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Tax Aspects of Mergers and Acquisitions

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Taxable Acquisitions

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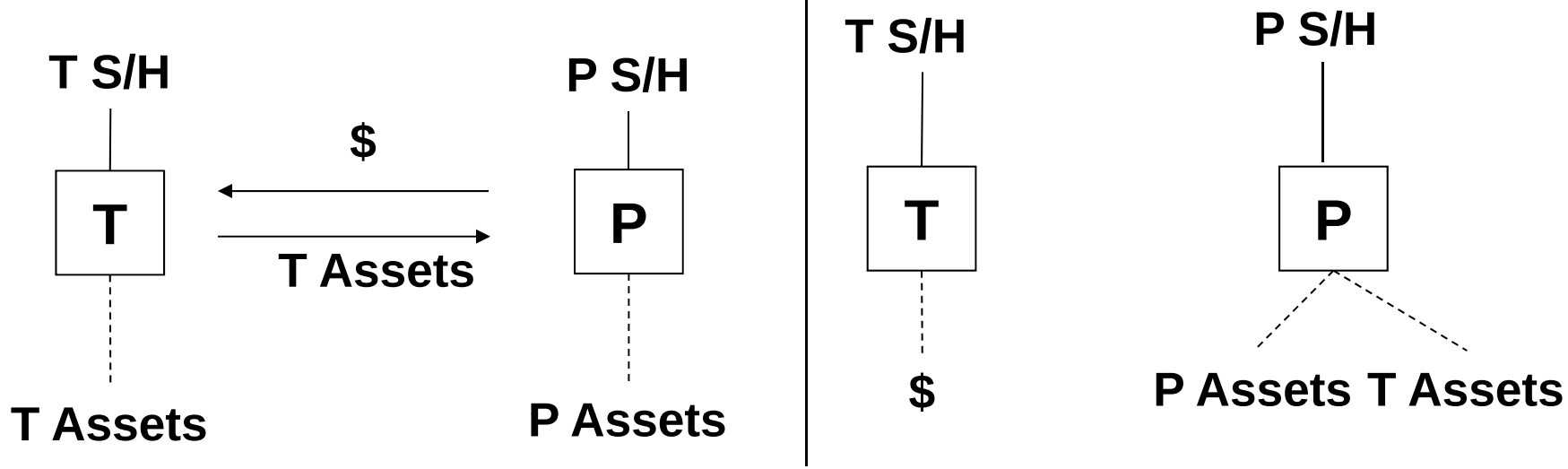
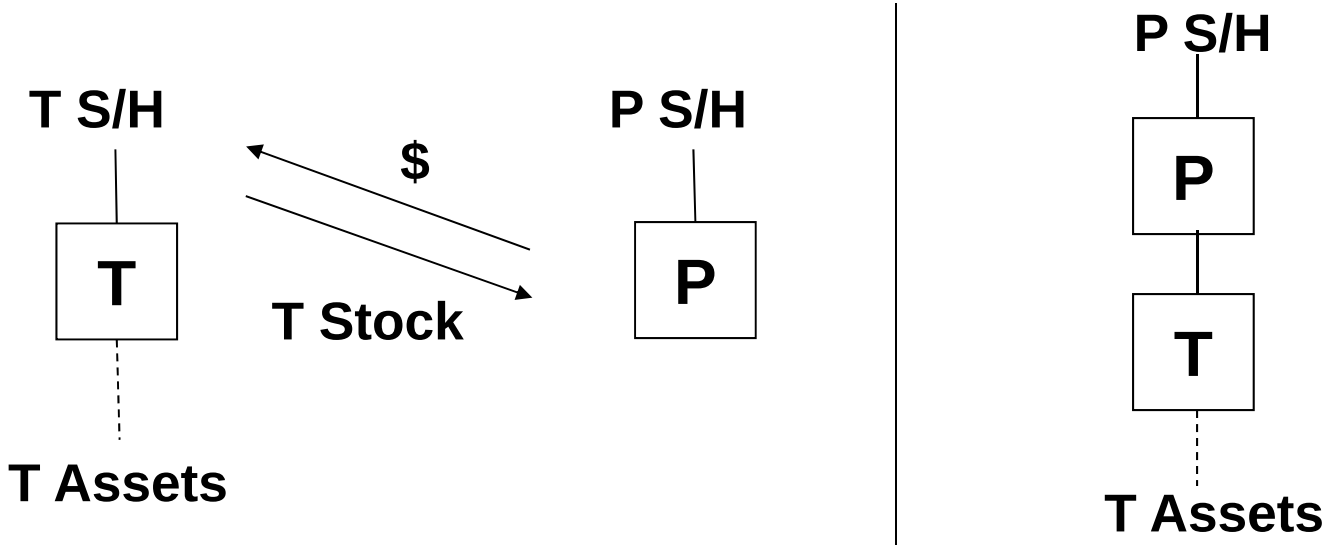


- T recognizes gain or loss.
- P takes a cost basis in the T assets.
- Under section 1060, the consideration is allocated to 7 classes of assets (residual method).
- Cash remains in T's hands. Cash to T S/H will be taxable to T S/H as a dividend or as capital gain (redemption proceeds or partial or complete liquidation).
- If T S/H is T's corporate parent, T may transfer the cash to T S/H as a dividend subject to 100% dividends-received deduction or as a liquidation subject to section 332.
- If T S/H and T file consolidated returns, T may transfer the cash to T S/H as a dividend, tax-free (but TS/H's basis in the T stock will be reduced) or as a liquidation subject to section 332
- T S/H and T may obtain the same result via a forward cash merger of T into D.

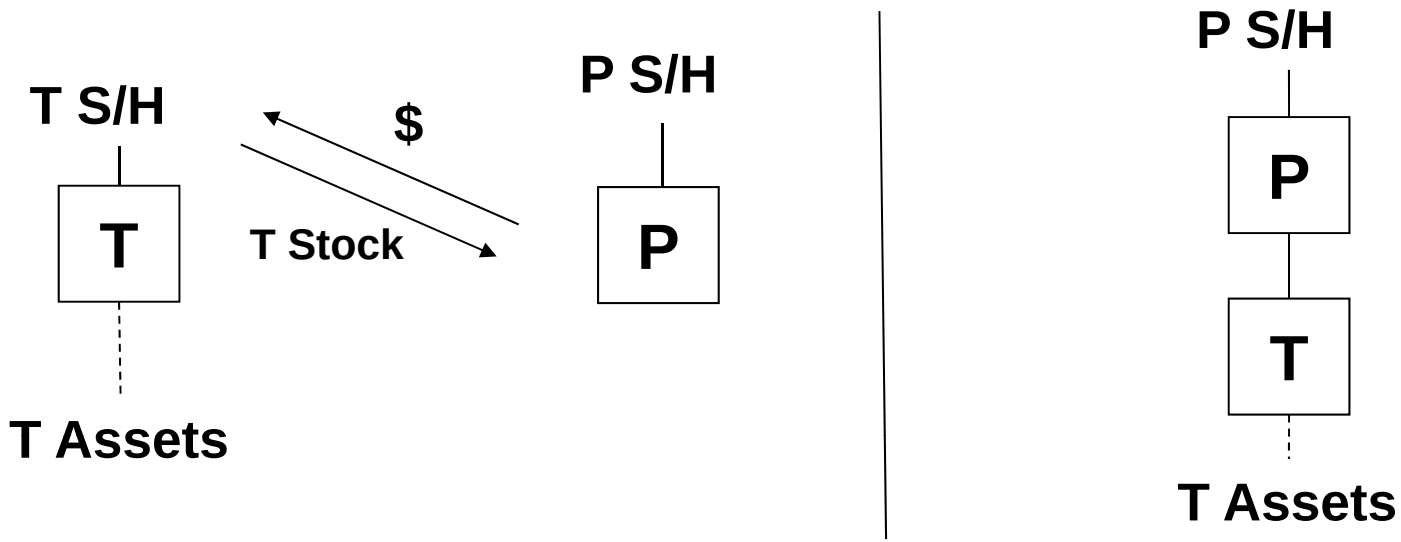
Stock Sale and Purchase

Stock Sale – General



- T does not recognize gain or loss.
- T S/H recognize gain or loss on sale of stock.
- T's basis in the T assets ("inside basis") and T's tax attributes are unaffected (apart from section 382 limitation and the like).
- If T S/H and T file consolidated returns, (1) a loss recognized by T S/H may be disallowed, and (2) T's E&P earned while T was a group member stays behind in the T S/H group.
- P's basis in the T stock is equal to the fair market value of the consideration paid.
- Same results if the T stock is sold to a disregarded entity owned by P.
- Same results if P forms a new subsidiary, S, and S is merged into T, with T S/H receiving cash.
- *See* sections 355(d) and (e).

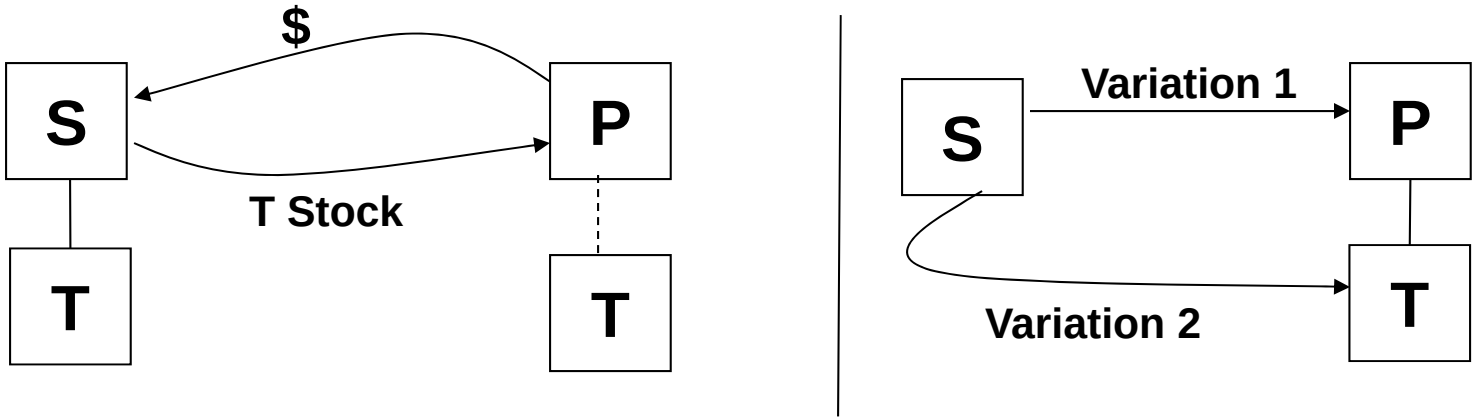
Stock Sale – Variations



Variations

1. T distributes a cash dividend to T S/H before the stock sale.
2. T redeems part of T S/H's stock, and T S/H sells the rest of the T stock to P.
3. At the time of the sale, T has unused NOL carryovers.
4. T and T S/H are members of a consolidated group.
   a. T S/H sells the T stock at a gain, and other group members have losses.
   b. T S/H sells the T stock at a gain, and T has unused losses.
   c. T S/H sells the T stock at a loss.

