prior to and 6 months after distribution. Acquisitions excluded from a plan under Safe Harbors V, VI, or VII are disregarded.

- **Safe Harbor III** - Acquisition occurring after a distribution is not part of a plan if there was no agreement, understanding, or arrangement concerning the acquisition at the time of the distribution and there was no agreement* concerning the acquisition within 1 year after the distribution.

* The term “agreement” as used here includes an understanding, arrangement, or substantial negotiations.
Temporary Section 355(e) Regulations
Safe Harbors (Continued)

Safe Harbor IV - Distribution occurring more than 2 years after an acquisition is not part of a plan if there was no agreement* concerning the distribution at time of acquisition or within 6 months thereafter.

Safe Harbor V - Acquisition of target stock listed on established market is not part of a plan if immediately before or after the transfer neither the transferor, the transferee, nor any coordinated group of which the transferor or transferee is a member is (a) the acquired corporation (Distributing or Controlled), (b) a corporation that is controlled (under section 368(c)) by the acquired corporation, (c) a member of a controlled group of corporations (under section 1563) of which the acquired corporation is a member, (d) an underwriter for the acquisition, (e) a controlling shareholder of the acquired corporation, or (f) a 10-percent shareholder of the acquired corporation.

Safe Harbor V does not apply if the acquired corporation knows, or has reason to know, that the transferor or transferee intends to become a controlling shareholder or a 10-percent shareholder at anytime after the acquisition and before the date that is 2 years after the distribution.

Safe Harbor V also does not apply to an indirect acquisition of voting power by a person other than the transferee that occurs by reason of the transfer.

* The term “agreement” as used here includes an understanding, arrangement, or substantial negotiations.
Temporary Section 355(e) Regulations
Safe Harbors (Continued)

- **Safe Harbor VI** - Acquisition of stock by employees, directors, or independent contractors in connection with such person’s performance of services for Distributing, Controlled, or a related person (under section 355(d)(7)(A)) in a transaction to which section 83 or 421(a) applies.
  - Safe Harbor VI does not apply if the acquirer or a coordinated group of which the acquirer is a member is either a controlling shareholder or a 10-percent shareholder of the acquired corporation immediately after the acquisition.

- **Safe Harbor VII** - Acquisition by a retirement plan of an employer that qualifies under section 401(a) or 403(a) will not be considered part of a plan.
  - Safe Harbor VII does not apply to the extent that the stock acquired by all of the employer’s qualified plans and any other person treated as the same employer under section 414(b), (c), (m), or (o) during the four year period beginning 2 years before the acquisition, in the aggregate, represents 10% or more of the vote or value.
Temporary Section 355(e) Regulations
Factors (Plan v. Non-Plan)

Factors Evidencing Plan:
Factors 1 and 2 involve Post-Distribution Acquisitions -
- Non-public offering - Agreement* during 2-year period before the distribution between D or C and the acquirer regarding the acquisition or a similar acquisition.
- Public offering - Discussions during 2-year period before the distribution between D or C and an investment banker regarding the acquisition or a similar acquisition.

Factors 3 and 4 involve Pre-Distribution Acquisitions -
- Non-public offering - Discussions during 2-year period before the acquisition regarding a distribution between D or C and the acquirer, or a person who intends to cause a distribution can meaningfully participate in the distribution decision as a result of the acquisition.
- Public offering - Discussions during 2-year period before the acquisition between D or C and an investment banker regarding a distribution.

Factor 5 involves Pre- and Post-Distribution Acquisitions -
- The distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition.

Factors Evidencing Non-Plan:
Factors 1 and 2 involve Post-Distribution Acquisitions -
- Public offering – No discussions between D or C and an investment banker during 2-year period before the distribution regarding the acquisition or a similar acquisition.
- There was an identifiable, unexpected change in market or business conditions occurring after the distribution resulting in unexpected acquisition.

Factors 3 and 4 involve Pre-Distribution Acquisitions -
- Non-public offering - No discussions during 2-year period before the acquisition between D or C and the acquirer regarding a distribution (unless acquisition occurs after public announcement of distribution, or a person other than D or C who intends to cause a distribution can meaningfully participate in the distribution decision as a result of the acquisition).
- There was an identifiable, unexpected change in market or business conditions occurring after the acquisition resulting in unexpected distribution.

Factors 5 and 6 involve Pre- and Post-Distribution Acquisitions -
- The distribution was substantially motivated by a business purpose (within the meaning of § 1.355-2(b)) other than to facilitate the acquisition or a similar acquisition of D or C.
- The distribution would have occurred at about the same time and in similar form regardless of acquisition or a similar acquisition.

* The term “agreement” as used here includes an understanding, arrangement, or substantial negotiations.
Temporary Section 355(e) Regulations
Operating Rules

- **Internal and Outside Advisor Discussions Rule** – Internal discussions and discussions with outside advisors by or on behalf of the officers or directors of Distributing or Controlled may be indicative of one or more business purposes for the distribution and the relative importance of such purposes.

- **Hostile Takeover Rule** – Distributions intending (in whole or substantial part) to decrease the likelihood of the takeover of either Distributing or Controlled (“the save me take him” purpose), will be treated as a business purpose to facilitate the acquisition, if Distributing engages in discussions with a potential acquirer regarding an acquisition of Distributing or Controlled.

- **Public Trading Rule** – Fact that distribution makes Controlled stock available for trading, or makes Distributing or Controlled stock trade more actively, is not taken into account on determining whether an acquisition is part of a plan.

- **Disregard of Section 355(e) Gain Rule** – Consequences of 355(e) and existence of indemnifications from section 355(e) gain are disregarded when determining intentions of parties.

- **Multiple Acquisitions Rule** – All acquisitions of Distributing or Controlled stock that are considered to be part of a plan are aggregated for purposes of the 50% test.
Temporary Section 355(e) Regulations
Definitions

- **Agreement, Understanding, or Arrangement** – Neither binding contract, nor agreement on all significant terms is necessary, but binding contract is *per se* showing of agreement.

- **Substantial Negotiations** – Requires discussion of *significant economic terms* between one or more officers, directors, or controlling shareholders of Distributing or Controlled (or someone with the permission of such persons) and the acquirer (or someone with the permission of the acquirer), or in the case of a public offering, with an investment banker.

- **Discussions** – Must involve one or more officers, directors, or controlling shareholders of the entity engaging in the discussions (or someone with the permission of such persons).

- **Similar Acquisition** – In the case of a non-public offering acquisition, an actual acquisition is “similar” to another potential acquisition if both effect a direct or indirect combination of all or a significant portion of the same business operations, and the ultimate owners of the business operations are substantially the same. In the case of a public offering acquisition, differences in the terms of stock, class of stock issued, size of the offering, timing of the offering, price, or participants, have no bearing on whether the acquisition and a potential acquisition are “similar.”
Temporary Section 355(e) Regulations

2001 Temporary Regulations:
- No similar rule

Safe Harbors:
- Safe Harbor I required business purpose other than to facilitate an acquisition “of Distributing or Controlled”
- Safe Harbors I and II required no agreement* concerning the acquisition before a date that is 6 months after the distribution
- Safe Harbor II available only if stock subject to acquisition business purpose was not more than 33% and amount actually acquired or subject to an agreement* within 6 months was not more than 20%
- Safe Harbor III available only if acquisition more than 2 years out and no agreement* at time of distribution or within 6 months thereafter
- Safe Harbor IV protected acquisitions more than 2 years before distribution if no agreement* at time of acquisition or 6 months after
- Safe Harbor V protected trading between less than 5% shareholders
- Safe Harbor V silent as to vote-shifting transactions
- Safe Harbor VI protected stock acquired by employee or director in section 83 transaction
- No similar safe harbor

2002 Temporary Regulations:
- Super Safe Harbor - No plan if no agreement* 2 years before the distribution

Safe Harbors:
- Safe Harbor I requires business purpose other than to facilitate an acquisition “of the acquired corporation”
- Safe Harbors I and II require no agreement* concerning the acquisition or a similar acquisition 1 year before and 6 months after the distribution
- Safe Harbor II available only if no more than 25% of the stock of the acquired corporation is acquired or subject to an agreement* within 1 year before and 6 months after the distribution
- Safe Harbor III available only if no agreement, understanding, or arrangement at time of distribution and no agreement* within 1 year thereafter
- No substantive change
- Safe Harbor V protects trading between less than 10% shareholders
- Safe Harbor V provides a special rule with respect to vote-shifting transactions
- Safe Harbor VI protects stock acquired by employee, director, or independent contractor in section 83 or section 421(a) transaction
- Safe Harbor VII protects certain acquisition of stock by a retirement plan

* The term “agreement” as used here includes an understanding, arrangement, or substantial negotiations.
Temporary Section 355(e) Regulations

2001 Temporary Regulations:

Plan Factors:

- 9 plan factors
- Post-distribution acquisitions (not involving public offerings or auctions) – discussions between D or C and the acquirer or a potential acquirer regarding the acquisition or a similar acquisition
- Pre-distribution acquisitions – discussions between D or C and the acquirer or a potential acquirer regarding the distribution
- Public offering or auction – discussions between D or C and investment banker or other outside advisor regarding acquisition (or, in the case of a pre-distribution offering or auction, discussions regarding the distribution)
- Distribution was motivated by an acquisition business purpose
- Acquisition and distribution occurred within 6 months of each other or there was an agreement* within 6 months
- Debt allocation between D and C made an acquisition likely

2002 Temporary Regulations:

Plan Factors:

- 6 plan factors
- Post-distribution acquisitions (not involving public offerings) – agreement* regarding the acquisition or a similar acquisition during 2-year period before the distribution
- Pre-distribution acquisitions – discussions between D or C and the acquirer, or person who intends to cause a distribution can meaningfully participate in decision to distribute as a result of the acquisition
- Public offering – discussions between D or C and investment banker regarding acquisition or similar acquisition (or, in the case of a pre-distribution offering, discussions regarding the distribution)
- No change
- Deleted
- Deleted

* The term “agreement” as used here includes an understanding, arrangement, or substantial negotiations.
Temporary Section 355(e) Regulations

2001 Temporary Regulations:
Non-Plan Factors:
- 7 non-plan factors
- Post-distribution acquisition (not involving public offerings or auctions) – no discussions between D or C and acquirer or a potential acquirer regarding the acquisition or similar acquisition
- Pre-distribution acquisition (not involving public offerings or auctions) – no discussions between D or C and acquirer regarding the distribution (N/A where acquisition is after the public announcement)
- Post-distribution public offering or auction – no discussions between D or C and investment banker or other outside advisor regarding acquisition
- Distribution was motivated in whole or substantial part by a non-acquisition business purpose
- Identifiable, unexpected change in market or business conditions occurring after the distribution (acquisition) that resulted in the acquisition (distribution)
- Distribution would have occurred at the same time and in similar form regardless of the acquisition or a similar acquisition

2002 Temporary Regulations:
Non-Plan Factors:
- 6 non-plan factors
- Deleted
- Pre-distribution acquisition (not involving public offerings) – no discussions between D or C and acquirer during 2-year period before the acquisition (N/A where acquisition is after the public announcement or where person who intends to cause a distribution can meaningfully participate in decision to distribute as a result of the acquisition)
- Post-distribution public offerings – no discussions between D or C and investment banker regarding acquisition or similar acquisition
- Same, except sentence deleted stating that the presence of an acquisition business purpose is relevant in determining extent motivated by non-acquisition business purpose
- No change
- No change (except to delete the parenthetical including a previously proposed similar acquisition that did not occur)
Temporary Section 355(e) Regulations

2001 Temporary Regulations:

Operating Rules:
- Reasonable certainty is evidence of an acquisition business purpose
- Reserved on substantial diminution of risk operating rule

Other Rules:
- Discussions not defined
- Substantial negotiations not defined
- Similar acquisition defined broadly to include different acquirers
- Reserved on Example 7 of proposed regulations (relating to multiple acquisitions)
- Option treated as an agreement on the date of grant, unless taxpayer established that not more likely than not to be exercised as of later of date of grant or date of distribution

2002 Temporary Regulations:

Operating Rules:
- Deleted
- Deleted substantial diminution of risk operating rule

Other Rules:
- Discussions defined to require discussions between officers, directors, or controlling shareholders
- Substantial negotiations defined to require discussions of significant economic terms
- Similar acquisition defined more narrowly to include combination of all or a significant portion of the same business operations, and ultimate owners substantially the same
- Deleted Example 7
- Option treated as an agreement, understanding, or arrangement on the earliest of (i) writing, (ii) transfer, or (iii) modification, if it was more likely than not to be exercised on such date
Facts: D and C’s purpose for a spin-off of C is that, if D and C are separated, their combined interest costs can be reduced. D spins off C. Negotiations between D and X begin 8 months after the spin-off, and 12 months after the spin-off X acquires all the stock of D for 10% of the stock of X.