Stock Sale With Indemnity



- S owns all the stock of T, which owns and operates a manufacturing facility.
- S sells the T stock to P for cash..
- Variation 1. At the time of the sale of the T stock, T is the defendant in a patent infringement lawsuit. In connection with the sale, S agrees to indemnify T against an adverse judgment. Five years after closing, a judgment is entered against T for damages plus interest dating back to three years before the closing. S pays the judgment.
- Variation 2. Five years after closing, P claims that S misrepresented the mechanical condition of T's operating facility. To settle the claim, S makes a payment to P. The payment consists of the cost of repairing and upgrading the facility plus interest from the date of closing.

Estate of McGlothlin v. Commissioner, 370 F.2d 729 (5th Cir. 1967)

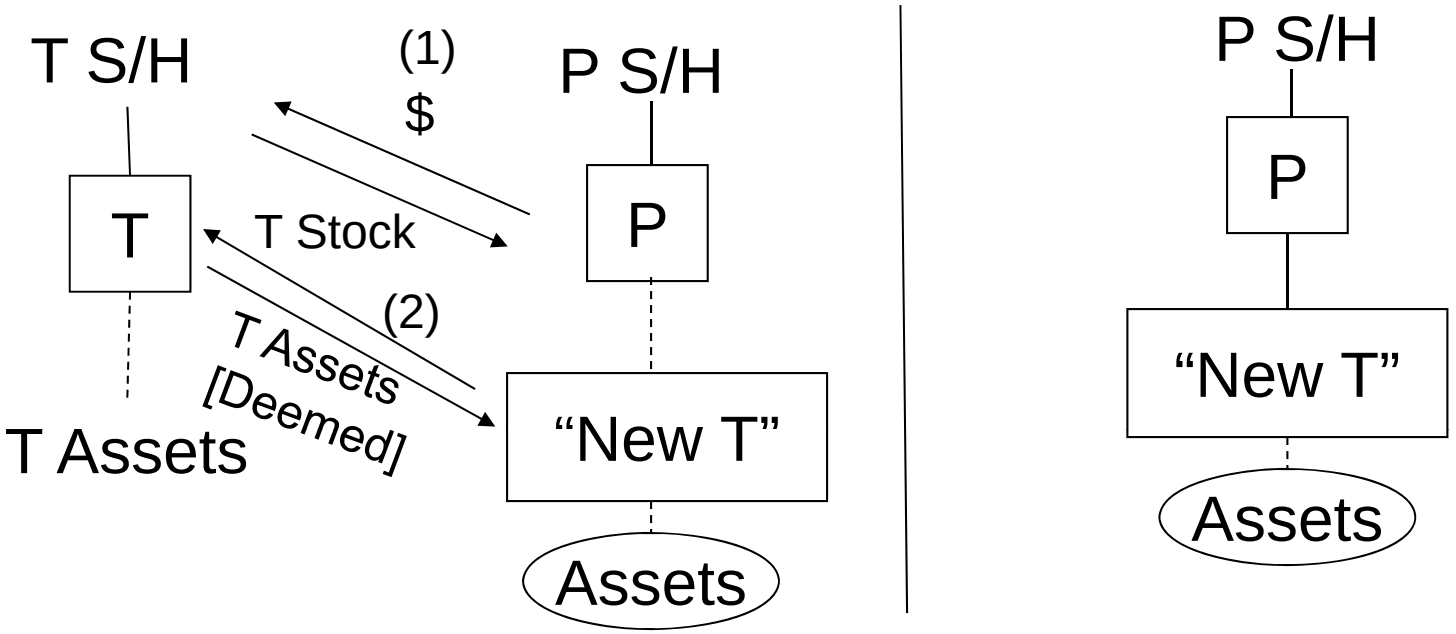
VCA Corporation v. United States, 566 F.2d 1192 (Ct. Cl. 1977)

Rev. Rul. 58-374, 1958-2 C.B. 396

Rev. Rul. 83-73, 1983-1 C.B. 84

GCM 38977 (Apr. 8, 1982)

Stock Sale – Section 338 Election



- Section 338(g) election is made unilaterally by P. It does not affect T S/H.
- Election results in deemed taxable sale by T of all its assets.
- Gain or loss is recognized to T in a separate, one-transaction return, not in consolidated group of either T S/H or P.
- If T is a domestic corporation with built-in gain, election is not attractive unless, *e.g.,* T has losses to shelter the gain.
- If T is a foreign corporation, election may be attractive to step up T's inside basis for U.S. tax purposes, eliminate historic earnings and profits, etc.

Section 1060

Section 1060

- Section 1060 applies to any "applicable asset acquisition." Section 1060(a).
  - An applicable asset acquisition is any transfer of assets constituting a trade or business if the purchaser's basis in the acquired assets is determined wholly by reference to the consideration paid for such assets. Section 1060(c).
  - Regulations broadly define "assets constituting a trade or business" as consisting of any group of assets (i) the use of which would constitute an active trade or business for purposes of section 355, or (ii) to which goodwill or going concern value could under any circum-stances attach. Treas. Reg. § 1.1060-1(b)(2)(i).
  - Prior to the enactment of section 1060 as part of the 1986 Act, taxpayers and the government had frequently skirmished over purchase price allocations.
- If section 1060 applies to a transaction, the "consideration received" for the acquired assets must be allocated among the assets in accordance with regulations under section 338(b)(5). Section 1060(a). *See also* Treas. Reg. § 1.1060-1(c)(2).
  - The regulations require that the consideration be allocated among the assets under the "residual method."
- If the transaction is an applicable asset acquisition, each party must satisfy certain reporting requirements. Section 1060 also imposes certain reporting requirements with respect to specific transactions that are not applicable asset acquisitions.

Section 1060 Regulations

- The IRS issued regulations under sections 338 and 1060. T.D. 8940 (February 12, 2001). These 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 regulations are generally effective for asset acquisitions occurring after March 16, 2001.
- The preamble states 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.
- Treas. Reg. § 1.1060-1(c)(2) incorporates the residual method by cross reference to the final section 338 regulations (Treas. Reg. §§ 1.338-6 and 1.338-7).

Section 1060 Regulations (cont'd)

- The 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 from what the purchaser is treated as purchasing. Treas. Reg. § 1.1060-1(b)(4).
  - 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. § 1.160-1(b)(5).
  - As long as any part of the assets are a trade or business, all 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).

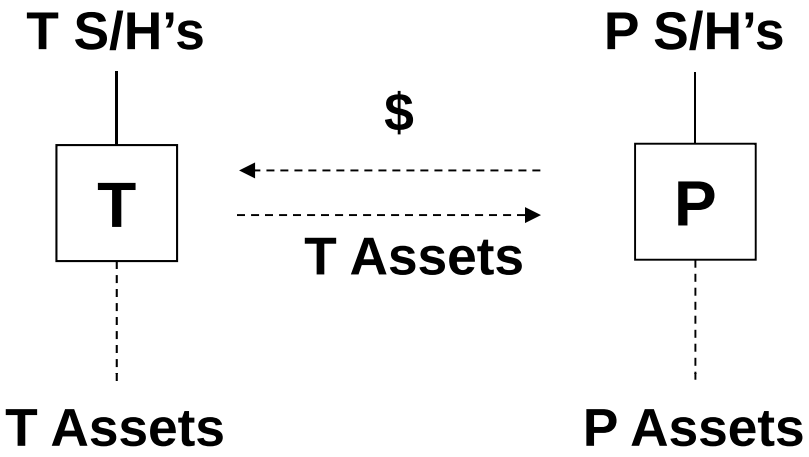
Final Section 1060 Regulations (cont'd)

- If, in connection with an 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 buyer and seller may 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).

Section 1060 Regulations (cont'd)

- The seven asset classes under the section 338 regulations are incorporated in the section 1060 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).

Allocation



- **Purchase Price = $1000**
- **T Assets include:**
  - **Cash: $100**
  - **Stock portfolio $125**
  - **Accounts Receivable $100**
  - **Inventory $150**
  - **Land $150**
  - **Building $200**

- Allocation using Residual Method:
  - Class I (cash) = $100
  - Class II (stock) = $125
  - Class III (accounts receivable) = $100
  - Class IV (inventory) = $150
  - Class V (land + building) = $350

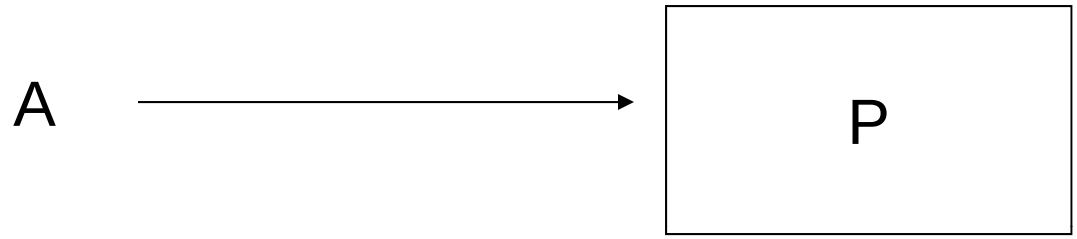
  - Total FMV of Assets in classes I-V = $825

  - Class VII (goodwill and going concern) = $1000 - $825 = $175

Reporting Requirements

- Form 8594. The parties to an applicable asset acquisition are each required to file an information statement:
- Who Must File
  - Both the purchaser and seller are required to file Form 8594.
  - The Form 8594 must be attached to each filer's timely filed Federal income tax return.
  - Taxpayers are not required to file Form 8594 if, pursuant to section 1031, the assets of a trade or business are exchanged for the assets of another trade or business.
- When and Where to File
  - The seller and purchaser must file Form 8594 as an attachment to their respective income tax return for the year in which the sale date occurred.
  - If any amount allocated to an asset is either increased or decreased in a subsequent year, the seller and/or purchaser (whoever is effected by the increase or decrease) must complete Parts I and III of Form 8594 and attach the Form to the income tax return for the year in which the increase or decrease is taken into account.
- Required Information
  - Form 8594 requires the following information:
    - The name, address, and taxpayer identification number of the seller and the purchaser, and the date of the sale/purchase.
    - The total amount of consideration for the assets.
    - The actual amount of Class I assets, and the aggregate fair market value of the assets included in each of Class II, III, IV, V, and VI and VII; Class VI and VII are grouped together on Form 8594.
    - The sum of the aggregate fair market values of all of the Class I - VII assets.
    - The amount of the sales price allocated to each asset Class (i.e., Class I - VI and VII).
    - Whether the allocation of purchase price was provided for in a sales contract or other written document signed by both parties; if the answer is yes, whether the aggregate fair market values for each asset class as listed on Form 8594 are same as the amounts agreed upon in the sales contract or other written document.
    - Whether there is a related covenant not to compete, employment or management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller); if so, the parties must attach a schedule specifying the type of agreement and the maximum consideration (exclusive of interest) to be paid pursuant to such agreement.
- Other Specified Transactions
  - The reporting requirements also apply to certain transactions that ordinarily are not applicable asset acquisitions. These transactions include:
    - A distribution of partnership property or a transfer of a partnership interest where section 755 applies (section 1060(d)(2)); and
    - A transfer by a 10-percent (by value) owner of an entity of any interest in such entity if, in connection with the transfer, the owner (or a related person) enters into an employment contract, covenant not to compete, royalty or lease agreement, or other agreement with the transferee (section 1060(e)(1)); the information to be provided in a section 1060(e) transaction is to be set forth in regulations, which have yet to be issued.

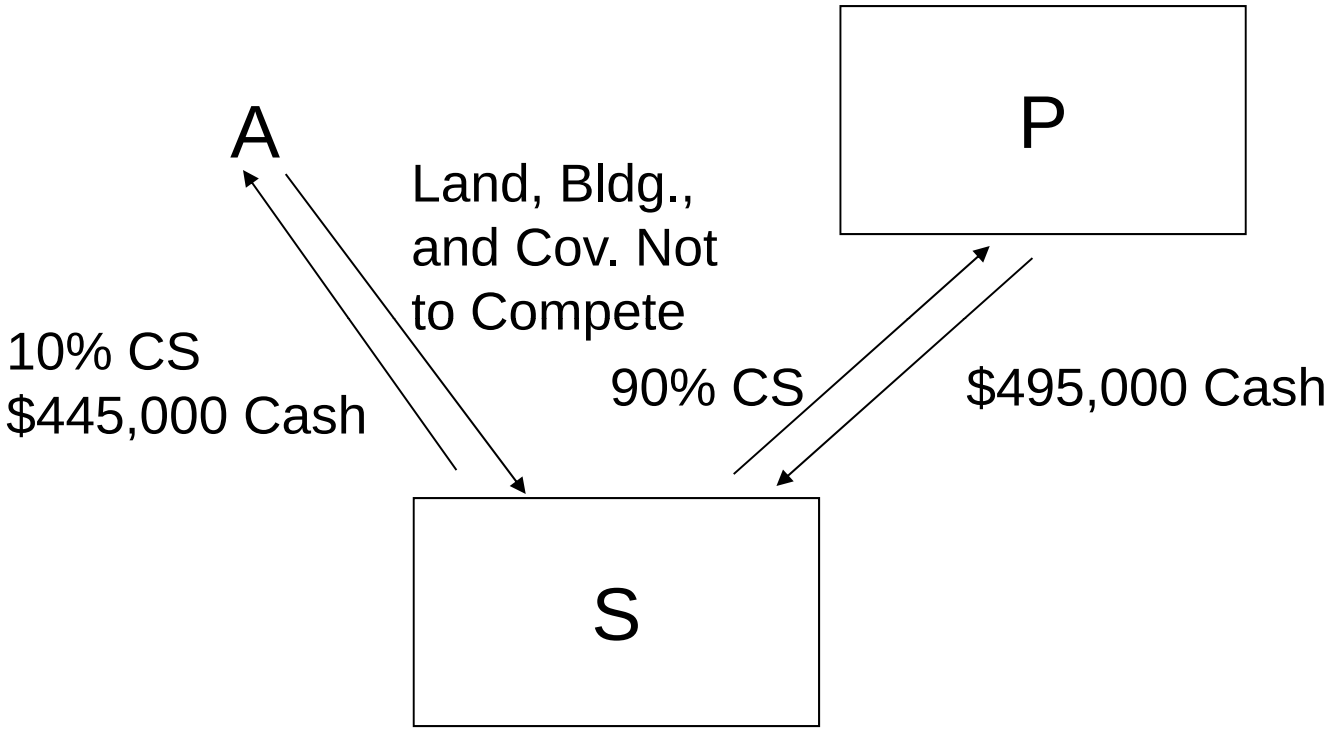
Applicable Asset Acquisition



	FMV	Basis
Land	$150,000	$100,000
Building	$250,000	$0
Covenant Not to Compete	$100,000	

Does section 1060 apply?
Do the assets constitute a trade or business?

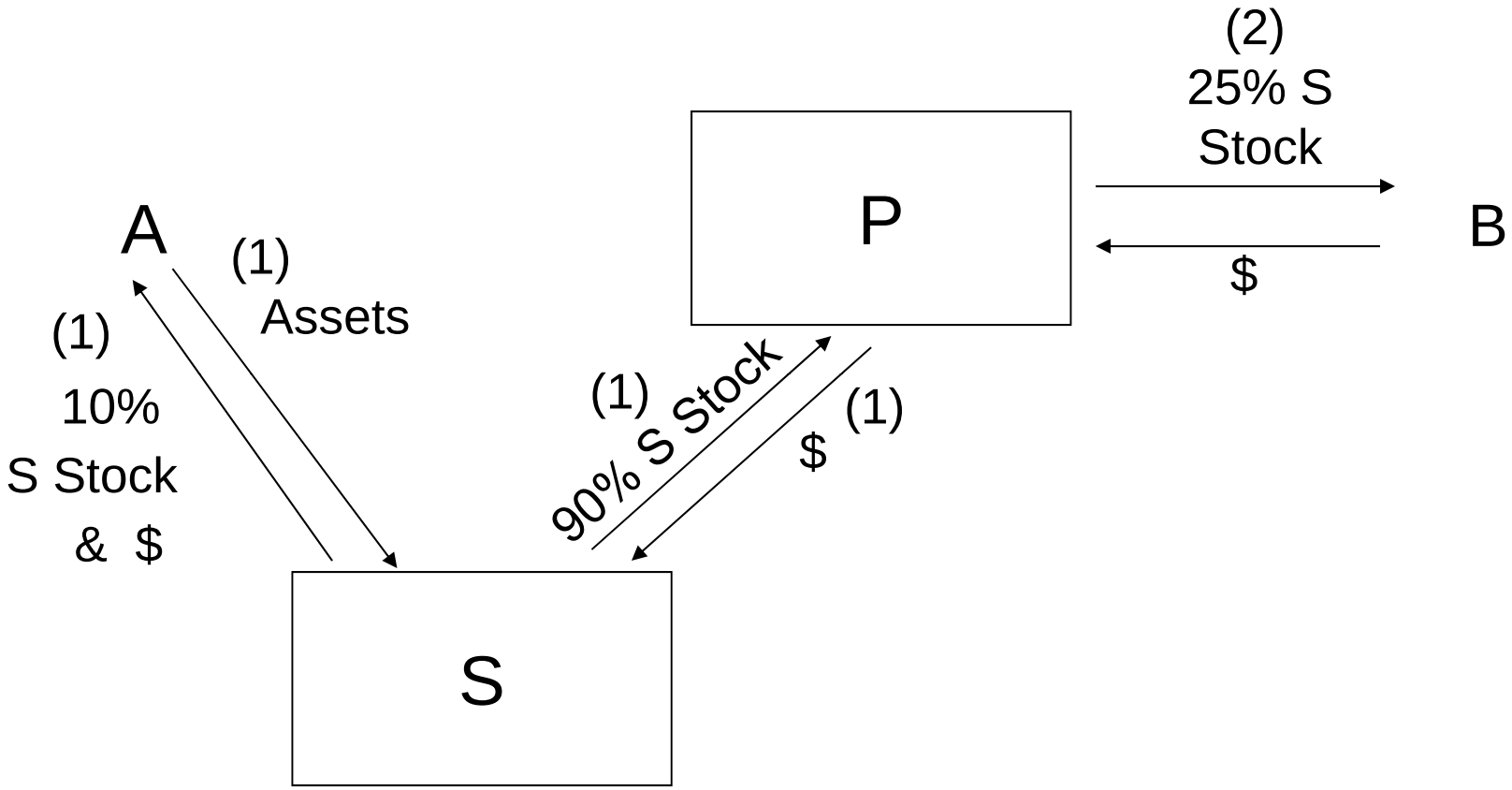
Applicable Asset Acquisition (cont'd)



Section 1060 does not apply.