Does the Super Safe Harbor apply? Is Safe Harbor I available? Is Safe Harbor III available? Does the result change if D has as an additional purpose the idea of facilitating a possible acquisition of D or C by X? By Y? Does the result change if substantial negotiations between D and X occurred 6 months before the spin-off, broke down 2 weeks prior to the distribution, then resumed 8 months after the spin-off? Thirteen months after the spin-off?
Facts: D and C’s purpose for a spin-off of C is to allow C to finance expansion of its distribution network by issuing 15% new stock in an IPO. D spins off C. As planned, 2 months after the spin-off C issues 15% of its stock in an IPO. Negotiations between D and X begin 8 months after the spin-off, and 12 months after the spin-off X acquires all the stock of D for 10% of the stock of X.

Does the Safe Harbor II apply to the IPO by C? Does Safe Harbor II apply to the acquisition of D by X? Does Treas. Reg. § 1.355-7(b)(2) or Safe Harbor I or III apply? Does the result change if C issues 30% of its stock in the IPO?
Temporary Section 355(e) Regulations
Safe Harbor IV

Facts: In year 3, D spins C off pro rata to all shareholders. In year 1, D had acquired all the C stock in a non-recognition transaction.

Does Safe Harbor IV apply to the distribution?

What if D’s distribution of C occurs in year 6?
Temporary Section 355(e) Regulations
Safe Harbor V – Public Trading

General Rule: Acquisition of target stock listed on an established market is not part of a plan if immediately before or after the transfer neither the transferor, the transferee, nor any coordinated group of which the transferor or transferee is a member is:
(1) the acquired corporation (Distributing or Controlled);
(2) a corporation that is controlled (under section 368(c)) by the acquired corporation;
(3) a member of a controlled group of corporations (under section 1563) of which the acquired corporation is a member;
(4) an underwriter for the acquisition;
(5) a controlling shareholder of the acquired corporation; or
(6) a 10-percent shareholder of the acquired corporation.
Temporary Section 355(e) Regulations
Safe Harbor VI - Options

Facts: D spins-off C stock and, on the same day, X merges into D pursuant to an agreement entered into within 1 year of the distribution. The X shareholders receive 49% of the D stock after the merger. Prior to the distribution, both D and X had outstanding options issued to employees and directors in connection with their performance of services. In connection with the merger, X options are converted into D options, and within 6 months after the distribution former employees of X exercise their options and receive D stock. If such options had been exercised prior to the merger, X shareholders would have received 50% of the D stock.

Does Safe Harbor VI apply to the acquisition of D stock by the former X employees? Does it make a difference if the X employees exercised their options for X stock prior to the merger?
Temporary Section 355(e) Regulations
Morris Trust Transaction

Facts: D wishes to combine with X, but X does not want to acquire C. D and X enter into an agreement for D to merge into X, subject to D’s spin-off of C and other conditions. One month after the agreement, D spins off C and, on the same day, D merges into X. The D shareholders own less than 50% of the X stock after the merger.

Are the spin-off and the acquisition of D by X parts of a “plan (or series of related transactions)” within the meaning of section 355(e)? See Temp. Treas. Reg. § 1.355-7T(j), Ex. 1.
Facts: D discusses the possibility of a public offering of 20% of the D stock with an investment banker. It is decided that D should be a stand alone company when the public offering occurs. One month later, D spins off C pro rata to the D shareholders in order to facilitate the stock offering of 20% of the D stock. The public offering of D stock occurs 7 months after the spin-off of C.

Are the spin-off and the public offering parts of a “plan (or series of related transactions)” within the meaning of section 355(e)? See Temp. Treas. Reg. § 1.355-7T(j), Ex. 2.
Facts: D, whose stock is widely held and listed on an established market, announces that it will spin off C pro rata to its shareholders. The spin-off is motivated by D’s desire to improve its financing options. Although neither D nor C has been approached about an acquisition of C, at the time of the spin-off, it is reasonably certain that C will be acquired. Less than 6 months after the spin-off, Y acquires C in a merger qualifying under section 368(a)(2)(E). The C shareholders receive less than 50% of the Y stock as a result of the merger.

Are the distribution of C and the acquisition of C by Y parts of a “plan (or series of related transactions)” within the meaning of section 355(e)? See Temp. Treas. Reg. § 1.355-7T(j), Ex. 3. Does the result change if either D or C had negotiated with Y regarding the acquisition of C prior to the spin-off?
Temporary Section 355(e) Regulations
Unexpected Opportunity

Facts: D, whose stock is widely held and listed on an established market, announces that it will spin off C pro rata to its shareholders. The spin-off is motivated by a bona fide business purpose other than to facilitate an acquisition. After the announcement, but before the spin-off, widely-held X becomes available as an acquisition target. There were no discussions between D or C and X prior to the announcement. D acquires X prior to the spin-off of C. After the acquisition, the X shareholders own 55% of D.

Are the acquisition of X by D and the spin-off of C parts of a “plan (or series of related transactions)” within the meaning of section 355(e)? See Temp. Treas. Reg. § 1.355-7T(j), Ex. 4. Does the result change if C is spun-off prior to the acquisition of X? Does the result change if X is acquired before the announcement?
Temporary Section 355(e) Regulations
Vote Shifting Transaction

D Public

D

C

X Public

X

Assets

49% Class A Stock

Facts: D wishes to acquire X, but X’s shareholders do not want to acquire an indirect interest in C, so D agrees to spin off C to facilitate the acquisition of X. The merger agreement between D and X provides that D will amend its corporate charter to provide for two classes of stock - Class A and Class B, both with 10 votes in the election of D directors. A disposition of Class B shares by an original shareholder will result in such shares having only 1 vote. One day before the merger, D spins off C. In the merger, D shareholders exchange their D stock for Class B stock, which constitutes 51% of the voting power of D, and X shareholders exchange their X stock for Class A stock. Within 30 days of the merger, some D shareholders sell their class B stock, but no former X shareholders sell their Class A stock. As a result, within 30 days of the merger, former X shareholders hold 52% of the voting power of D.

Are the spin-off of C and the merger of X into D parts of a “plan (or series of related transactions)” within the meaning of section 355(e)? Is the public trading of the Class B shares part of a plan? See Temp. Treas. Reg. § 1.355-7T(j), Ex. 5. What if the public trading was primarily by a family of mutual funds that owned 10% of the D stock?
Temporary Section 355(e) Regulations
Smuckers Acquisition of Jif/Crisco

Facts: Pursuant to an agreement between P&G and Smuckers, P&G contributed its Jif and Crisco brands to a newly-formed subsidiary, Jif-Crisco, and Jif-Crisco was spun off to P&G SHs. Jif-Crisco merged into Smuckers in exchange for 29.5 million newly-issued shares of Smuckers stock, which were distributed to P&G SHs. The terms of the Smuckers shares issued in the merger provide for 10 votes per share, except that if they are sold, each share will have one vote with respect to extraordinary events, such as selling the company, unless the stock is held for more than four years, in which case it will increase to 10 votes.

Result: The distribution of Jif-Crisco and the merger of Jif-Crisco into Smuckers should be considered part of a plan. See Temp. Treas. Reg. § 1.355-7T(b)(3)(i) (agreement within 2 years of distribution), (b)(3)(v) (business purpose to facilitate the acquisition). However, section 355(e) does not apply immediately after the merger because P&G SHs obtained 52.5% voting control of Smuckers. Does the result change if, as expected, P&G SHs sell their shares after the merger? See Temp. Treas. Reg. § 1.355-7(d)(5)(i), (ii)(B); P.L.R. 200234044.
Temporary Section 355(e) Regulations
Comcast Merger with AT&T Broadband

Facts
1. AT&T spins off AT&T Broadband and AT&T’s 25.5% interest in Time Warner to AT&T shareholders
2. Parent corporation is formed with two merger subsidiaries
3. AT&T Merger merges into AT&T Broadband with AT&T Broadband surviving
4. Comcast Merger merges into Comcast with Comcast surviving
5. Steps 2-4 treated as section 351 nontaxable exchanges

Result
1. The spin-off of AT&T Broadband followed by the acquisition AT&T should be considered part of a plan.
2. Section 355(e) should not apply because AT&T shareholders receive more than 50% of Parent. Does the result change if this is a vote shifting transaction?
Facts: Distributing and Option Holder substantially negotiate for Option Holder to acquire an option to acquire 25% of Distributing. 5 months later, Distributing distributes Controlled for a non-acquisition business purpose. 5 months after the distribution, Distributing and Option Holder enter into an option to allow Option Holder to purchase 25% of Distributing. 3 years after the distribution, Option Holder exercises the option and acquires 25% of Distributing.

Distributing and the Option Holder will be treated as if they substantially negotiated for the acquisition of the Distributing stock within six months before the distribution, thus, Safe Harbors 1 and 2 are unavailable. In addition, because the substantial negotiations occurred before the distribution, Super Safe Harbor is not present. See Temp. Treas. Reg. § 1.355-7T(e)(1), (d)(1) and (2), and (b)(2).
Temporary Section 355(e) Regulations

Similar Acquisition

X PUBLIC

D PUBLIC

Y PUBLIC

X

D

C

Y Stock

100% D Stock

Facts: D, X, and Y are each publicly traded corporations engaged in the manufacturing and sale of trucks. C is engaged in the manufacture and sale of buses. D and X engage in substantial negotiations regarding X’s acquisition of D stock from the D shareholders in exchange for X stock. D and X do not reach an agreement regarding the acquisition. 3 months after D and X begin negotiations, D spins off C. 3 months after the spin-off, Y acquires all of the D stock from the D shareholders in exchange for Y stock.

Are the spin-off of C and the acquisition of D stock by Y parts of a “plan (or series of related transactions)” within the meaning of section 355(e)? See Temp. Treas. Reg. § 1.355-7T(j), Ex. 6. Does the result change if, instead of Y acquiring D, a wholly owned subsidiary of X acquires D?

Assume instead that C was not a pre-existing corporation so that D engaged in the sale and manufacture of trucks and buses, and that the truck business was significant relative to the bus business. 3 months after X and D begin negotiations for the acquisition of D, D contributes its truck business to C and spins off C. After the distribution, X begins negotiations with C and acquires C 3 months later. See Temp. Treas. Reg. § 1.355-7(j), Ex. 7.
Temporary Section 355(e) Regulations
Similar Acquisition – Ex. 7 of Old Prop. Regs.

1. D PUBLIC
   
   D
   
   C
   
   C
   
   X
   
   30% D STOCK
   
   Y

2. One month later
   
   D PUBLIC
   
   D
   
   C
   
   D
   
   X
   
   Y
   
   30% D STOCK
   
   19% D STOCK

3. One year later
   
   D PUBLIC
   
   D
   
   C
   
   D
   
   X
   
   Y
   
   Z
   
   17% D STOCK
   
   30% D STOCK
   
   2 STOCK

Facts: A publicly traded corporation (“D”) owns all the stock of a controlled corporation (“C”). C, which engages in a separate line of business from D, has been an impediment to D’s strategy to grow its business through acquisitions. Prior to distributing C, D has identified two potential targets, X and Y. D negotiates with X, but has no contact with Y prior to distribution. 1 month after the distribution of C, D acquires X for 30% of D’s stock. 7 months after the distribution of C, D begins negotiating with Y, and, 5 months later, acquires Y for 19% of D’s stock. 18 months after the distribution, D acquires Z for 17% of D’s stock. D had not identified Z as a target until after the distribution. What is the result under the new temporary regulations?
Temporary Section 355(e) Regulations
Similar Acquisition – Section 355(e) Transaction

Facts: P substantially negotiates with D to acquire the stock of C in exchange for P stock. D distributes all of the stock of its wholly owned subsidiary, C, in a tax-free spin-off pursuant to section 355. Within six months, P offers to acquire the C stock in a tax-free reorganization. Instead of a direct acquisition, C agrees to a transaction wherein C’s shareholders drop their stock into a newly formed LLC in exchange for a one-third interest in the LLC, and P drops some of its assets into the LLC in exchange for two-thirds of the interests.

Is the acquisition of C stock by LLC a similar acquisition? Does the result change if C and P contribute assets to LLC in exchange for LLC interests? Assume instead that P is wholly owned by individual A. Prior to the distribution P and D terminate negotiations and A sells all of the P stock to individual B. B and D then begin substantial negotiations, and D distributes C. Is the acquisition of C stock by LLC a similar acquisition?
Prop. Treas. Reg. § 1.355-8

- Section 355(e)(4)(D) provides that, for purposes of section 355(e), any reference to Distributing or Controlled includes a reference to any “predecessor” or “successor” of Distributing or Controlled.

- On November 22, 2004, Treasury and IRS issued Prop. Treas. Reg. § 1.355-8 providing:
  - Definitions of “predecessor” and “successor”
  - Rules for determining whether there has been an acquisition of a “predecessor” or “successor”
  - Rules limiting the amount of gain recognized under section 355(e) in certain circumstances
Prop. Treas. Reg. § 1.355-8
Definitions of “Predecessor” and Related Rules

**Distributing:** Under the proposed regulations, a corporation is a predecessor of Distributing if it satisfies one of the following tests:

- A corporation that before the distribution transfers property to Distributing in a transaction to which section 381 applies (a “combining transfer”) if:
  - Distributing subsequently transfers some (but not all) of the acquired property to Controlled (or a predecessor of Controlled) (“a separating transfer”), and
  - The basis of such property immediately after the transfer to Controlled (or a predecessor of Controlled) is determined in whole or in part by reference to the basis of the property in the hands of Distributing immediately before the transfer.