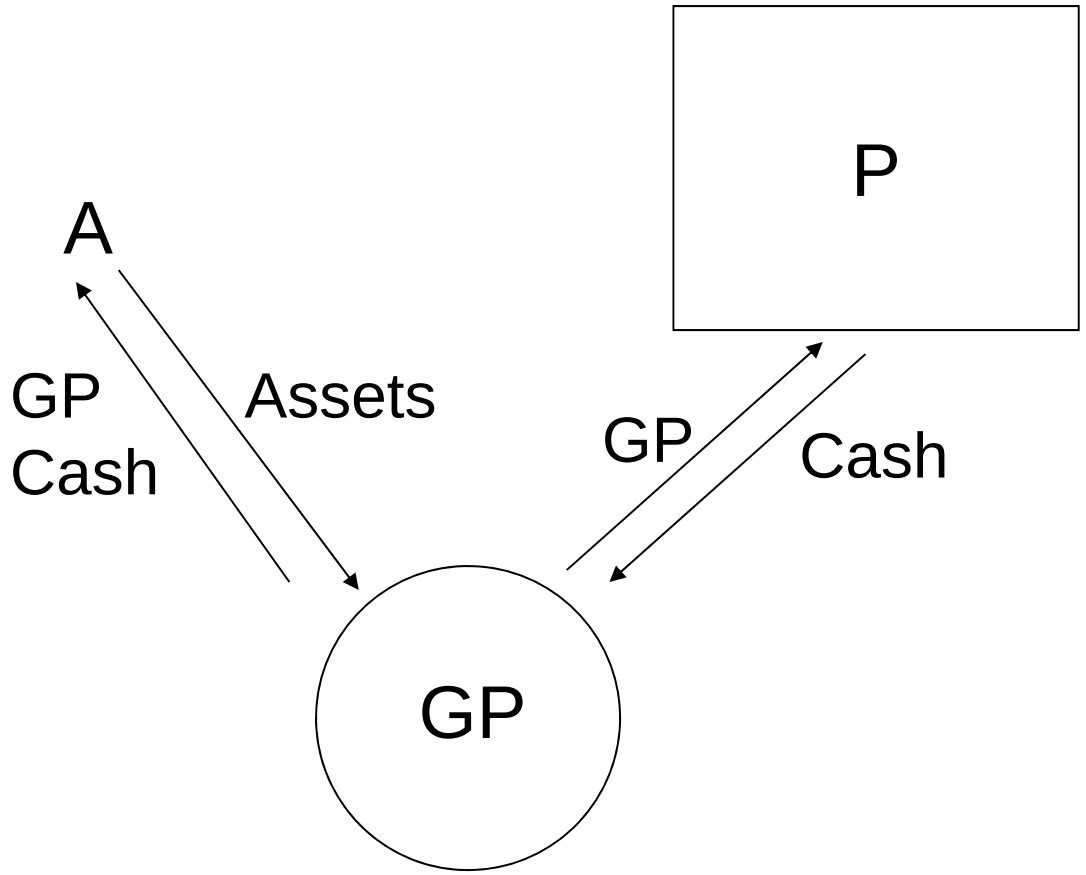
What is S's basis in the assets transferred by A to S?

Applicable Asset Acquisition (cont'd)



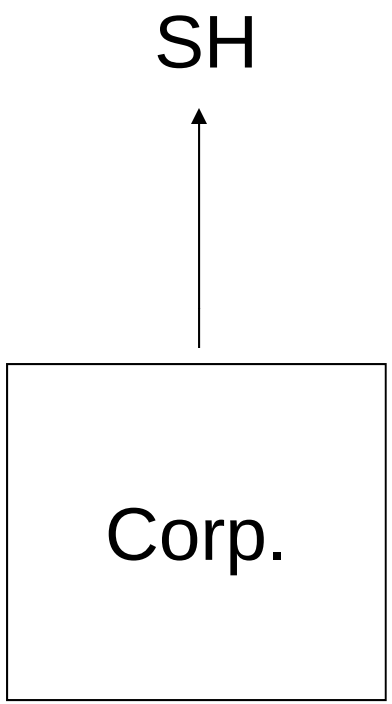
Busted section 351; section 1060 applies.

Applicable Asset Acquisition (cont'd)



Section 707(a)(2)(B).

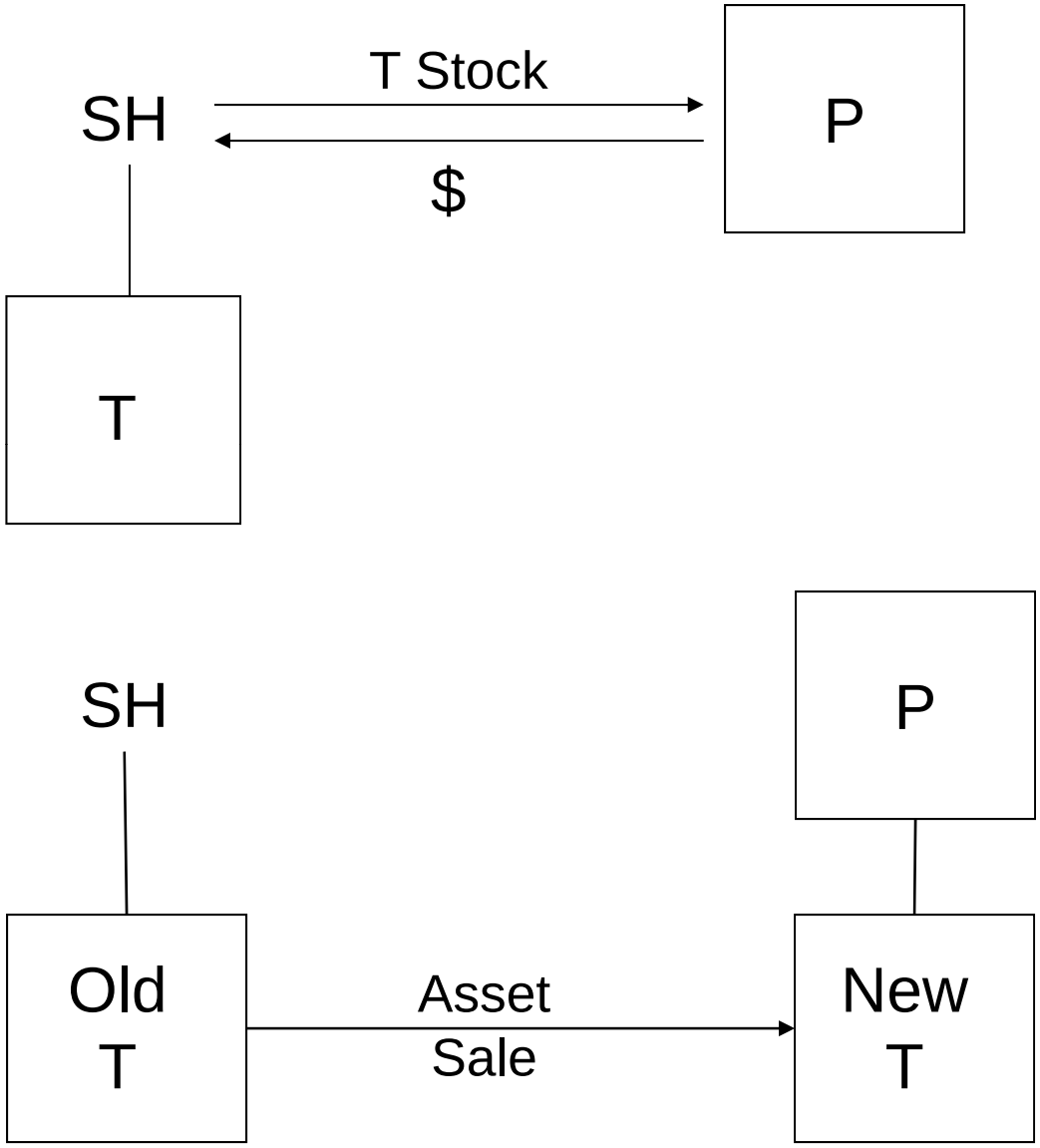
Applicable Asset Acquisition (cont'd)



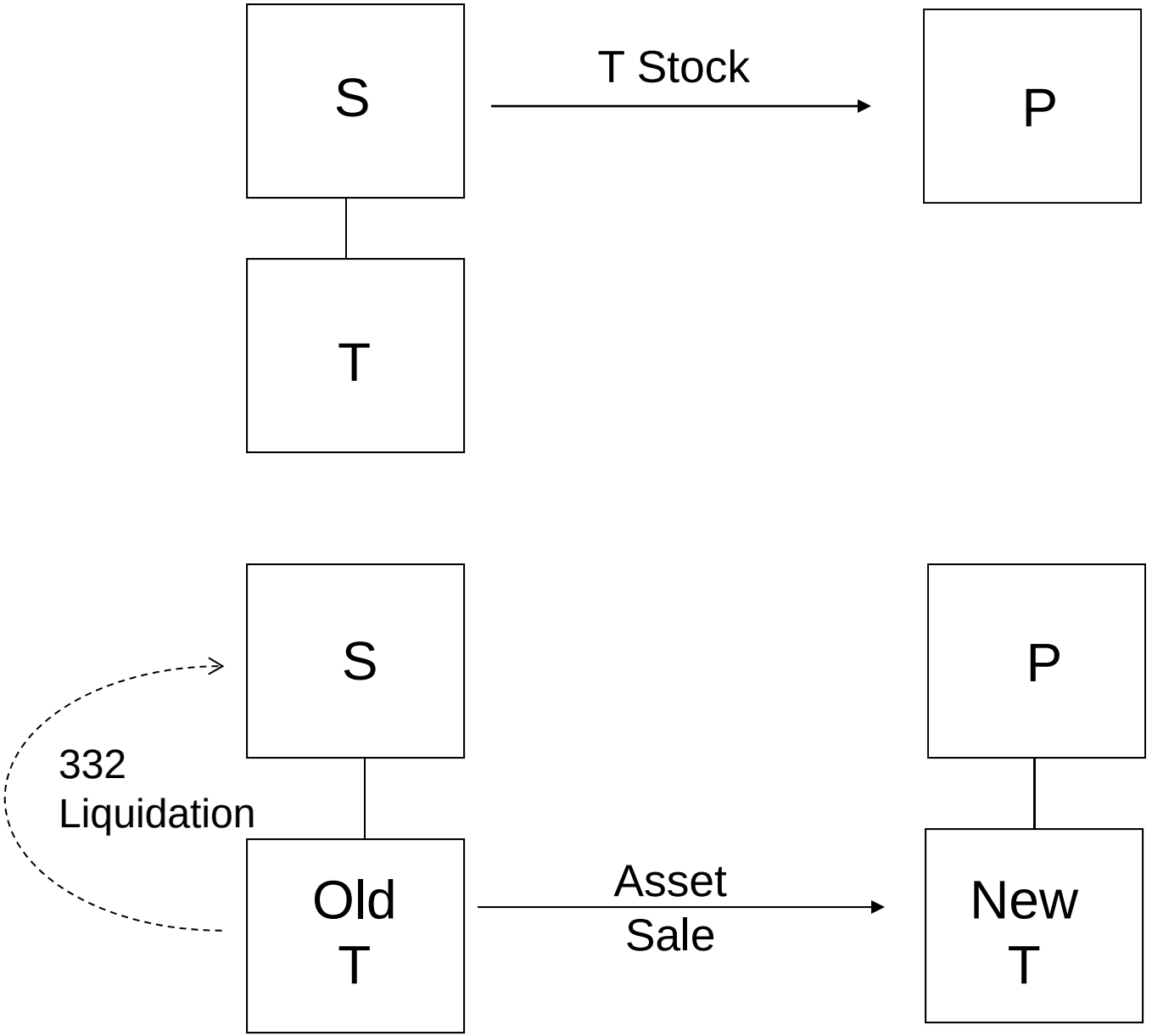
1. Corporation liquidates.
2. Section 302(a) redemption.
3. Section 301 distribution.

Section 338(h)(10) Developments

Section 338



Section 338(h)(10)



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 regulations:
  - Old T is treated as transferring all of its assets by sale to an unrelated person.
  - 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).
  - 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.
  - If T is an S corporation, the deemed asset sale and deemed liquidation are considered as occurring while it is still 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).

Factors influencing desirability of Section 338(h)(10) election

- Where a Section 338(h)(10) election results in T taking stepped-up basis in its assets, P should be prepared to pay more for the stock of T than it would have paid had it acquired T with the historic tax basis in its assets
- The following factors influence the desirability of making a Section 338(h)(10) election:
  - Desire for a stock transaction
  - Cost (or benefit) of the election to S
    - The relative cost or benefit of the election will depend upon whether S pays more or less tax than it would have paid upon a straight stock sale. This difference (if any) will depend, in turn, on the relationship between T's net tax basis (i.e., gross basis less liabilities) in its assets (net inside basis) and S's tax basis in its T stock ("outside basis")
    - The presence of T net operating losses, capital losses, or other attributes
  - The value of the election to P
    - The amount of step-up
    - The allocation of step-up – i.e., whether it goes to short-lived assets, or assets to be soon disposed of, or instead, to 15-year Section 197 intangibles
    - P's ability to realize the benefit of the step-up

Section 338 Regulations: Accounting Rules

- Under the 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.
- 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 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.

Section 338 Regulations

Allocation Rules

- Seven asset classes under the 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).

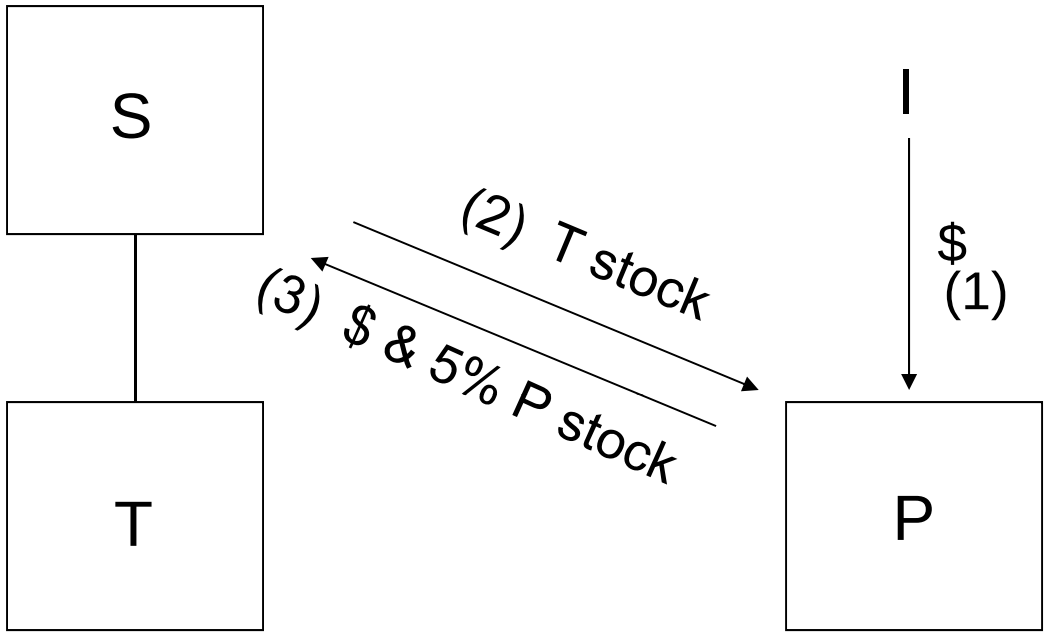
Treas. Reg. § 1.338-3
Qualification for the Section 338 Election

- The regulations include a single definition of purchase applicable to both targets and target affiliates. 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).

Section 338 Regulations

- Definition of "Purchase"
  - The regulations include a single definition of purchase applicable to both targets and target affiliates. 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.
  - Section 338(h)(3)(A) defines the term "purchase" as "any acquisition of stock," subject to the following conditions:
    - The basis of the T stock in the hands of P is not determined (i) in whole or part by reference to the adjusted basis of such stock in the hands of T's former shareholders, or (ii) under section 1014(a) (property acquired from a decedent);
    - The T stock is not acquired in an exchange to which section 351, 354, 355 or 356 applies or in any other transaction described in the regulations in which the transferor recognizes less than all of its realized gain or loss; and
    - The T stock is not acquired from a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) -- the option attribution provision), be attributed to P. The regulations provide that the relationship between the purchaser and seller is tested immediately after the transaction. *See* Treas. Reg. § 1.338-3(b)(3)(ii).
  - Treas. Reg. § 1.338-3(b)(1)
    - "An individual cannot make a qualified stock purchase of target. Section 338(d)(3) requires, as a condition of a qualified stock purchase, that a corporation purchase the stock of target. If an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include new P's merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase."

Qualified Stock Purchase – Effect of Section 351

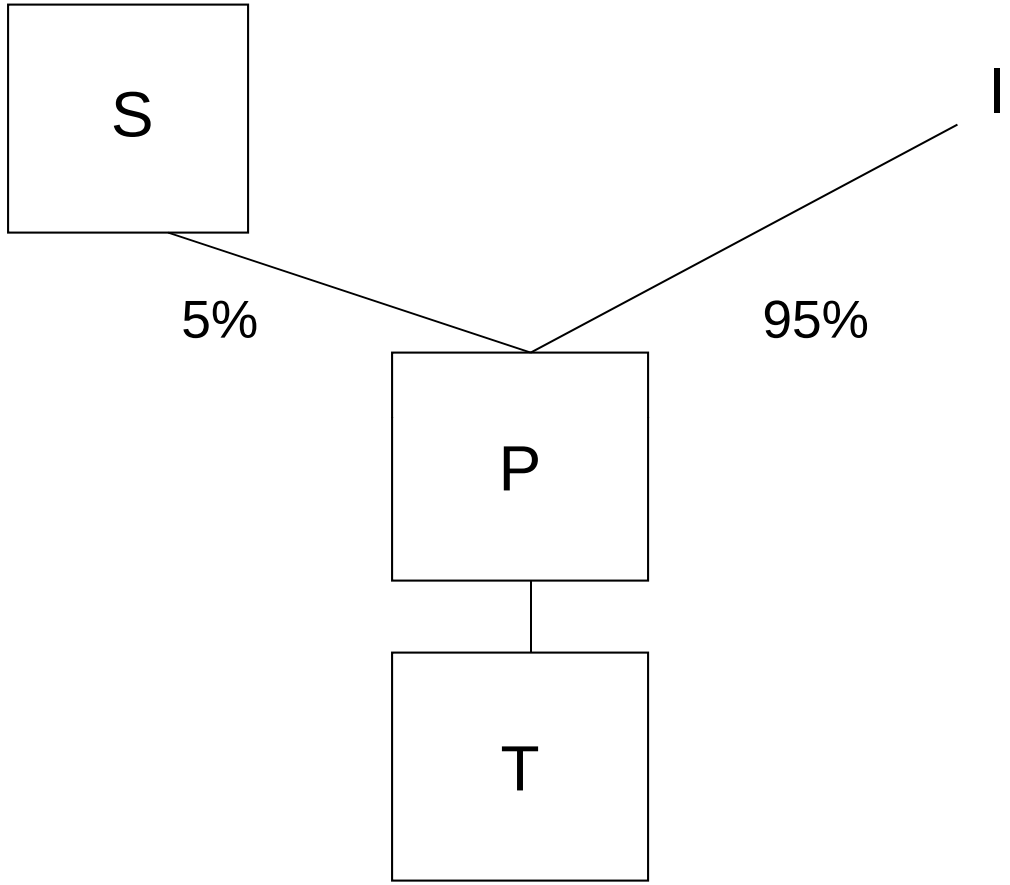


1. Investor (“I”) transfers cash to Newco (“P”)

2. S transfers T stock to P.

3. P transfers cash and 5% of P stock to S.

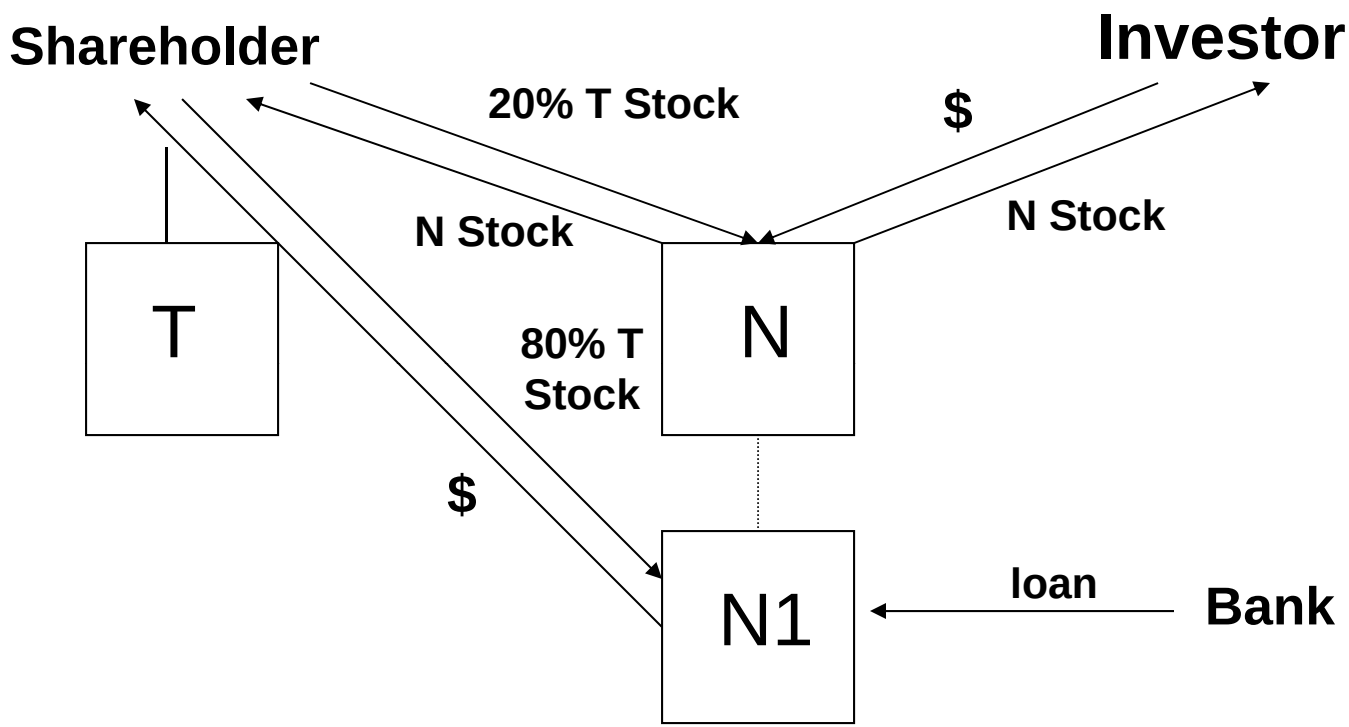
Qualified Stock Purchase – Effect of Section 351 (cont'd)