- A corporation that, before the distribution, transfers property to Distributing in a combining transfer if:
  - Some but not all of the property transferred to Distributing includes Controlled stock, and
  - After the combining transfer, Distributing transfers less than all the property acquired (other than the Controlled stock) to Controlled.
Prop. Treas. Reg. § 1.355-8
Definitions of “Predecessor” and Related Rules (cont.)

- **Controlled**
  - The preamble to the proposed regulations states that the policy underlying the definitions of a predecessor of Distributing does not appear to necessitate a definition of a predecessor of Controlled, because Controlled generally will not be able to transfer property that it receives in such a transaction to Distributing tax-free.
  - Nonetheless, the proposed regulations provide a definition for the purposes of determining whether a corporation is a predecessor of Distributing, calculating the limitations on gain recognition, and the special affiliated group rule (described below).
  - A predecessor of Controlled is defined as a corporation that, before the distribution, transfers property to Controlled in a transaction to which section 381 applies.
Prop. Treas. Reg. § 1.355-8
Definitions of “Predecessor” and Related Rules (cont.)

- **Deemed acquisitions:**
  - If there is a predecessor of Distributing, then each person that owned an interest in Distributing immediately before the combining transfer is treated as acquiring stock representing an interest in the predecessor of Distributing in the combining transfer.
  - If an acquisition of Distributing occurs after Distributing’s combination with a predecessor, the acquisition will count not only as an acquisition of Distributing, but also as an acquisition of the predecessor.

- **Separate counting for Distributing and its predecessors:** The measurement of whether one or more persons have acquired stock that in the aggregate represents a 50% or greater interest in either a predecessor of Distributing or Distributing that is part of a plan that includes the distribution shall be made separately.

- **Predecessor of a predecessor is excluded:** The proposed regulations specifically exclude from the definition of predecessor a corporation that transfers property to a predecessor of Distributing or Controlled in a transaction to which § 381 applies.
  - This rule does not apply to corporations that have engaged in an “F” reorganization. Under the proposed regulations, the resulting corporation in an “F” reorganization is treated as the same corporation that engaged in the reorganization.

- **Multiple predecessors permitted:** More than one corporation may be a predecessor of Distributing or Controlled.

- **Substitute assets:** If Distributing transfers any property it received in the combining transfer in a transaction in which gain or loss is not recognized in whole, the property received by Distributing is treated as transferred to Distributing in the combining transfer.
Prop. Treas. Reg. § 1.355-8
Predecessor of Distributing: Example

**Facts:** X owns 100% of the stock of P and Y owns 100% of the stock of D. P merges into D in an “A” reorganization. Immediately after the merger, X and Y own 10% and 90%, respectively, of the stock of D. D then contributes to C one of the assets acquired from P in the merger. D receives additional C stock in exchange. D distributes the stock of C to X and Y pro rata.

**Analysis:** Under the proposed regulations, P is a predecessor of D because: (i) before the distribution P transferred property to D in a transaction to which section 381 applies, (ii) D transferred some but not all of the acquired property to C, and (iii) immediately after the transfer to C, the property has a basis determined in whole or in part by reference to the basis of the property in the hands of D immediately before the transfer to C. Y is treated as acquiring stock representing 90% of the voting power and value of P. See Prop. Treas. Reg. § 1.355-8(g), Ex. 1.
Prop. Treas. Reg. § 1.355-8
Predecessor of Controlled: Example

Facts: X owns 100% of the stock of P and P owns various assets including 100% of the stock of R. Y owns 100% of the stock of D and D owns 100% of the stock of C. P merges into D in an “A” reorganization. Immediately after the merger, X and Y own 10% and 90%, respectively, of the stock of D. D then causes R to merge into C in a “D” reorganization. D distributes the stock of C to X and Y pro rata.

Analysis: R is a predecessor of C because before the distribution R transferred property to C in a transaction to which section 381 applies. P is a predecessor of D because some but not all of the property transferred to D includes stock of R, a predecessor of C, and after the merger, D does not transfer all of the property acquired from P to C. Y is treated as acquiring stock representing 90% of the voting power and value of P. See Prop. Treas. Reg. § 1.355-8(g), Ex. 3.
Prop. Treas. Reg. § 1.355-8
Definition of “Successor” and Related Rules

- **Successor:** Under the proposed regulations, a successor is any corporation to which Distributing or Controlled transfers property after the distribution in a transaction to which section 381 applies (a “successor transaction”).

- **Deemed Acquisitions:**
  - If there is a successor of Distributing, then each person that owned an interest in the successor of Distributing immediately before the successor transaction is treated as acquiring Distributing stock in the successor transaction.
  - If there is a successor of Controlled, then each person that owned an interest in the successor of Controlled immediately before the successor transaction is treated as acquiring Controlled stock in the successor transaction.
  - If stock of the successor of Distributing is acquired after the successor transaction, the stock of the successor is treated as the stock of Distributing.
  - If stock of successor of Controlled is acquired after the successor transaction, the stock of the successor is treated as the stock of Controlled.

- **Successor of successor permitted:** The proposed regulations permit more than one successor.
  - Example: Distributing transfers property to Corporation X after the distribution in a transaction to which § 381 applies, and X transfers property to Corporation Y in a transaction to which § 381 applies. Each of X and Y may be a successor of Distributing. See Prop. Treas. Reg. § 1.355-8(c)(2).
Facts: X owns 100% of the stock of each of D and R. D owns 100% of the C stock. D distributes all of its C stock to X. Immediately after the distribution, C merges into R in a “D” reorganization. Immediately after the merger, X owns all of the R stock. Subsequently, Z purchases 60% of the stock of R from X.

Analysis: R is a successor of C because after the distribution C transfers property to R in a transaction to which section 381 applies. Accordingly, Z acquired an interest in a successor of C. The stock of R is treated as stock of C. Therefore, Z is treated as acquiring a 60% interest in C. See Prop. Treas. Reg. § 1.355-8(g), Ex. 5.
In general, a plan (or series of related transactions) will not result in the application of section 355(e) if, immediately after the completion of such plan or transactions, Distributing and all controlled corporations are members of a single affiliated group. See section 355(e)(2)(C).

The proposed regulations provide that, for purposes of section 355(e)(2)(C):
- A predecessor of Distributing or Controlled is treated as continuing in existence following its transfer of property to Distributing or Controlled, and
- Distributing or Controlled is treated as continuing in existence following a transfer of property to a successor.
Prop. Treas. Reg. § 1.355-8
Limits On Gain Recognition

- The proposed regulations provide two rules limiting the amount of gain that Distributing must recognize under section 355(e) in certain circumstances.

- **Acquisition of a Predecessor of Distributing:** If a distribution and acquisition of stock that in the aggregate represent a 50% or greater interest in a predecessor of Distributing are part of a plan, then the amount of gain that Distributing recognizes by reason of such acquisition will not exceed the amount of gain, if any, that the predecessor of Distributing would have recognized if immediately before the distribution, the predecessor had
  - Transferred the property that was transferred to Controlled and the stock of Controlled that it transferred to Distributing in the combining transfer to a newly formed, wholly owned corporation solely for stock of such corporation in an exchange to which section 351 applied (even if section 351 would not have actually applied), and
  - Sold the stock to an unrelated person for cash equal to its fair market value.

- **Acquisition of Distributing:** If a distribution and acquisition of stock that in the aggregate represent a 50% or greater interest in Distributing are part of a plan and the acquisitions occur in the combining transfer, then the amount of gain that Distributing recognizes will not exceed the amount of gain that Distributing would have recognized had it not transferred assets of the predecessor to Controlled and had it not acquired any Controlled stock from the predecessor.
  - The proposed regulations calculate the gain limitation as the excess, if any, of the amount described in section 355(c)(2) or section 361(c)(2), as applicable, over the amount of gain, if any, that Distributing would have been required to recognize if there had been acquisitions of stock that in the aggregate represent a 50% or greater interest in the predecessor of Distributing that was part of the plan involving the distribution.
Prop. Treas. Reg. § 1.355-8
Limits on Gain Recognition: Example

**Facts:**
- X owns 100% of the stock of P and Y owns 100% of the stock of D. P merges into D in an “A” reorganization. In the merger, X acquires 60% of the D stock. After the merger, therefore, X and Y own 60% and 40%, respectively, of the stock of D. D then contributes to C, a newly formed corporation, some of the assets acquired from P in the merger and one asset that it owned prior to the merger, in exchange for C stock in a transfer that qualifies as a “D” reorganization. After the contribution, D distributes the C stock to its shareholders pro rata.

- Immediately before the distribution, the contributed asset that D had owned prior to the merger had a basis of $3 and a fair market value of $10 and the contributed assets acquired from P have an aggregate basis of $1 and an aggregate value of $30. In addition, immediately before the distribution, D’s C stock has a basis of $4 and a fair market value of $40.
Analysis:

**Predecessor:** P is a predecessor of D because before the distribution P transferred property to D in a transaction to which section 381 applies, D transferred some but not all of the acquired property to C, and immediately after the transfer to C, the property has a basis determined in whole or in part by reference to the basis of the property in the hands of D immediately before the transfer to C.

**Gain Recognition:**

Y is treated as acquiring stock representing 40% of the voting power and value of P. There are not acquisitions that in the aggregate represent a 50% or greater interest in P in the merger that are pursuant to a plan that includes a distribution. However, there is an acquisition by X of a 60% interest in D in the merger. If that acquisition were pursuant to a plan that includes the distribution, D would be required to recognize gain in the amount described in section 361(c)(2) ($36 of gain).

D would recognize $7 of gain. Since the acquisition occurred in the combining transfer, the amount of gain recognized by D would not exceed $7, the built in gain on D’s assets transferred to C. The proposed regulations provide that this gain limitation is determined by a different equation: the excess of the gain described in section 361(c)(2) ($36) over the gain that D would have been required to recognize if there had been an acquisition of stock representing a 50% or greater interest in P (but not D) that was part of a plan involving the distribution ($30 - $1, or $29). See Prop. Treas. Reg. 1.355-8(g), Ex. 4.
Section 1060 and Section 338(h)(10)
Final Section 1060 Regulations

• The IRS has issued final regulations under sections 338 and 1060. T.D. 8940 (February 12, 2001). The final regulations are substantially the same as temporary regulations issued on January 5, 2000 (T.D. 8858), and proposed regulations issued on August 10, 1999 (REG-107069-97, 64 Fed. Reg. 43,461).

• The final regulations are generally effective for asset acquisitions occurring after March 16, 2001.

• The preamble to the proposed regulations provided that the proposed 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.

• For purposes of section 1060, the most significant changes in the final regulations are modifications to the asset classes in the section 338 regulations.
  • The scope of Class II assets was modified to provide that 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).
  • The scope of Class III assets was expanded to consist of assets that the taxpayer marks to market at least annually and debt instruments (including receivables but excluding certain debt instruments).
Final Section 1060 Regulations Continued

- The final regulations no longer separately state the residual allocation method. Instead, Treas. Reg. § 1.1060-1(c)(2) incorporates the residual method by cross reference to the the final section 338 regulations (Treas. Reg. §§ 1.338-6 and 1.338-7).

- The final regulations clarify that:
  - A trade or business is present if goodwill or going concern value could attach to the group of assets, regardless of whether any value will eventually be allocated to the residual class (Class VII). Treas. Reg. § 1.1060-1(b)(2)(iii).
  - The presence of section 197 intangibles is a factor to be considered in determining whether goodwill or going concern value could attach. Treas. Reg. § 1.1060-1(b)(2)(iii)(A).
  - A purchaser is subject to section 1060 even if the seller in the transaction is treated as selling something different than the purchaser is treated as purchasing. Treas. Reg. § 1.1060-1(b)(4).
Final Section 1060 Regulations Continued

• The final regulations clarify that:
  • In determining whether a group of assets constitute a trade or business, all transfers from the seller to the purchaser in a series of related transactions are aggregated. Treas. Reg. § 1.1060-1(b)(5).
  • As long as any part of the assets are a trade or business, all of the assets are to be treated as a single trade or business for purposes of applying the residual method. Treas. Reg. § 1.1060-1(b)(6).
  • The final regulations provide that if, in connection with the applicable asset acquisition, the seller enters into a covenant not to compete with the purchaser, that covenant is treated as an asset transferred as part of a trade or business. Treas. Reg. § 1.1060-1(b)(7).
  • The final regulations allow the buyer and seller to adjust their allocation of consideration to particular assets for costs incurred which are specifically identified with those assets. Thus, the total amount the seller allocates to an asset for which it incurs specifically identifiable costs would be less than its fair market value and, for the purchaser, greater than its fair market value. Treas. Reg. § 1.1060-1(c)(3).
Final Section 1060 Regulations Continued

- Seven asset classes under the final section 338 regulations.
  - 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.
  - Class II -- actively traded personal property within the meaning of section 1092(d)(1) and Treas. Reg. § 1.1092(d)-1, certificates of deposits, and foreign currency. Class II assets do not include stock of target affiliates, other than actively traded stock described in section 1504(a)(4)).
  - Class III -- assets that the taxpayer marks to market at least annually for Federal income tax purposes and debt instruments (including accounts receivable but excluding certain other debt instruments).
  - 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.
  - Class V -- all assets other than Class I, II, III, IV, VI, and VII assets.
  - Class VI -- all section 197 intangibles, as defined in section 197, except goodwill and going concern value.
  - Class VII -- goodwill and going concern value (whether or not the goodwill and going concern value qualifies as a section 197 intangible).
Applicable Asset Acquisition

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Does section 1060 apply?
Do the assets constitute a trade or business?
Applicable Asset Acquisition Continued

Section 1060 does not apply.
Applicable Asset Acquisition Continued

Busted section 351; section 1060 applies.
Applicable Asset Acquisition Continued

Section 707(a)(2)(B).
Applicable Asset Acquisition Continued

1. Corporation liquidates.
2. Section 302(a) redemption.
3. Section 301 distribution.
Section 338

T Stock

$
Section 338(h)(10)

S

T

T Stock

P

332 Liquidation

Old T

New T

Asset Sale

P
Final Section 338 Regulations
Overview

• The IRS has issued final regulations under sections 338 and 1060. T.D. 8940 (February 12, 2001). The final regulations are substantially the same as temporary regulations issued on January 5, 2000 (T.D. 8858), and proposed regulations issued on August 10, 1999 (REG-107069-97, 64 Fed Reg. 43,461).