Variations

- S is several individuals, some shareholders sell P stock, while others do not.
- The transaction is leveraged.

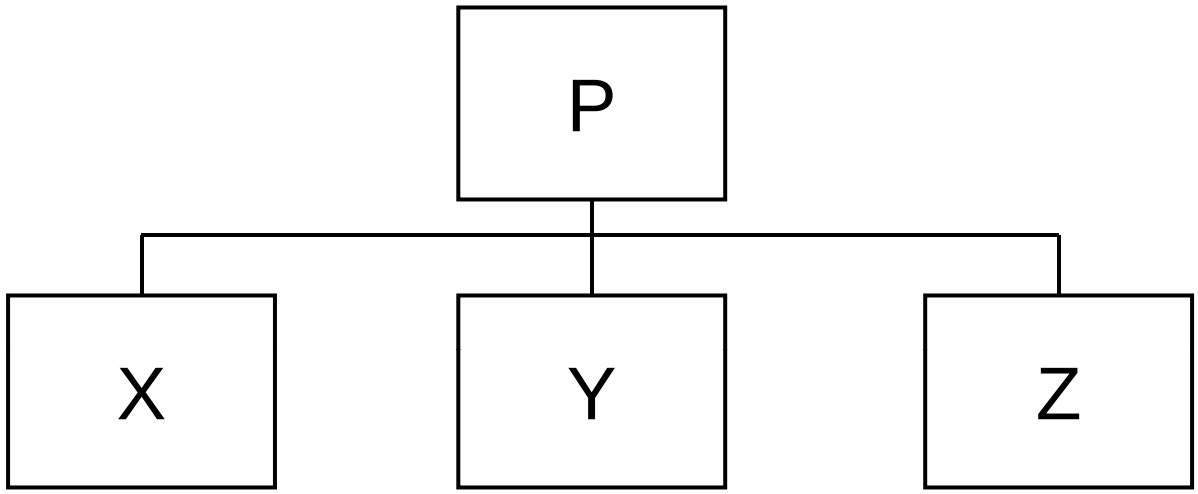
Qualified Stock Purchase – Section 351 (cont'd)



Facts: Shareholder contributes 20 percent of the T stock to N in exchange for N stock, and Investor contributes cash to N in exchange for N stock. N forms N1. N borrows money from Bank. Shareholder sells 80 percent of the T stock to N1 in exchange solely for cash.

Issues: Is the acquisition by N1 of T stock a qualified stock purchase transactions? How is N's non-purchased stock treated?

Section 338(h)(10) and “Busted 351” Transaction

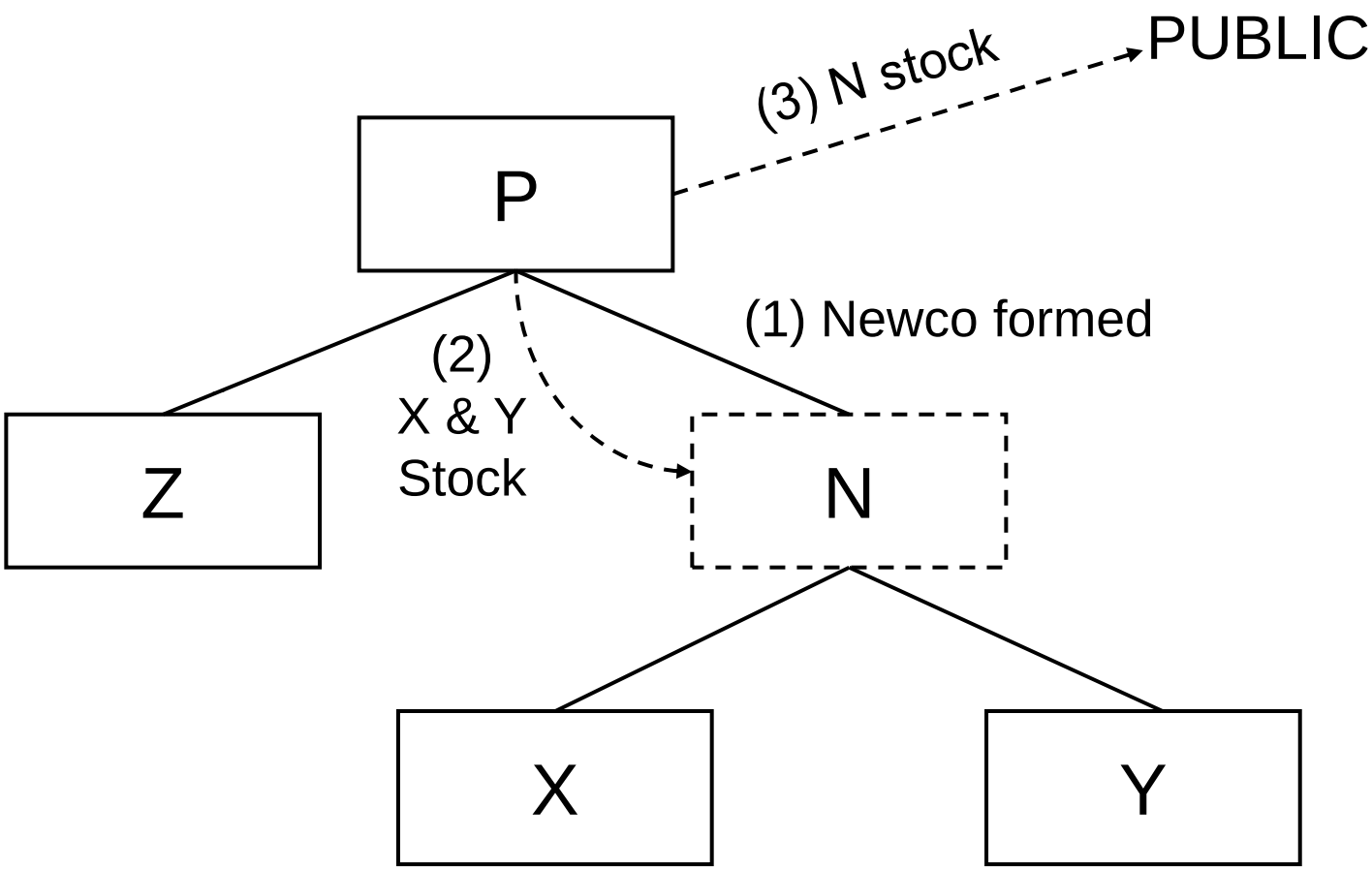


Facts

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.

Section 338(h)(10) and "Busted 351" Transaction (cont'd)



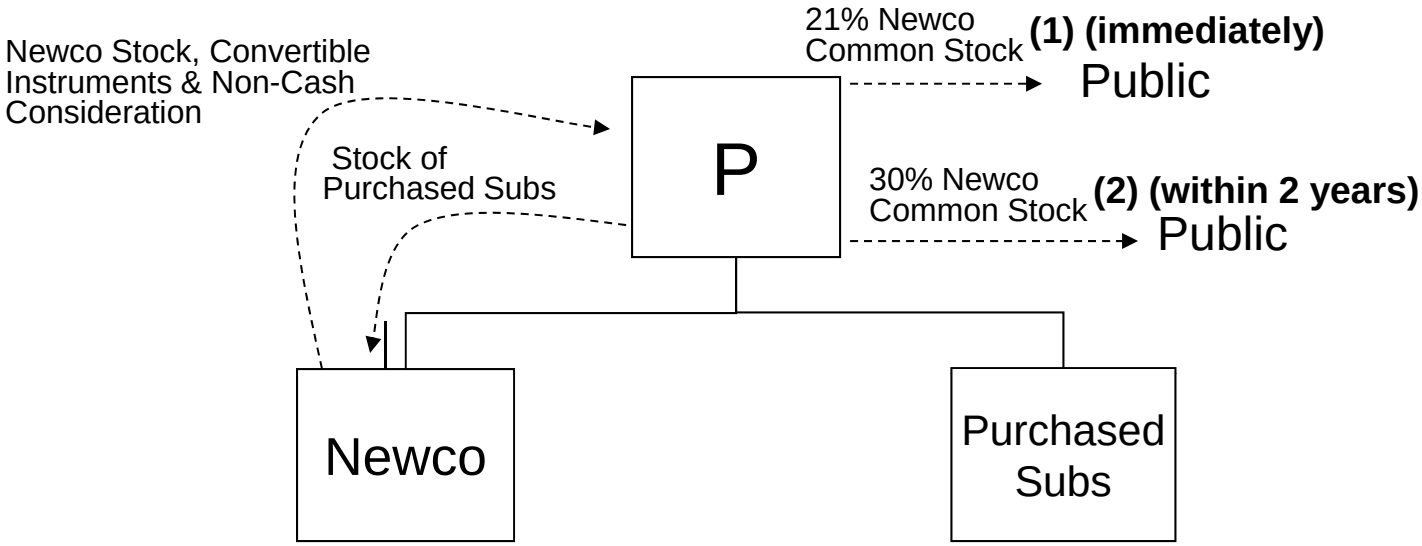
3. P forms Newco (N) and P transfers the X and Y stock to N. Pursuant to a prearranged plan, P sells the N stock to the Public.