• The final regulations revise all of the regulations under section 338 other than those dealing with international matters and stock consistency.

• The final regulations are generally effective for qualified stock purchases occurring after March 16, 2001.

• The temporary regulations are generally effective for qualified stock purchases occurring after January 5, 2000 and on or before March 16, 2001.

• The preamble to the proposed regulations provided that the proposed 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.
Final Section 338 Regulations

Organization

• § 1.338-1 General principles; status of old and new T
• § 1.338-2 Nomenclature and definitions; mechanics of the section 338 election.
• § 1.338-3 Qualification
• § 1.338-4 Seller’s side; ADSP
• § 1.338-5 Buyer’s side; AGUB
• § 1.338-6 Allocation
• § 1.338-7 Redeterminations
• § 1.338-8 Consistency
• § 1.338-9 International
• § 1.338-10 Returns
• § 1.338(h)(10)-1 Section 338(h)(10)
Final Section 338 Regulations

Accounting Rules

• Under the old regulations, the first element in the definition of ADSP was the grossed-up basis of the purchasing corporation’s recently purchased T stock. The combination of the link between the definitions of ADSP and AGUB with the rule in the prior regulations that contingent payments are taken into account in AGUB as they become fixed and determinable effectively afforded old T open-transaction treatment. This treatment would not have been available in the case of an actual asset sale.

• The final regulations remove the link between the calculation of the first element of ADSP and the purchaser's basis in recently purchased T stock.

• Under the final regulations 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.

• The amount realized is determined as if old T itself were the selling shareholder. Old T may use the installment method of section 453 in the calculation of the first element of ADSP.
Final Section 338 Regulations

Accounting Rules Continued

- General principles of tax law apply in determining the timing and amount of the elements 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, to the individual elements of ADSP.

- The same rules apply for purposes of determining (and redetermining) AGUB.

- These changes replace the “fixed and determinable” standard of the old regulations.

- 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.

- The amount of liabilities of old T taken into account to calculate ADSP is determined as if old T had sold its assets to an unrelated person for consideration that included the unrelated person’s assumption of, or taking subject to, the liability.

- In order to be taken into account in AGUB, a liability must be a liability of T that is properly taken into account under general principles of tax law that would apply if new T had acquired its assets from an unrelated person for consideration that included the assumption of, or taking subject to, the liability.
Final Section 338 Regulations
Allocation Rules

• Seven asset classes under the final regulations
  • 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.
  • Class II -- actively traded personal property within the meaning of section 1092(d)(1) and Treas. Reg. § 1.1092(d)-1, certificates of deposits, and foreign currency. Class II assets do not include stock of target affiliates, other than actively traded stock described in section1504(a)(4)).
  • Class III -- assets that the taxpayer marks to market at least annually for Federal income tax purposes and debt instruments (including accounts receivable but excluding certain other debt instruments).
  • 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.
  • Class V -- all assets other than Class I, II, III, IV, VI, and VII assets.
  • Class VI -- all section 197 intangibles, as defined in section 197, except goodwill and going concern value.
  • Class VII -- goodwill and going concern value (whether or not the goodwill and going concern value qualifies as a section 197 intangible).
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).

For purposes of determining whether the parties are related at the time of the purchase of the T stock, the relationship between the purchaser and seller is tested immediately after the transaction. See Treas. Reg. § 1.338-3(b)(3)(ii).
Treas. Reg. § 1.338(h)(10)-1

Deemed Asset Sale and Liquidation

• Treas. Reg. § 1.338(h)(10)-1 describes the model on which taxation of the section 338(h)(10) election is based. Under 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 till an S corporation.

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

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

Deemed Asset Sale and Liquidation Continued

- 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, 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)-1T(d)(3).

- 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).

- However, 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).

- 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. Treas. Reg. § 1.338(h)(10)-1(d)(8).

- The final regulations remove the term MADSP from the regulations and extend the use of the term "aggregate deemed sales price" or "ADSP" generally applicable to section 338 transactions to section 338(h)(10). The "other relevant items" included in the calculation of MADSP are not included in the calculation of ADSP.
Final Section 338 Regulations

Comparison with the Temporary Regulations

• Definition of “Purchase”

  • The proposed regulations provided that in order for a “purchase” of target stock to occur, more than a nominal amount had to be paid for the stock of target.

  • The IRS and Treasury received comments on this provision, and did not include this rule in the temporary regulations. Rather, the temporary regulations specifically reserved the issue pending further consideration of the comments.

  • 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.
Final Section 338 Regulations
Comparison with the Temporary Regulations Continued

- **Allocation Rules**
  - The top-down allocation method was retained in the final regulations. However, certain changes were made to the definitions of Class II and Class III assets.
  - The scope of Class II assets was modified to provide that 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).
  - The scope of Class III assets was expanded to consist of assets that the taxpayer marks to market at least annually and debt instruments (including receivables but excluding certain debt instruments). Under the temporary regulations, Class III assets were accounts receivable, mortgages, and credit card receivables from customers which arise in the ordinary course of business.
Final Section 338 Regulations

Comparison with the Temporary Regulations Continued

• First Year Price Adjustments
  • The temporary regulations provide that increases or decreases with respect to the elements of ADSP that are taken into account before the close of target’s first taxable year are taken into account for purposes of determining ADSP and the deemed sale tax consequences as if they had been taken into account at the beginning of the day after the acquisition date. Similar rules applied for purposes of changes to AGUB. The final regulations remove these rules providing special treatment for changes in ADSP or AGUB occurring before the close of new target’s first taxable year and instead apply the general rule that governs the allocation of all changes in ADSP or AGUB after the acquisition date.

• Changes to Form 8023 and 8594
  • The preamble to the final regulations indicates that the allocation of ADSP and AGUB that is currently submitted on the election form (Form 8023) instead will be submitted by the purchaser and seller(s) separately on their income tax returns. Such a change will be effectuated when Form 8023 is revised. The information about ADSP and AGUB will be reported by each party separately on Form 8594, which also will be revised.
1. Newco buys T stock from S.
2. Newco is liquidated into P.
3. P and X form a partnership. P transfers the T stock to the partnership.
Section 338 -- Purchase

Has a Corporation Made the Purchase Continued

Liquidate T

P

GP

X

T
Section 338 -- Purchase
Has a Corporation Made the Purchase

Facts: Corporation X and Individual A own Partnership P. Corporation T’s only significant asset is 100% of the stock of T1. T1 owns intellectual property. P wishes to acquire the stock of T1 and achieve a step-up in the basis of T1’s assets. P forms Newco N, which acquires 100% of the T stock in a QSP. A section 338 election is made for both T and T1. Immediately thereafter, T distributes the T1 stock to N, who in turn distributes the T1 stock to P.

Question: Has a “purchase” been made? See PLR 200122007 (Feb. 13, 2001); Treas. Reg. section 1.338-3(b)(1).
Facts: P purchases 100% of the stock of T and makes a section 338 election for T. Before the close of the day, P causes T to sell all of the T1 stock to a third party.

Question: Is T considered to have purchased the stock of T1 prior to the sale of T1 stock? See Treas. Reg. section 1.338-1(d); Former Temp. Treas. Reg. section 1.338-3T(b)(4)(ii) Ex. 2; Treas. Reg. 1.338-3(b)(1).
Section 338 -- Purchase

Common Ownership of S and P

Has P purchased the T stock?
Application of Section 338 to the Purchase of an Insolvent Corporation -- Insolvent Target Corporation

**Facts**

Corporation T owns assets with a value of $1,000,000 and has liabilities of $1,000,001. P purchases all the stock of T from individual A for $1 and attempts to make a section 338(g) election with respect to T.

**Questions**

1. What are the results of this election?

2. Would the results be different under the recently issued final section 338 regulations?

**References**

Section 338(h)(3)(A)
Treas. Reg. § 1.332-2(b)
New Treas. Reg. § 1.338-3(b)(2)
Rev. Rul. 56-387, 1956-2 C.B. 189
Application of Section 338(h)(10) to the Purchase of an Insolvent Corporation -- Insolvent Target Corporation

**Facts**

Corporation T owns assets with a value of $1,000,000 and has liabilities of $1,000,001. P purchases all the stock of T from corporation S for $1 and attempts to make a section 338(h)(10) election with respect to T.

**Questions**

1. What are the results of this election?

2. Would the results be different under the recently issued final section 338 regulations?

**References**
Section 338(h)(3)(A)
Treas. Reg. § 1.332-2(b)
New Treas. Reg. § 1.338-3(b)(2)
Rev. Rul. 56-387, 1956-2 C.B. 189
Application of Section 338(h)(10) to the Purchase of an Insolvent Corporation --
Insolvent Target Subsidiary

```
S

T

T1
Assets 1,000,000
Liabilities 900,000

T2

T3
Assets 100,000,000
Liabilities 99,900,000

T
Assets 10,000,000
Liabilities 6,000,000

T stock

$ P
```

Assets 100,000,000
Liabilities 99,900,000
Intercompany Debt – Rev. Rul. 68-602 and Treas. Reg. § 1.1502-13(g)

- **Alternative 1**: T liquidates into P.
- **Alternative 2**: P contributes the intercompany debt to capital and T liquidates.
- **Alternative 3**: Same as Alternative 2, except that after contributing the intercompany debt to capital, P sells T stock to X, and P and X make a joint 338(h)(10) election.
- **Alternative 4**: Without contributing the intercompany debt to capital, P sells T stock to X for $1, and P and X make a joint 338(h)(10) election.
- **Alternative 5**: Same as Alternative 4, except that T’s debt is third party debt. What is new T’s basis in the assets if the debt is recourse or non-recourse?
Section 338 -- Purchase

Cash Investment

1. A owns all T stock.

2. P transfers cash to T for 90% of T stock.

3. Has P purchased the T stock?

4. What if T also has non-voting preferred stock that is not bought?
Section 338 -- Purchase

Cash Investment Followed by Redemption

1. A owns all T stock.
2. P transfers cash to T for 1 share of T stock.
3. A is redeemed by T (using funds other than those provided by P.)
4. Has P purchased the T stock?
Qualified Stock Purchase -- Effect of Section 351

1. Investor ("I") transfers cash to Newco ("P")

2. S transfers T stock to P.

3. P transfers cash and 5% of P stock to S.
Qualified Stock Purchase -- Effect of Section 351

Continued

Variations

- S is several individuals, some shareholders sell P stock, while others do not.
- The transaction is leveraged.
1. P is formed.
2. Management contributes 5% of T stock and X contributes $15 in cash, in exchange for 25% and 75% interest in P, respectively.
3. P forms S.
4. $80 is borrowed, secured by the T assets, to acquire the T stock.
5. S is merged into T with T surviving.
6. Acquisition of T stock with borrowed funds constitutes a redemption.
7. T stock from management -- section 351 -- is not purchased.
8. Section 338 will not apply unless X contributes cash equal to four times the value of management’s stock and that cash is used to purchase T stock.
1. P is formed.
2. Management (M) contributes $5 in cash and X contributes $15 in cash.
3. P forms S.
4. $80 is borrowed, secured by the T assets, to acquire the T stock.
5. S is merged into T with T surviving. M receives $5 in the transaction.
6. The service might ignore the $5 contribution by M and treat the transaction as if M transferred its T stock to P in a section 351 exchange. Alternately, the Service could treat the transaction as if M contributed its T stock and $5 in cash to P in exchange for P stock and $5 in cash (boot).
7. The result is the same as the prior example -- section 338 is not available.
Facts: P and T are widely held manufacturing corporations organized under the laws of state A. T has only voting common stock outstanding, none of which is owned by P. P seeks to acquire all of T’s outstanding stock. For valid business reasons, the acquisition will be effected by a tender offer for at least 51% of T’s stock, to be acquired solely for P voting stock, followed by a merger of S, P’s newly formed wholly owned subsidiary, into T. Pursuant to the tender offer, P acquires 51% of T’s stock from T’s shareholders for P voting stock. P then forms S which merges into T in a statutory merger under the laws of state A. In the merger, P’s S stock is converted into T stock and each of the T shareholders holding the remaining 49 percent of the outstanding T stock exchanges its shares of T stock for a combination of consideration, two-thirds of which is P voting stock and one-third of which is cash. Assume (i) that the tender offer and merger are treated as an integrated acquisition by P of all of the T stock, and (ii) that all nonstatutory requirements under sections 368(a)(1)(A) and 368(a)(2)(E), and all statutory requirements under section 368(a)(2)(E), other than the requirement that P acquire control of T in exchange for its voting stock, are satisfied. Assume the same facts, except what if S initiates the tender offer for T stock and, in the tender offer, acquires 51% of the T stock for P stock provided by P?
**King Enterprises** Transaction

**Facts:** The shareholders of T exchange all of their T stock for consideration consisting of 50% P voting stock and 50% cash. Immediately following the exchange, and as part of the overall plan, P causes T to merge upstream into P. The transaction should qualify as an “A” reorganization. See *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-26, 2001-23 I.R.B. 1 (May 11, 2001).
**Facts:** P owns all of the stock of S, a newly formed wholly owned subsidiary. Pursuant to an integrated plan, P acquires all of the stock of T, an unrelated corporation, in a statutory merger of S into T, with T surviving. In the merger, the T shareholders exchange their stock for consideration of 70% P voting stock and 30% cash. Immediately thereafter, T merges upstream into P.