Section 338(h)(10) and "Busted 351" Transaction (cont'd)

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; PLR 9541039, as modified by PLR 9549036; PLR 9142013.
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 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* sections 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 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).

PLR 200427011

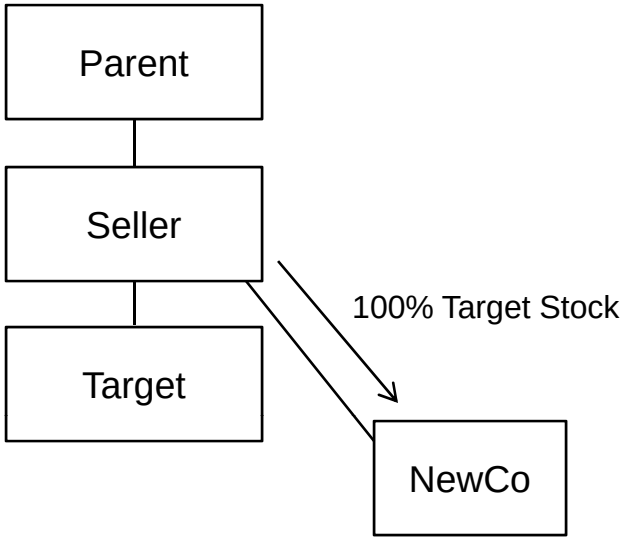


Facts: P was a holding company for a group of corporations (the "purchased subs") which operated in the financial services and insurance industry. P's ultimate owner wanted to reduce its investment in the financial services and insurance business. Accordingly, P's ultimate owner adopted a plan of divestiture and took the following steps: (a) P created a new corporation, "Newco," to which it transferred the purchased subs in exchange for 100 percent of Newco's common stock, 100 percent of a convertible debt instrument, Newco's assumption of certain P liabilities, and additional non-stock consideration; (b) P entered into a firm commitment to sell more than 20 percent of the Newco common stock and substantially all of the convertible debt instrument in a public offering within a certain number of days; and (c) within a certain number of months, P would make a second public offering, reducing its stock interest in Newco to less than 50 percent.

Ruling: The Service ruled that as long as P completed the additional offerings and sales (thereby reducing its direct and indirect ownership of Newco stock to below 50 percent), Newco's acquisition of the purchased subs from P would qualify as a QSP within the meaning of section 338(d)(3), thus making P and Newco eligible to make a section 338(h)(10) election. Thus, the Service effectively ruled that

1. Newco would not have such a carryover basis in the stock of the target subsidiaries (i.e., in the absence of a section 338(h)(10) election, section 302(a) would apply to the deemed payment) and
2. P and Newco would not be in a related party relationship at the time of the exchange. *See* Treas. Reg. § 1.338-3(b)(3)(iv), Example 1.

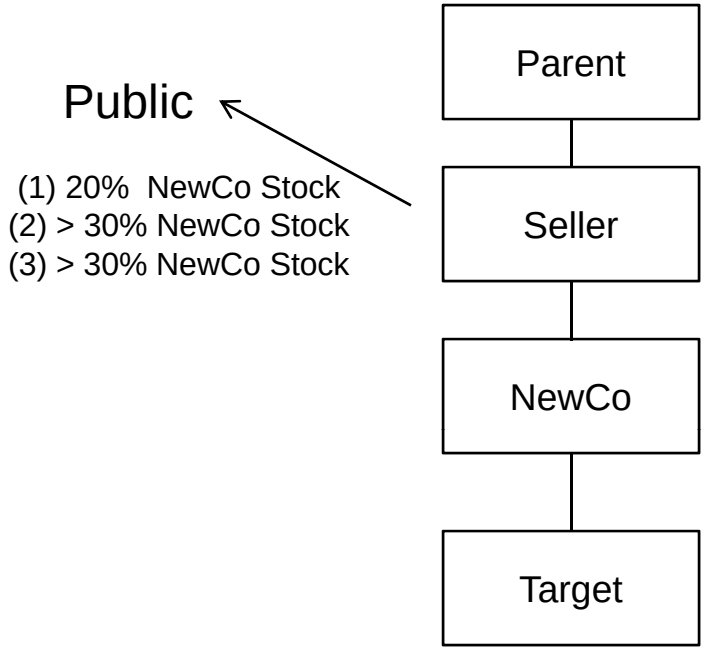
PLR 201228011



Facts
- Parent is the common parent of an affiliated group of corporations filing a consolidated return. Its stock is publicly traded.
- Seller is a holding company.
- NewCo is a newly organized corporation created by Seller to participate in the Proposed Transaction.

Proposed Transaction
- Seller will transfer all of Target's common stock to NewCo in exchange for NewCo preferred stock and NewCo common stock.
- NewCo's only outstanding securities will be the common and preferred stock owned by Seller.

PLR 201228011



Proposed Transaction (cont'd)

- Seller will sell to the public more than 20 percent of the NewCo common stock.
- A section 338(h)(10) election will be made with respect to NewCo's acquisition of Target stock.
- Within X months of the IPO, Seller will sell to the public more than 30 percent of the total shares of NewCo stock, reducing Parent's direct and indirect ownership of NewCo stock to less than 50 percent of the value of NewCo stock.
- Within Y months of the IPO and the 30 percent sale, Seller will sell to the public more than 30 percent of the total shares of NewCo stock, reducing Parent's direct and indirect ownership of NewCo stock to 20 percent or less of the value of NewCo stock.
- Seller thereafter intends to dispose of any remaining NewCo stock.

PLR 201228011

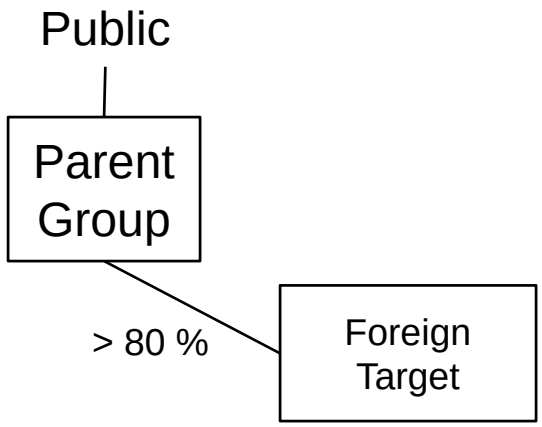
Representations

- "Parent and Seller plan to dispose of at least 80 percent of the vote and value of the NewCo stock in the Proposed Transaction within a certain number of months of the IPO."
- "NewCo [and] Target will cease to be members of the Parent Group at the end of the day upon which more than 20 percent of the NewCo common stock is disposed of in the Initial Sales."

Rulings

- "NewCo's acquisition of all of Target's common stock from Seller in the Exchange will be a 'qualified stock purchase' within the meaning of section 338(d)(3)."
- "Seller and NewCo will be eligible to make the election under section 338(h)(10) with respect to NewCo's acquisition of the Target common stock in the Exchange."
- "Seller will recognize as a corresponding item any loss or deduction it would recognize if section 331 applied to the Deemed Liquidation, subject to the limitations imposed by Treas. Reg. § 1.1502-13(f)(5)(ii)(C)(2)."
- "Provided that neither Parent and NewCo nor Seller and NewCo are members of a controlled group immediately after the Proposed Transaction, the anti-churning rules of section 197(f)(9) and Treas. Reg. § 1.197-2(h) will not apply to any section 197(f)(9) intangible deemed acquired under section 338(h)(10) from Target."

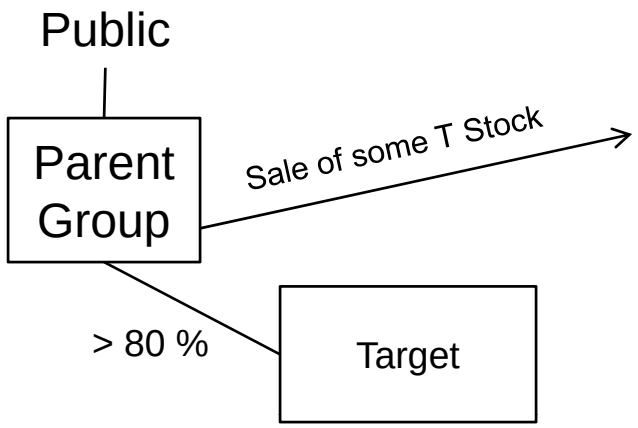
PLR 201216026



Facts

- Parent, a publicly traded corporation, is the parent of an affiliated group (Parent Group) of corporations filing a consolidated U.S. federal income tax return.
- Through a number of transactions, Parent Group purchased more than 80 percent (but less than 100 percent) of the stock of Target within a 12 month period.
- Target is a publicly traded company under the laws of Country Y.
- Under Country Y's securities laws, a publicly traded company must have public shareholders holding more than a 20 percent interest.
- Parent Group does not have the financial capacity to purchase the remaining outstanding Target stock within the required time period.