**Result:** If the acquisition were viewed independently from the upstream merger of T into P, the result should be a QSP of T stock followed by a section 332 liquidation. See Rev. Rul. 90-95, 1990-2 C.B. 67. However, because step transaction principles apply, see King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969), the transaction is treated as a single statutory merger of T into P under section 368(a)(1)(A). P acquires the T assets with a carry-over basis under section 362, and P may not make a section 338 election for T.

**Note:** On July 8, 2003, the Service issued new final and temporary regulations that permit taxpayers to turn off the step transaction doctrine and to make a section 338(h)(10) election in the transaction described above. See Treas. Reg. § 1.338-3(c)(1)(i), (2) and Temp. Treas. Reg. § 1.338(h)(10)-1T.
New Temp. Treas. Reg. § 1.338(h)(10)-1T(c)(2), (e)

• The new temporary 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) . . . ” Temp. Treas. Reg. § 1.338(h)(10)-1T(c)(2).

• 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.

• 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 Temp. Treas. Reg. § 1.338(h)(10)-1T(e), Ex. 12 & 13.

• 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.

• The regulations are effective for stock acquisitions occurring on or after July 8, 2003.
Rev. Rul. 2001-46 - Situation 2

Facts: Same facts as in Situation 1, except that the T shareholders receive solely P stock in exchange for their T stock, so that the merger of S into T, if viewed independently of the upstream merger of T into P, would qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

Result: Step transaction principles apply to treat the transaction as a merger of T directly into P.

Note: The taxpayers cannot not change this result under the new section 338 regulations because, standing alone, P’s acquisition of T does not constitute a qualified stock purchase.
**King Enterprises Transaction - Variation**

**Facts:** Same facts as in Variation 1, except P sells T’s assets to X a third party immediately after the merger of T into P.

**Questions:**
1. Does the Step-Transaction Doctrine apply?
2. What is the result of this transaction for Federal income tax purposes?
**Facts:** T currently operates two businesses. T contributes all of its Business 2 assets to C, a newly formed wholly owned subsidiary. T distributes the stock of C to T shareholders in a spin-off. P acquires T from the T shareholders in exchange for P stock. Immediately thereafter, T is liquidated into P.

**Form:** The above steps in form constitute a section 355 transaction, a B reorganization, and a section 332 liquidation.

**Result:** Step transaction principles apply to treat P’s acquisition of T as if: (1) P purchased a portion of T’s assets and (2) T liquidated. See Rev. Rul. 67-274; Elkhorn Coal. Under Rev. Rul. 67-274, P’s acquisition of T is not a valid B reorganization. Because T liquidates into P, Rev. Rul. 67-274 combines the steps and treats the transaction as an acquisition by P of T’s assets in a C reorganization. In this transaction, the acquisition does not qualify as a C reorganization because Elkhorn Coal steps together the spin-off and the acquisition such that P cannot be said to acquire substantially all of T’s assets. Therefore the transaction will be a taxable acquisition and not a tax-free reorganization.

**Issue:** Can P’s acquisition of T be treated as a qualified stock purchase followed by a section 332 liquidation? See Rev. Rul. 2001-46; Treas. Reg. § 1.338-3(c)(1)(i), (2); Temp. Treas. Reg. § 1.338(h)(10)-1T(c)(2), (e).
**Facts:**

1. T makes a tender offer to all of its shareholders to acquire T stock to increase the percentage ownership of T’s largest shareholders.
2. T’s largest shareholders contribute T stock to Q solely in exchange for Q stock.
3. Q forms wholly-owned subsidiary Q1 that merges into T, with T surviving the merger. All of T’s remaining shareholders except Q will receive cash for T stock as part of the merger.
4. Q will make a Subchapter S election and a QSub election for T, resulting in a deemed liquidation of T.

**Result:** Four steps of the transaction will be collapsed and treated as the transfer by T of “substantially all” of its assets to Q in exchange for Q stock and the assumption by Q of T’s liabilities, followed by the liquidation of T. The transaction will qualify as a “D” Reorganization.
Section 338 -- Qualified Stock Purchase

Target Stock Owned by Subsidiary

1. The public owns 60% of T stock. X owns the remaining 40% of T stock.
2. P purchases the T stock held by the public.
3. Has P made a QSP of T?
   See PLR 8425120.
Qualified Stock Purchase: Acquisition of Partnership Interests

**Facts:** PRS owns 80% of the stock of corporation T. P acquires 100% of the partnership interests of PRS.

**Issue:** Has P made a QSP of T? See Rev. Rul. 99-6, 1999-1 C.B. 432.
1. P purchases the stock of T from S and makes a section 338 election for T.
2. May P make a section 338 election for X, Y and Z?
3. May P make a section 338(h)(10) election for X, Y and Z?
Techniques for Avoiding a QSP

1. P buys T’s assets.

2. P acquires T in a “B” reorganization.
Techniques for Avoiding a QSP Continued

1. P buys T’s assets.

2. S merges into P.
Techniques for Avoiding a QSP Continued

1. P buys T’s assets.
2. P buys 79% of T stock.
3. A buys 21% of T stock.
Techniques for Avoiding a QSP Continued

1. P buys T’s assets.

2. P buys 100% of the vote of the T stock, but only 75% of the value.
Section 338(h)(10) and “Busted 351” Transaction

Facts

1. P, X, Y, and Z file a consolidated return.

2. P wishes to sell X and Y to the public and to step up the basis of the X and Y assets.
3. P forms Newco (N) and P transfers the X and Y stock to N. Pursuant to a prearranged plan, P sells the N stock to the Public.
Section 338(h)(10) and “Busted 351” Transaction Continued

Results

1. The transfer of the X and Y stock to N should not qualify as a section 351 transaction. P is not in control of N immediately after the transfer. See Rev. Rul. 79-194, 1979-1 C.B. 145; TAM 9747001 (July 1, 1997); PLR 9541039 (July 20, 1995), as modified by PLR 9549036 (Sept. 12, 1995); PLR 9142013 (July 17, 1991).

2. Thus, N is deemed to purchase the X and Y stock.

3. In this event, P and N can file a section 338(h)(10) election to treat the transaction as a sale of assets by X and Y followed by section 332 liquidations.

4. The recently issued final regulations contain a similar example. See Treas. Reg. § 1.338-3(b)(3)(iv), Ex. 1.

5. How much stock does P have to sell?
   - P must sell more than 20% of N stock for section 351 not to apply. See section 351(a) and 368(c).
   - P must sell at least 50% of the N stock so that P and N are not related for purposes of section 338(h)(3)(A)(iii).
   - P must sell more than 80% of the N stock to avoid the application of the anti-churning rules of section 197(f)(9).
   - Prior to the effective date of recently finalized Treas. Reg. § 1.197-2 it was possible that the anti-churning rules could have applied even if P sold all of the N stock because of the momentary relationship between P and N. See Old Prop. Treas. Reg. § 1.197-2(h)(6)(ii).
Facts
1. Same as above, except that both P and N sell stock to the public.

Results
1. Does section 351 apply? If so, section 338(h)(10) is not available.

2. Does the answer change if P and N each use different investment bankers?
Basis Allocation in a Bargain Purchase

Facts
Corporation S owns all of the stock of Corporation T ("T"). Because of poor management, T is under strong pressure from S to dispose of its business and liquidate. P is interested in acquiring T's business, but realizes the pressure that T is under, and hence will only pay 75 cents on the dollar for T's assets. T’s assets include cash, equipment and the stock of T1, and have a combined fair market value of $2,000. P purchases the T stock from S for $1,500 and the parties make joint section 338(h)(10) elections for T and T1.

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<th>FMV</th>
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<tr>
<td>Cash</td>
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<tr>
<td>Equipment</td>
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</tr>
<tr>
<td>T1 Stock</td>
<td>$500</td>
</tr>
<tr>
<td>Cash</td>
<td>$300</td>
</tr>
<tr>
<td>U.S. Gov’t Securities</td>
<td>$100</td>
</tr>
<tr>
<td>Equipment</td>
<td>$100</td>
</tr>
</tbody>
</table>

Questions
1. How will basis be allocated among T and T1's assets under the temporary regulations?
2. Does the basis allocation follow the class system described in Temp. Treas. Reg. § 1.338-6T (i.e., do all Class I and Class II assets receive basis before Class V assets?).
Basis Allocation in a Bargain Purchase Continued

Result

Under Temp. Treas. Reg. § 1.338-6T, basis is allocated under the residual method. Consideration is first allocated to Class I assets, then to Class II, then to Class III assets, then to Class IV assets, then to Class V assets, then to Class VI assets, and finally to Class VII assets. Basis is allocated to each class up to its fair market value and then to the next class of assets. Basis is allocated to the assets within a Class up to their fair market value (and in proportion to their fair market value, if the total consideration is less than their fair market value).

**T Assets -- Total basis to be allocated $1500**

\[
\left(\frac{\text{FMV of Individual Asset}}{\text{FMV of all assets in Class}}\right) \times \text{Amt. to be allocated to the Class} = \text{Basis of Individual Asset}
\]

<table>
<thead>
<tr>
<th>Class</th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash</strong></td>
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</tr>
</tbody>
</table>

**Classes II, II, and IV $0**

None

**Class V $500**

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<thead>
<tr>
<th>Description</th>
<th>$500 x $500 = $250</th>
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</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>$500 x $500 = $250</td>
</tr>
<tr>
<td>T1 Stock</td>
<td>$500 x $500 = $250</td>
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</table>

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Basis Allocation in a Bargain Purchase Continued

T1 Assets -- Total basis to be allocated $250

<table>
<thead>
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<th>Class</th>
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<th>Basis</th>
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</thead>
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<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$300</td>
<td>$250</td>
</tr>
</tbody>
</table>

Class II $0

U.S. Gov’t Securities $100 $0

Class V $0

Equipment $100 $0
Facts
Corporation S owns all the stock of Corporations T and T1. T operates businesses 1 and 2. Corporation P is unrelated to S. P wishes to acquire Business 1 but not any of the other assets owned by S.

Thus, before the effective date of the recently issued final regulations, the following transactions take place:
• T adopts a plan of complete liquidation.
• T distributes Business 2 to S.
• S sells the T stock to P; S and P make a section 338(h)(10) election.

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

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

6. What would be the result under the recently issue final regulations?

References
Old Treas. Reg. § 1.338(h)(10)-1(e)(2)(ii)
Treas. Reg. § 1.1502-13(j)(2)
New Treas. Reg. § 1.338(h)(10)-1(d)(4)
New Treas. Reg. § 1.338(h)(10)-1(e),Ex.2
PLR 9738031, PLR 9735038, PLR 9210041, PLR 9137040,
PLR 9044063, PLR 8938036, PLR 8821047
1. On February 1, 1999, T sells an asset to P1 and recognizes gain. The gain is taken into account under Treas. Reg. § 1.1502-32 in determining S’s basis in the T stock.

2. On January 1, 2000, P1 makes a QSP of T. No section 338 election is made for T.

3. The carryover basis rule applies to the asset without the need for any action by P. Thus, P1’s basis in the asset is T’s adjusted basis in the asset immediately before the sale to P1.
1. On February 1, 1999, P1 makes a QSP of T2. A section 338(h)(10) election is made for T2 and T2 recognizes gain on each of its assets. T2’s gain is taken into account under Treas. Reg. § 1.1502-32 in determining S’s basis in T stock.

2. On January 1, 2000, P1 makes a QSP of T. No section 338 election is made for T.

3. The acquisition of T2 stock is treated as an acquisition of T2’s assets on February 1, 1999, because a section 338(h)(10) election is made for T2. Also, the carryover basis rule applies to the T2 assets.
Consistency Rules: Consolidation
Indirect Acquisitions -- Example 1

1. On February 1, 1999, pursuant to an arrangement, T sells an asset to Z and recognizes gain.
2. On February 15, 1999, P1 makes a QSP of T. No section 338 election is made for T.
3. March 1, 1999, P1 buys the asset from Z.
4. Because the transaction was arranged so as to avoid the consistency rules, P1’s basis in the asset is T’s adjusted basis in the asset immediately before the sale of Z.
Consistency Rules: Consolidation
Indirect Acquisitions -- Example 2

1. On February 1, 1999, T transfers an asset to T1 in exchange for additional T1 stock and cash. The gain is deferred under Treas. Reg. § 1.1502-13.

2. On March 1, 1999, P1 makes a QSP of T and, pursuant to Treas. Reg. § 1.1502-13(f), the deferred gain is taken into account by T immediately before T ceases to be a member of the S group. No section 338 election is made for T.

3. During the portion of T’s consistency period following T’s acquisition date, T1 owns the asset while it is affiliated with T. Consequently, the indirect acquisition rules apply to the asset if there is an arrangement. See Treas. Reg. § 1.338-8(f)(2)(iii). The fact that at the time T1 acquires the asset from T, T1 is related to T indicates an arrangement exists.
Final Section 197 Regulations


- Certain intangibles are excepted from section 197 if they are not acquired as part of the purchase of a trade or business. The final regulations retain the definition of trade or business contained in the proposed regulations. Thus, a trade or business is defined as it is in section 1060 (i.e., one to which goodwill or going concern value could, under any circumstances, attach).

- The proposed regulations provided that amounts paid for a covenant not to compete entered into in connection with a redemption agreement, which is nondeductible under section 162(k), is not subject to section 197. The final regulations deleted any references to section 162(k).

- The proposed regulations were to be effective upon publication of the regulations in final form. The final regulations clarify that the regulations are effective only with respect to property acquired on or after the date the final regulations are published.
Final Section 197 Regulations Continued

• The final regulations provide a few modifications to the anti-churning rules.
  
  • The final regulations expressly state the purpose of the anti-churning rules and provide that the anti-churning rules are to be applied in a manner that carries out their purpose.
  
  • The final regulations modify the definition of a related person for purposes of the anti-churning rules in the case of a series of related transactions. The final regulations test relatedness only immediately before the first transaction and immediately after the last transaction, not during the period in between as in the proposed regulations. The final regulations also apply this rule to a series of transactions that together comprise a qualified stock purchase within the meaning of section 338(d)(3).
  
  • The final regulations also provide that any relationship created as part of a series of related transactions in which a person acquires stock of a corporation constituting 80 percent followed by a liquidation of the corporation under section 331 is generally disregarded.
Final Section 197 Regulations Continued

• The final regulations modify the rules applicable to transactions involving partnerships in several respects.

  • The proposed regulations contained a distinction between the treatment of the sale of an interest in an intangible asset followed by a contribution of the intangible to a partnership, on the one hand, and the formation of a partnership followed by the sale of the partnership interest on the other. The proposed regulations provided that the anti-churning rules applied in the former situation but not the latter. The final regulations retain this distinction.

  • In a case involving the formation of a partnership followed by the sale of a partnership interest, the proposed regulations provided that a partner could amortize a section 743 adjustment with respect to a section 197 intangible only if the formation of the partnership and the sale of the partnership interest are “unrelated transactions.” The final regulations remove the unrelated transaction requirement.

  • The final regulations permit remedial allocations of amortization deductions to noncontributing partners, provided that they are not related to the contributing partner.
Final Section 197 Regulations Continued

- The final regulations add a rule that the continued use (by license or otherwise) of an intangible by a partner could cause the anti-churning rules to apply with respect to that partner’s share of the intangible in situations where a basis step-up under section 732(d) or 743(b) otherwise would be amortizable.
Section 197 -- Covenant Not to Compete

Acquired in Connection with Stock Redemption

**Facts**
1. A owns 10 percent of T’s stock.

2. T redeems all of its stock owned by A. T and A have no business relationship other than the corporation-shareholder relationship.

3. In connection with the stock redemption, T and A enter into a covenant not to compete, pursuant to which A agrees that he will not compete with the business of T within a prescribed geographical territory for a period of three years. T pays A consideration for this agreement in addition to the amount paid for the stock redeemed.

**Questions**
1. Does section 197 apply to the amount paid for the covenant not to compete?
Section 197 -- Anti-Churning Rules

Series of Transactions

Facts
1. A owns all of T’s stock.

2. P purchases 25 percent of the T stock from A in January of Year 1.

3. P purchases the remaining 75 percent of the T stock in June of Year 1 and makes a section 338 election.

Questions
1. Are P and T considered related for purposes of the anti-churning rules?
Section 197 -- Anti-Churning Rules

Series of Transactions

Facts
1. A owns all of T’s stock.
2. A sells all of T’s stock -- 60 percent to X and 40 percent to Y.
3. X and Y liquidate T under section 331.

Questions
1. Do the anti-churning rules apply to this transaction?
Section 197 -- Anti-Churning Rules

Series of Transactions

Facts
1. A owns all of T’s stock.

2. A sells all of T’s stock to P-SHIP, in which X has a 60-percent interest and Y has a 40-percent interest.

3. T liquidates into P-SHIP under section 331.

Questions
1. Do the anti-churning rules apply to this transaction?
Section 197 -- Anti-Churning Rules

Facts
1. X owns a business (including goodwill), which it runs as a division.

2. X sells 50 percent of its business to Y.

3. X and Y contribute their respective interests in the business to a partnership.

Questions
1. Do the anti-churning rules apply to this transaction?
Facts
1. X and its wholly owned subsidiary, Y, own equal interests in a partnership. The partnership owns a business (including goodwill), and it has a section 754 election in place.

2. X sells its 50-percent partnership interest to M.

Questions
1. Do the anti-churning rules apply to this transaction?
Section 197 -- Anti-Churning Rules

**Facts**
1. X and its wholly owned subsidiary, Y, form a partnership, with X contributing a business (including goodwill) in exchange for a 99-percent interest and Y contributing cash in exchange for a one-percent interest.

2. The partnership makes a section 754 election.

3. One month later, X sells a 50-percent partnership interest to M.

**Questions**
1. Do the anti-churning rules apply to this transaction?
CONTINGENT LIABILITIES

IS IT AN ASSUMED OBLIGATION? – FACTORS

• Results from Buyer’s Operation
• Arises Out of Post-Acquisition Events
• Buyer Aware of Liability
• When Did Legal Liability Arise
• Reflection in Price
• Express Assumption by the Buyer
• Balance Sheet Reserve
CONSEQUENCES OF AN ASSUMED LIABILITY

TO THE SELLER

• Income Inclusion – When
  What Amount

• Installment Reporting

• Offsetting Deduction

• Imputed Interest Income

TO THE BUYER

• Capitalize Payment

• Deduct Payment

• Report Income

• Imputed Interest Expense
CONTINGENT LIABILITIES
SECTION 338(h)(10)

Results under the Old Section 338 Regulations

SELLER’S MADSP

MADSP = G + L + X

• Initially Include Only Fixed and Determinable Liabilities of Old T
• Recompute MADSP When Liability is Fixed
• Offsetting Deduction
• Other Treatment

BUYER’S BASIS

• Use AGUB Formula
• Include Bona Fide Liabilities of Old T
• Exclude Contingent Liabilities Until Fixed
• Other Treatment
RESULT UNDER THE TEMPORARY SECTION 338 REGULATIONS

SELLER’S ADSP

\[ \text{ADSP} = G + L \]

- Temporary regulations eliminate the “Fixed and Determinable” standard for determining the Liabilities of Old T.
- General principles of tax law apply in determining the timing and the amount of liabilities to be included in 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.

BUYER’S BASIS

- Use AGUB Formula
- Temporary regulations eliminate the “Fixed and Determinable” standard.
- In order to be taken into account for AGUB, a liability must be a liability of T that is properly taken into account in basis under general principles of tax law.
Mark J. Silverman

Mark J. Silverman heads Steptoe & Johnson's tax practice. He is a member of The American Law Institute, Tax Advisory Group for the Study of Subchapter C of the Internal Revenue Code. He was formerly an advisor to the Committee on Ways and Means during their consideration of revisions to the corporate tax provisions of the Internal Revenue Code. He is a Fellow of the American College of Tax Counsel. Mr. Silverman was formerly a Council member of the American Bar Association, Section of Taxation and was formerly Chair of the Corporate Tax Committee. He chaired the Tax Section Task Force on Leveraged Buyouts. Mr. Silverman co-authored the Tax Advisors Planning Series on Financially Troubled Businesses, he was formerly Corporate Tax Editor of The Journal of Taxation, and is a member of the advisory boards of NYU Institute on Federal Taxation, BNA Tax Management, Consolidated Returns Tax Report, M&A Tax Report and Corporate Taxation magazines. Mr. Silverman is on the Editorial Board of The American Journal of Tax Policy, and is on the Board of Trustees of the Southern Federal Tax Institute. Mr. Silverman chairs the ALI-ABA annual consolidated returns program. Mr. Silverman was formerly a member of the Executive Committee of the New York State Bar Association. In addition, he is an Adjunct Professor of Law at Georgetown University Law Center and was formerly attorney-advisor to Judge Samuel B. Sterrett of the United States Tax Court. Mr. Silverman is a frequent speaker on tax matters and has published numerous articles on the subject.
Mark J. Silverman (cont’d)

Planning and Transactional Practice
Mr. Silverman focuses on planning and transactional matters. He has extensive experience in structuring acquisitions, mergers, and spin-off transactions for large public corporations, as well as closely held businesses. He has authored a book on the tax consequences of financially troubled businesses and advises corporations on consolidated return issues. Mr. Silverman advises leverage buyout groups, venture capitalists and privately held commercial real estate developers with respect to various transactional matters. He is often called upon to advise the Internal Revenue Service, Treasury Department and the staffs of the Congressional tax writing committees with respect to corporate tax issues.

Tax Policy Practice
A significant part of Mr. Silverman’s practice involves the resolution of tax policy issues before Congress and the Treasury Department. These issues arise in the context of pending or proposed legislation and proposed Treasury Department regulations. Mr. Silverman is currently meeting with members of Congress and their staffs on many of the corporate tax provisions proposed by the Administration and by members of Congress (including corporate spin-offs, financial product provisions, and corporate capital gains).

Audit and Controversy
Mr. Silverman also handles audit and controversy matters. He has extensive experience negotiating with field agents, appeals officers and district counsel in settling significant audit issues. Mr. Silverman frequently prepares technical advice requests and often meets with National Office officials with respect to audit and tax litigation matters.

Recently, Mr. Silverman was successful in convincing the National Office to reverse its position with respect to a technical advice memorandum involving the deduction of environmental clean-up costs.
Mark J. Silverman (cont’d)

PROFESSIONAL AFFILIATIONS
American Bar Association
American Law Institute
Fellow, American College of Tax Counsel
New York State Bar Association
Federal Bar Association

MEMBERSHIP IN
STATE BARS
District of Columbia
New York
Overview—2004 Legislation

- Working Families Tax Relief Act Of 2004
  - Individual tax provisions
  - Business provisions
    - Extension of the research credit
    - Extension of the work opportunity credit

- American Jobs Creation Act of 2004 (“AJCA”)
  - FSC/ETI repeal
  - Domestic manufacturing incentives
  - Corporate provisions
  - Partnership provisions
  - Repatriation of foreign earnings
  - Other selected international provisions
  - Tax shelter provisions
  - Other targeted anti-abuse provisions
  - Compensation
  - Miscellaneous provisions
Corporate Provisions
Limitation on Transfer of Built-in Losses—
Overview

- **Section 362 Prior to AJCA: Section 351 Transactions (Other than Loss Importation Transactions Discussed Below)**
  - Under section 358, the transferor's basis in the stock of the controlled corporation was the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received, and by the amount of any loss recognized by the transferor.
  - Under section 362, the corporation's basis in the transferred property was the same as it would have been in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

- **Section 362 as Amended by AJCA: Section 362(e)(2)—Transfer of losses in a Section 351 Transaction**
  - If the aggregate adjusted basis of property contributed by a transferor (or by a control group of which the transferor is a member) to a corporation exceeds the aggregate fair market value of the property transferred:
    - The transferee's aggregate basis in the properties is limited to the aggregate fair market value of the transferred property.
    - Any required basis reduction is allocated among the transferred properties in proportion to their built-in-loss immediately before the transaction.
    - Transferor and transferee may elect to limit the basis in the stock received by the transferor to the aggregate fair market value of the transferred property, in lieu of limiting the basis in the assets transferred.
      - Such election shall be included with the tax returns of the transferor and transferee for the taxable year in which the transaction occurs and, once made, shall be irrevocable.
Limitation on Transfer of Built-in Losses—Example

**Facts:** P contributes: (i) Asset A with a fair market value of $100 and an adjusted basis of $200 and (ii) Asset B with a fair market value of $100 and a basis of $90 to S in exchange for S stock in a section 351 exchange.

**Analysis:** Unless P and S elect otherwise, P’s basis in its S shares is $290. There is an aggregate built-in loss of $90 in Assets A and B. Thus, S’s aggregate basis in Assets A and B equals $200 (i.e., the aggregate fair market value of Assets A and B). S’s basis in Asset A is reduced to $110 [200 – ($90 x $90/$90)] (i.e., the proportionate share of built-in loss allocable to Asset A). S’s basis in Asset B remains $90 [$90 – ($90 x $0/$90)]. See section 362(e)(2).
Limitation on Importation of Built-in Losses—Overview

- **Section 362 Prior to AJCA: Incorporations, Reorganizations and Liquidations**
  - The basis of property received by a corporation, whether from domestic or foreign transferors, in a tax-free incorporation, reorganization, or liquidation of a subsidiary corporation was the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor.

- **Section 362 as Amended by AJCA: Section 362(e)(1)—Importation of Losses (Incorporations, Reorganizations and Liquidations)**
  - If a “net built-in loss” is imported into the U.S in a tax-free incorporation or reorganization from persons not subject to U.S. tax, the basis of each property so transferred is its fair market value.
    - A “net built-in loss” is treated as imported into the U.S. if the aggregate adjusted bases of property received by a transferee corporation exceed the fair market value of the properties transferred.
  - Similar rules apply in the case of the tax-free liquidation by a domestic corporation of its foreign subsidiary.
**Limitation on Importation of Built-in Losses—Example**

**Facts:** FP, a non-U.S. corporation not subject to U.S. taxation, incorporates S, a U.S. corporation. FP contributes to S: (i) Asset A with a fair market value of $100 and an adjusted basis of $200 and (ii) Asset B with a fair market value of $100 and a basis of $90 in exchange for S stock in a section 351 exchange. Immediately before the contribution, FP’s gain or loss with respect to Assets A and B is not subject to U.S. taxation.

**Analysis:** FP’s basis in its S shares is $290. Although this transaction is subject to the rules of sections 362(e)(1) and (e)(2), the loss importation rules of section 362(e)(1) have priority. See section 362(e)(2)(A)(i). Thus, S’s basis in Asset A is reduced to $100 and S’s basis in Asset B is increased to $100. See section 362(e)(1).
Treatment of Transfers to Creditors in Divisive Reorganizations—Overview

- **Section 361(b)(3) Prior to AJCA: Transfers to Creditors**
  - A transferor corporation did not recognize gain if it received money or other property in a section 368(a)(1)(D) reorganization and distributed that money or other property to its shareholders or creditors.
  - The amount of property that could be distributed to creditors without gain recognition was unlimited.

- **Section 361(b)(3) as Amended by AJCA**
  - The amount of money plus the fair market value of other property that a distributing corporation can distribute to its creditors without gain recognition under section 361(b) is limited to the amount of the basis of the assets contributed to a controlled corporation in a divisive reorganization.
Treatment of Transfers to Creditors in Divisive Reorganizations—Example

**Facts:** D owns all of the stock of C in which it has a basis of $100. D conducts business A and B, and C conducts business A. For valid business purposes, D wants to spin-off business A to its shareholders. D contributes its business A assets, which have an aggregate fair market value of $500 and an adjusted basis of $250, to C in exchange for $200 worth of C stock and $300 cash. D uses the cash to repay currently outstanding debt. D then distributes all of its C stock pro rata to its shareholders. Assume that the spin-off qualifies under section 355.

**Analysis:** The amount of money and the fair market value of other properties the D can receive tax-free under section 361(b) and then distribute to D creditors without gain recognition is limited to the total adjusted basis of the properties transferred by D to C. Therefore, D has $50 of gain ($300 cash distributed to its creditors - $250 aggregate basis in property contributed to C). See section 361(b)(3).
Clarification of the Definition of Nonqualified Preferred Stock—Overview

Section 351(g) Prior to AJCA

- In general, the receipt of nonqualified preferred stock by an exchanging shareholder in a reorganization, section 351 transaction, or corporate division is taxable
- Nonqualified preferred stock is defined as any “preferred stock” if
  - The holder has the right to require the issuer or a related person to redeem or purchase the stock
  - The issuer or a related person is required to redeem or purchase the stock
  - The issuer or a related person has the right to redeem or repurchase, and, as of the issue date, it is more likely than not that such right will be exercised or
  - The dividend rate of the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction stock)
- “Preferred stock” is defined as stock that is “limited and preferred as to dividends and does not participate in corporate growth to any significant extent”

Section 351(g)(3)(A) as Amended by AJCA

- The definition of “preferred stock” is clarified to ensure that stock for which there is not a real and meaningful likelihood of actually participating in the earnings and profits of the corporation is not considered to be outside the definition of stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent
- Effective date: May 14, 2003
Clarification of the Definition of Non-Qualified Preferred Stock—Example

**Facts:** P contributes assets to S in exchange for S common stock and S preferred stock. The S preferred stock entitles a holder to a dividend that is the greater of seven percent or the dividends S common shareholders receive.

**Analysis:** The S preferred stock does not avoid being preferred stock for purposes of section 351(g) if the S common shareholders are not expected to receive dividends greater than seven percent. See section 351(g)(3)(A).
Other Corporate Provisions

- **Rules for Payment of Estimated Tax for Certain Deemed Asset Sales**
  - Section 338(h)(13) is amended to provide that the exception for estimated tax purposes for tax attributable to a deemed asset sale does not apply with respect to a qualified stock purchase for which an election is made under section 338(h)(10)

- **Definition of Controlled Group of Corporations**
  - The definition of “controlled group” in section 1563 is amended to eliminate the 80% test
  - Thus, a controlled group is two or more corporations if five or fewer persons who are individuals, estates, or trusts own (actually or constructively) more than 50% of the combined voting power or more than 50% of the total value, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation
  - This modification applies only for purposes of section 1561, relating to corporate tax brackets, the accumulated earnings credit, and the minimum tax

- **Liabilities in excess of basis in acquisitive “D” reorganizations**
  - Section 357(c) does not apply to acquisitive “D” reorganizations
Other Corporate Provisions

- Affirmation of Consolidated Return Regulation Authority
  - In exercising its authority under section 1502 to issue consolidated return regulations, the Treasury Department may provide rules treating corporations filing consolidated returns differently from corporations filing separate returns.

- Not Enacted
  - “Active Trade or Business” affiliation test under section 355.
Partnership Provisions
Partnership Provisions

Transfers of Partnership Interests Prior to AJCA (Section 743)

- A partnership did not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made a section 754 election.
- If an election was in effect, adjustments were made with respect to the transferee partner to account for the difference between the transferee partner’s proportionate share of the adjusted basis of the partnership property and the transferee’s basis in its partnership interest. These adjustments were intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner.
- Under these rules, if a partner purchased an interest in a partnership with an existing built-in loss and no election under section 754 was in effect, the transferee partner could have been allocated a share of the loss when the partnership disposes of the property (or depreciates the property)

Distributions of Partnership Property Prior to AJCA (Section 734)

- Adjustments to the basis of the partnership’s undistributed properties were not required unless the partnership has made a section 754 election. If a section 754 election was in effect, adjustments were made by a partnership to increase or decrease the remaining partnership assets to reflect any increase or decrease in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by the distributee partner)
- To the extent the adjusted basis of the distributed properties increased (or loss is recognized) the partnership’s adjusted basis in its properties is decreased by a like amount; likewise, to the extent the adjusted basis of the distributed properties decrease (or gain was recognized), the partnership’s adjusted basis in its properties was increased by a like amount.
- Under these rules, a partnership with no election in effect under section 754 could distribute property with an adjusted basis lower than the distributee partner’s proportionate share of the adjusted basis of all partnership property and leave the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.
Partnership Provisions—Loss Transfer and Basis Adjustment Rules As Amended by AJCA

- Contributions of Property (Section 704(c) as amended by AJCA)
  - In general, built-in losses in contributed property are to be taken into account only by the contributing partner
  - In determining the amount of items allocated to partners other than the contributing partner, the basis of contributed built-in loss property is treated as the fair market value at the time of contribution
    - Thus, if the contributing partner’s partnership interest is transferred or liquidated, the partnership’s adjusted basis in the built-in loss property is based on its fair market value at the time of contribution, and the built-in loss is eliminated

- Transfers of Partnership Interests (Section 743 as amended by AJCA)
  - Basis adjustments under section 743 are generally required in the case of the transfer of a partnership interest with respect to which there is a “substantial” built-in loss (rather than being elective)
    - A “substantial” built-in loss exists if the partnership’s adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property
Partnership Provisions—Loss Transfer and Basis Adjustment Rules As Amended by AJCA

- Distributions of Partnership Property (Section 734 as Amended by AJCA)
  - Basis adjustment under section 734(b) is generally required in the case of a distribution with respect to which there is a “substantial” basis reduction
    - A “substantial” basis reduction means a downward adjustment of more than $250,000 that would be made to the basis of partnership assets if a section 754 election were in effect

- Exceptions are provided in amended sections 743 and 734 for “securitization partnerships” and in section 743 for “electing investment partnerships"
Partnership Provisions—Section 743 Example

No actual section 754 election
Not electing investment P/S
Not securitization P/S

D  75%

A  25%

P/S

3P

$4M Cash

$4.3M Aggreg. Basis
$4.0M Aggreg. Value
$0.3M Built-In Loss

O/B=$1.075M

P/S Int.

1

$1M Cash

Analysis: Before the transaction, there is $300,000 of built-in loss in P/S assets. Under previous law, without a section 754 election, this transaction would have permitted D, A, and B to recognize $375,000 of built-in loss. Under new law, although there is no section 754 election, section 743(b) applies with respect to B so that B does not benefit from A’s 25% share of the $300,000 built-in loss in P/S assets recognized upon the sale of those asset to 3P, thereby decreasing total built-in loss recognized by D, A, and B to $300,000 (D recognizes a loss of $225,000, A recognizes a loss of $75,000, and B does not recognize a gain or loss). See 743(b)(2); Treas. Reg. § 1.743-1(j)(1).
Partnership Provisions—Section 734 Example

No actual section 754 election
Not securitization P/S

Prop. 2
Prop. 1 (AB=$5M)
V = $1M
O/B = $5M

$1M Cash

P/S
3P

Analysis: Before the transaction, there is $8 million of built-in loss in P/S assets. Under previous law, without a section 754 election, the total built-in loss recognized by A, B, and C would have been $10 million. Under new law, although there is no section 754 election, section 734(b) applies so as to decrease the adjusted basis of Prop. 2 by $2 million at step 1, thereby decreasing the total built-in loss recognized by A, B, and C to $8 million. See section 734(b)(2)(B).
Other Selected Partnership Provisions

- **No reduction of basis under section 734 in stock of corporate partner held by partnership**
  - In applying the basis allocation rules to a distribution in liquidation of a partner’s interest, a partnership is precluded from decreasing the basis of corporate stock of a partner or a related person.
  - Any decrease in basis that, absent the provision, would have been allocated to the stock is allocated to other partnership assets.
  - If the decrease in basis exceeds the basis of the other partnership assets, then gain is recognized by the partnership in the amount of the excess.

- **Recognition of COD income realized on the satisfaction of debt with a partnership interest**
  - Section 108(e)(8) is expanded to include partnership interests.
  - If a partnership transfers a capital or profits interest to a creditor to satisfy partnership debt, the partnership will recognize COD income equal to the excess of the partnership’s debt over the fair market value of the partnership interest used to satisfy the debt.
Tax Shelter and Other Targeted Provisions
**Tax Shelter Provisions—Tighten Reporting and Penalty Rules (Taxpayers)**

- Penalty for failing to disclose a “reportable” transaction (new section 6707A)
  - Amount of the penalty:
    - $10,000/$50,000 for “reportable” transactions
    - $100,000/$200,000 for “listed” transactions
  - Definitions
    - “Reportable” transaction is one with respect to which information has to be provided with a return or statement “because, as determined under regulations prescribed under section 6011, [the] transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion.”
      - Is this less than all section 6011 reportable transactions?
    - “Listed” transaction is a “reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.”
  - The penalty cannot be waived for failing to report a “listed” transaction
Penalty for failing to disclose a “reportable” transaction (new section 6707A), continued

- The conference agreement notes that the penalty can be waived for failing to disclose a “reportable” transaction (other than a listed transaction) but only if:
  - The non-disclosing person has a history of complying with the tax laws
  - The violation is due to an unintentional mistake of fact and
  - Imposing the penalty would be against “equity and good conscience”

- Applies regardless of whether transaction results in an understatement of tax
- Applies in addition to any accuracy related penalties
- A publicly traded entity required to pay this penalty for failing to disclose a “listed” transaction must disclose the imposition of the penalty in a filing with the SEC (regardless of whether the amount of the penalty is “material” for SEC purposes)
- Effective date: Taxable years ending after the date of enactment
Tax Shelter Provisions—Tighten Reporting and Penalty Rules (Taxpayers)

- Reportable Transactions
  - Defined in Treas. Reg. § 1.6011-4

  - Six categories of “reportable” transactions
    - Listed Transactions
    - Confidential Transactions
    - Transactions with tax benefit loss protection
      - See Rev. Proc. 2004-65 for a list of transactions with contractual protection that are not reportable transactions
    - Significant loss generators
    - Transactions with significant tax-book differences
    - Transactions involving a brief asset holding period
      - See Rev. Proc. 2004-68 for a list of transactions with brief asset holding periods that are not reportable transactions
LISTED TRANSACTIONS

- **Notice 2004-31** – Intercompany Financing Through Partnerships
- **Notice 2004-30** – S Corporation Tax Shelter Involving Shifting Income to Tax Exempt Organization
- **Notice 2004-20** – Abusive Foreign Tax Credit Transactions
- **Revenue Ruling 2004-20** – Abusive Transactions Involving Insurance Policies in IRC 412(i) Retirement Plans
- **Revenue Ruling 2004-04** – Prohibited Allocations of Securities in an S Corporation
- **Notice 2004-8** – Abusive Roth IRA Transactions
- **Notice 2003-81** – Offsetting Foreign Currency Option Contracts
- **Notice 2003-77** – Improper use of contested liability trusts to attempt to accelerate deductions for contested liabilities under IRC 461(f)
- **Notice 2003-55** – Accounting for Lease Strips and Other Stripping Transactions
- **Notice 2003-47** – Transfers of Compensatory Stock Options to Related Persons
- **Notice 2003-24** – Certain Trust Arrangements Seeking to Qualify for Exception for Collectively Bargained Welfare Benefit Funds under § 419A(f)(5)
- **Notice 2003-22** – Offshore Deferred Compensation Arrangements
- **Revenue Ruling 2003-6** – Abuses Associated with S Corp ESOPs
- **Revenue Ruling 2002-69** – Lease In / Lease Out or LILO Transactions
- **Notice 2002-50** – Partnership Straddle Tax Shelter
- **Notice 2002-35** – Notional Principal Contracts
- **Notice 2002-21** – Inflated Basis “CARDS” Transactions
- **Notice 2001-45** – §302 Basis-Shifting Transactions
- **Notice 2001-17** – Contingent Liability Transactions
- **Notice 2001-16** – Intermediary Transactions
- **Notice 2000-61** – Guam Trust
- **Notice 2000-60** – Stock Compensation Transactions
- **Notice 2000-44** – Inflated Partnership Basis Transactions
- **Revenue Ruling 2000-12** – Debt Straddles
- **Treasury Regulation § 1.7701(l)-3** – Fast Pay or Step-Down Preferred Transactions
- **Notice 99-59** – BOSS Transactions
- **Treasury Regulation § 1.643(a)-8** – Certain Distributions from Charitable Remainder Trusts
- **ASA Investering Partnership v. Commissioner** – Transactions similar to that described in the ASA Investering litigation and in ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998)
- **Notice 95-34** – Certain Trusts Purported to be Multiple Employer Welfare Funds Exempted from the Lists of §§ 419 and 419A
- **Revenue Ruling 90-105** – Certain Accelerated Deductions for Contributions to a Qualified Cash or Deferred Arrangement or Matching Contributions to a Defined Contribution Plan
Tax Shelter Provisions—Tighten Reporting and Penalty Rules (Taxpayers)


- A loss under section 165 from the sale or exchange of an asset if:
  - the basis of the asset is a qualifying basis
  - the asset is not an interest in a pass-through entity
  - the loss is not treated as ordinary under section 988
  - the asset has not been separated from any portion of the income it generates
  - the asset is not, and has never been, part of any straddle transaction
- Casualty losses
- Losses from a compulsory or involuntary conversion
- A loss arising from any mark-to-market treatment of any item, provided that the taxpayer computes its loss:
  - by using a qualifying basis,
  - by using a basis resulting from previously marking the item to market, or
  - by making appropriate adjustments for previously determined mark-to-market gain or loss
- A loss described from a hedging transaction described in section 1221(b) or from a mixed straddle account
- A loss attributable to basis increases under section 860C(d)(1)
- A loss attributable to the abandonment of depreciable tangible property that was used by the taxpayer in a trade or business and that has a qualifying basis
- A loss arising from the bulk sale of inventory if the basis is determined under section 263A
- A loss that is equal to, and determined solely by reference to, a payment of cash by the taxpayer
Tax Shelter Provisions—Tighten Reporting and Penalty Rules (Taxpayers)


- Book loss claimed before or without tax loss
- Tax income claimed before or without book income
- Depreciation differences relating solely to lives, methods or conventions
- Percentage depletion and deductible drilling costs
- Capitalization and amortization under sections 195, 248, and 709
- Bad debt and cancellation of indebtedness income
- Federal, state, local, or foreign taxes
- Compensation amounts, including options, pensions
- Charitable contributions of cash or tangible property
- Tax exempt interest
- Dividends, including dividends received deductions, amounts treated as dividends under section 78, distributions of previously taxed income, and income inclusions under sections 551, 951, and 1293
- A dividends paid deduction by a publicly-traded REIT
- Patronage refunds or dividends of cooperatives
- Items resulting from the application of section 1033
- Items resulting from the application of sections 354, 355, 361, 367, 368, or 1031, if the taxpayer complies with the filing and reporting requirements for these sections
- Items resulting from debt-for-debt exchanges
- Items resulting from the treatment of a group of mortgages as a single asset for book purposes but as multiple assets for tax purposes
- Items resulting solely from the treatment as a sale, purchase, or lease for book purposes and as a financing for tax purposes
- Treatment of a transaction as a sale for book purposes and as a nontaxable transaction under section 860F(b)(1)(A) for tax purposes
Tax Shelter Provisions—Tighten Reporting and Penalty Rules (Taxpayers)


- Items resulting from differences solely due to the use of hedge accounting for book purposes and not for tax purposes, or vice versa
- Items resulting solely from the use of the mark-to-market method of accounting for book purposes and not for tax purposes, or vice versa
- Items resulting from the application of section 1286
- Inside buildup, death benefits, or cash surrender value of life insurance or annuity contracts
- Life insurance reserves determined under section 807 and non-life insurance reserves determined under section 832(b)
- Capitalization of policy acquisition expenses of insurance companies
- Imputed interest income or deductions
- Gains and losses arising under sections 986(c), 987, and 988
- Items excluded under section 883, section 921, or an applicable treaty from a foreign corporation’s income that would be otherwise subject to tax under section 882.
- Section 481 adjustments
- Inventory valuation differences, whether attributable to LIFO computations or obsolescence reserves
- Section 198 deductions for environmental remediation costs
- Items that are reported on a gross basis for tax and on a net basis for book, or on a net basis for tax and a gross basis for book, if the differing reporting produces no net book-tax difference for the taxable period
- Any item resulting from the use of different book and tax treatment of original issue discount, market discount, acquisition discount, de minimis original issue discount, qualified stated interest, amortizable bond premium, bond issuance premium, or debt issuance costs
Tax Shelter Provisions—Tighten Reporting and Penalty Rules (Taxpayers)

- Two-tier accuracy related penalty for a reportable transaction (new section 6662A of the Code)
  - A new accuracy-related penalty
  - Applies to reportable and listed transactions

- Penalty rates
  - A 20% accuracy related penalty is imposed on any understatement attributable to an adequately disclosed listed or reportable avoidance transaction
  - A 30% accuracy related penalty is imposed on any understatement attributable to an listed or reportable avoidance transaction that is not adequately disclosed
    - The 30% penalty cannot be waived under the reasonable cause exception (described below)

- Calculation of the Understatement
  - An understatement is the sum of:
    - The product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the proper treatment of the item and
    - The amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item
Tax Shelter Provisions—Tighten Reporting and Penalty Rules (Taxpayers)

- **Two-tier accuracy related penalty for a reportable transaction (new section 6662A of the Code), continued**
  - The 20% penalty can be waived for reasonable cause (the “strengthened reasonable cause exception”), which exists only if it is shown that there was reasonable cause for the understatement and the taxpayer acted in good faith
  - Such a showing requires:
    - Adequate disclosure (in accordance with the section 6011 regulations) of the transaction
    - That there is or was substantial authority for the taxpayer’s position and
    - That the taxpayer reasonably believed that its position was more likely than not the correct position
  - A taxpayer will be treated as having a “reasonable belief” only if such belief:
    - Is based on the facts and law that exist at the time of the tax return and
    - Relates solely to the taxpayer’s chances of success on the merits and does not take into account the possibility that
      - A return will not be audited
      - The treatment will not be raised on audit or
      - The treatment will be resolved through settlement if raised on audit
Two-tier accuracy related penalty for a reportable transaction (new section 6662A of the Code), continued

- A taxpayer may rely on an opinion of a tax advisor in establishing its belief, but a taxpayer may not rely on an opinion of a tax advisor if the opinion
  - Is provided by a “disqualified tax advisor” or
  - Is a “disqualified opinion”

- A “disqualified tax advisor” is any advisor who
  - Is a material advisor (as that term is defined under section 6111)
  - Is compensated directly or indirectly by a material advisor with respect to the transaction
  - Has a fee arrangement with respect to the transaction that is contingent on all or part in the intended tax benefits from the transaction being sustained or
  - Has a “disqualifying financial interest” with respect to the transaction, as determined by regulations

- A “disqualified opinion” is an opinion that
  - Is based on “unreasonable factual or legal assumptions”
  - “Unreasonably relies” upon representations, statements, findings or agreements of the taxpayer or any person,
  - Does not identify and consider all relevant facts, or
  - Fails to meet any other requirements prescribed by Treasury
Two-tier accuracy related penalty for a reportable transaction (new section 6662A of the Code), continued

- Coordination with other penalties
  - Any understatement upon which this penalty is imposed is not subject to the accuracy related penalty under section 6662
  - Any understatement upon which this penalty is imposed is included for purposes of determining whether any understatement is a “substantial understatement” under section 6662
  - Any understatement upon which this penalty is imposed is not subject to the valuation misstatement penalties under sections 6662(e) or 6662(h)
  - This accuracy related penalty shall not apply to any portion of an understatement to which a fraud penalty under section 6663 applies

- A publicly traded entity may be required to disclose the imposition of this penalty in a filing with the SEC (regardless of whether the amount of the penalty is “material” for SEC purposes)
- Effective date: Taxable years ending after the date of enactment
Tax Shelter Provisions—Tighten Reporting and Penalty Rules (Promoters)

- **Penalty on Promoters of Tax Shelters (amendments to section 6700 of the Code)**
  - Increase in the promoter penalty from $1,000 to 50% of the gross income derived from the tax shelter

- **Disclosure of Reportable Transactions**
  - “Material Advisors” are required to disclose reportable transactions on an information return prescribed by Treasury
    - Treasury and IRS have issued interim guidance regarding how and when a material advisor must file an information return. See Notice 2004-80
  - Failure to timely file the information return results in a penalty
    - Reportable transactions (other than listed transactions): $50,000
    - Listed transactions: the greater of $200,000 or 50% of the material advisor’s gross income derived from the transaction before the due date of the information return—intentional disregard results in an increase to 75% of the material advisor’s gross income
  - A “Material Advisor” is anyone who:
    - Provides material aid, assistance, or advice with respect to insuring, organizing, promoting, selling, implementing, or carrying out any reportable transaction and
    - Directly or indirectly derives more than $250,000 in gross income from providing such assistance or advice ($50,000 if substantially all of the tax benefits of the reportable transaction are provided to natural persons)
Tax Shelter Provisions—Tighten Reporting and Penalty Rules (Promoters)

- **Investor Lists**
  - Material Advisors are required to maintain investor lists with respect to reportable transactions
    - Treasury and IRS have issued interim guidance regarding the maintenance of investor lists. See Notice 2004-80
  - A material advisor who fails to make its investor list available to the IRS within 20 days of receiving a written request to do so is subject to a $10,000/day penalty

- **Confidentiality**
  - Communications with respect to tax shelters are not subject to the confidentiality protections that otherwise apply to a communication between a taxpayer and a federally authorized tax practitioner
Other Selected Anti-Abuse Rules

- Substantial Understatement Penalty
  - The definition of “substantial” as it applies to corporate taxpayers for purposes of section 6662 is amended so that a corporate taxpayer has a substantial understatement if the amount of the understatement exceed the lesser of
    - 10% of the tax required to be shown on the return for the taxable year or
    - $10 million

- Interest provisions
  - Denial of interest deduction on underpayments attributable to non-disclosed reportable transaction
  - Freeze of suspension of interest where Secretary fails to contact taxpayer
  - Deposits to suspend the running of interest (favorable)

- Not enacted
  - Codification of the “Economic Substance Doctrine”
  - CEO tax return signature requirement
  - “Super 269”