PLR 201216026



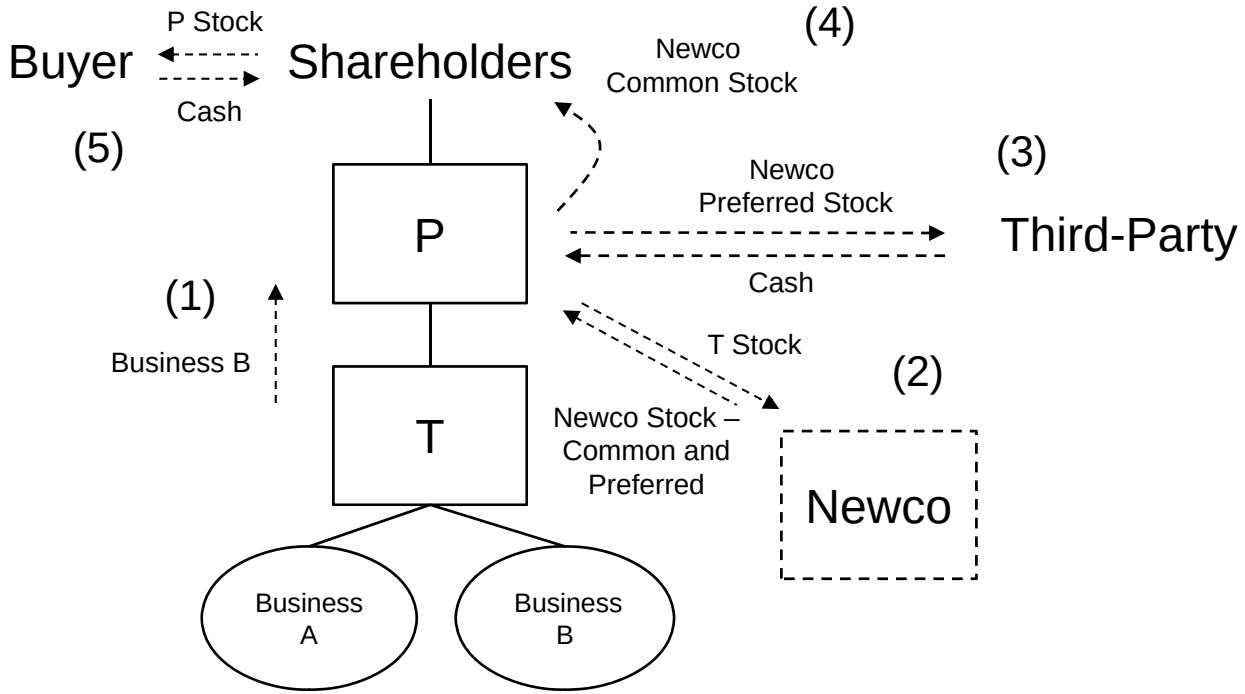
Facts

- To comply with Country Y's laws, Parent Group proposes to sell stock reducing its interest in Target to below 80 percent. When it has the financial capacity to do so, Parent Group intends to acquire all of the Target stock.

Ruling

- "Notwithstanding the proposed … stock sale, the acquisition of Target constitutes a qualified stock purchase within the meaning of section 338(h)(10)."

Intragroup Section 338(h)(10) Election
Example – Recent PLRs

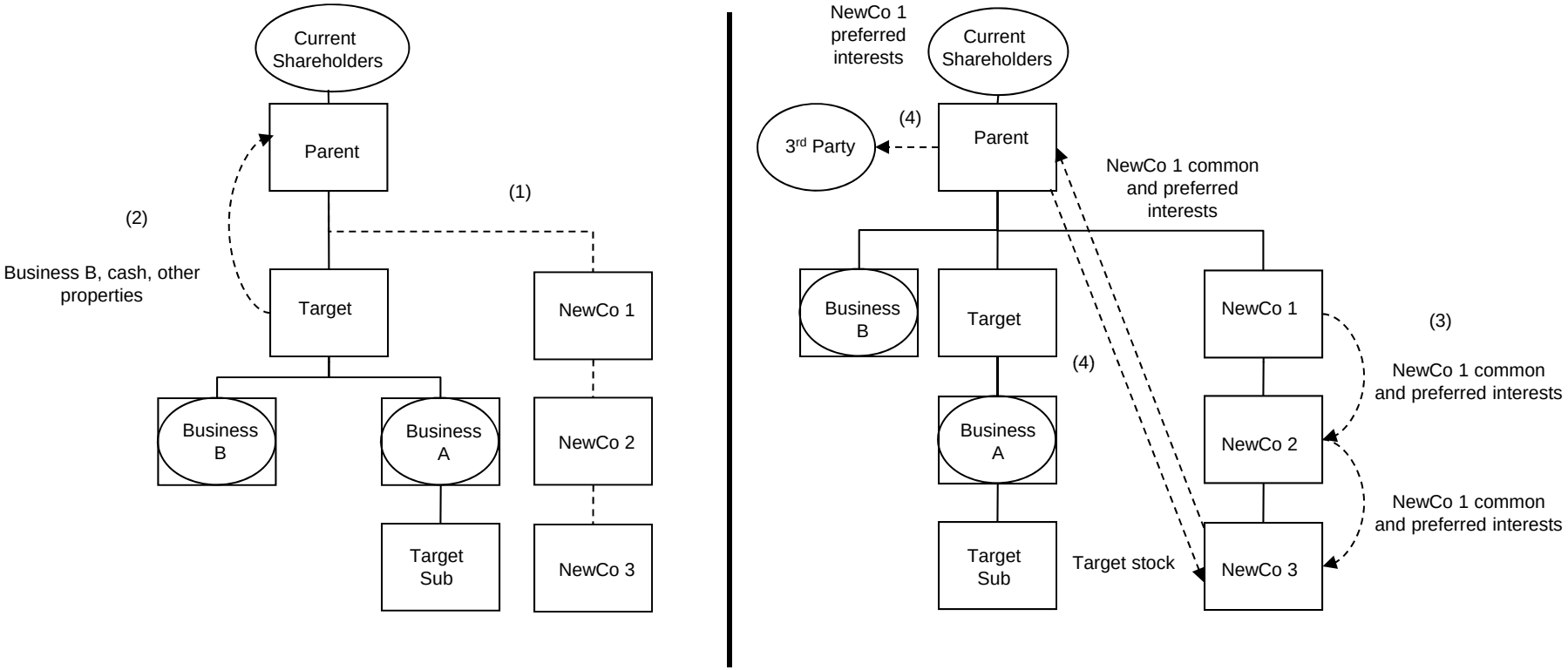


Facts: P is the common parent of a consolidated group. T operates Businesses A and B. T distributes Business B to P. P forms Newco and transfers the stock of T to Newco in exchange for Newco common and preferred stock. Pursuant to a binding obligation, P sells the Newco preferred stock to an unrelated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

Result

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

PLR 201126003



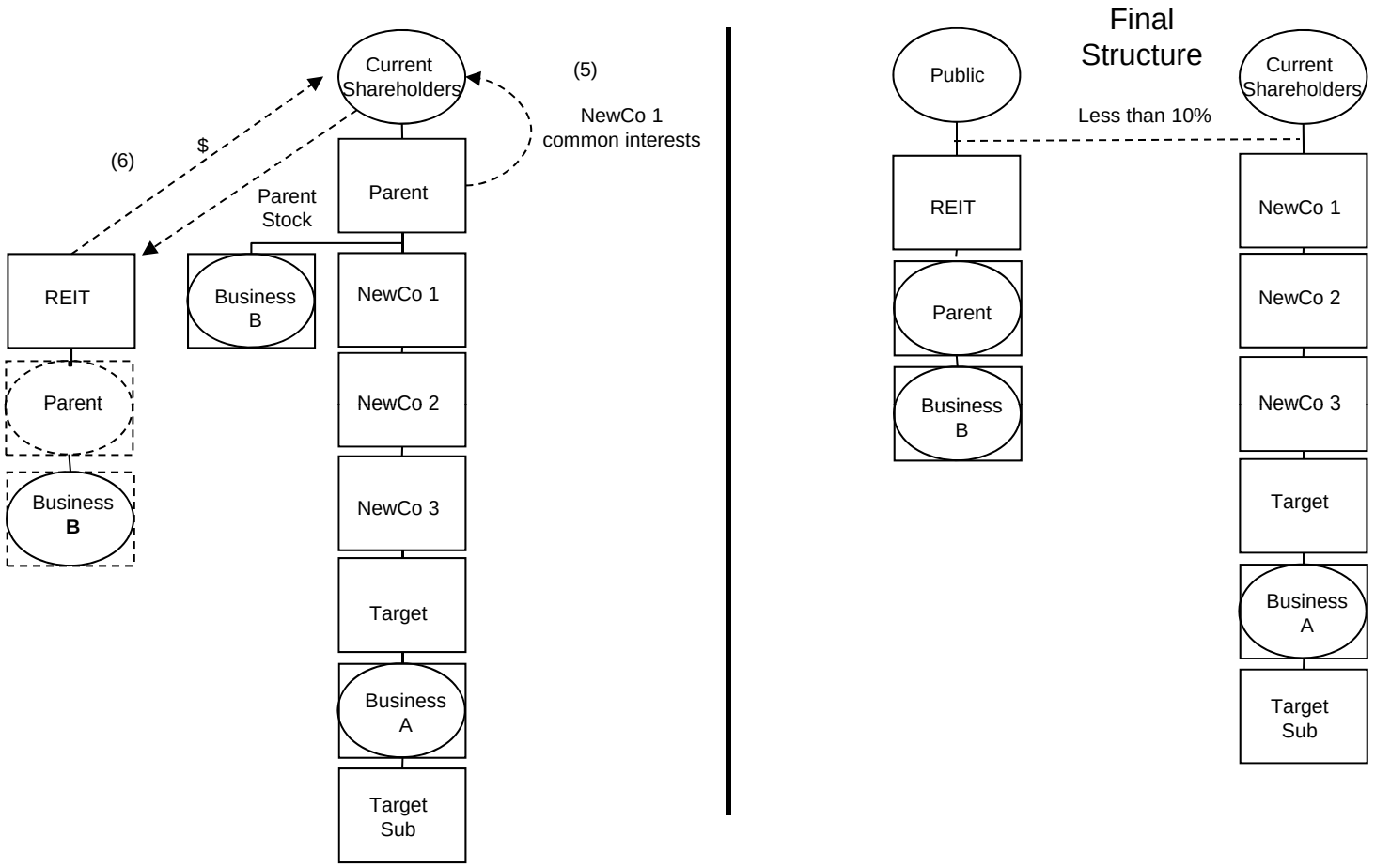
Step 1**:** Parent will form NewCo 1. NewCo 1 will form NewCo 2. NewCo 2 will form NewCo 3. The three entities will be formed as LLCs and will elect to be treated as corporations for federal income tax purposes.

Step 2**:** Target will distribute cash, Business B and various other properties to Parent. This distribution is intended to be part of the deemed section 332 liquidation in connection with the section 338(h)(10) election for Target.

Step 3**:** NewCo 1 will contribute its common membership interests and preferred membership interests to NewCo 2. NewCo 2 will contribute the NewCo 1 common and preferred membership interests to NewCo 3.

Step 4: Parent will transfer 100% of the stock of Target to NewCo 3 in exchange for NewCo 1 common and preferred membership interests. Pursuant to a binding obligation, Parent will transfer the NewCo preferred interests to an unrelated third party. A section 338(h)(10) election will be made with respect to the acquisition of the stock of Target.

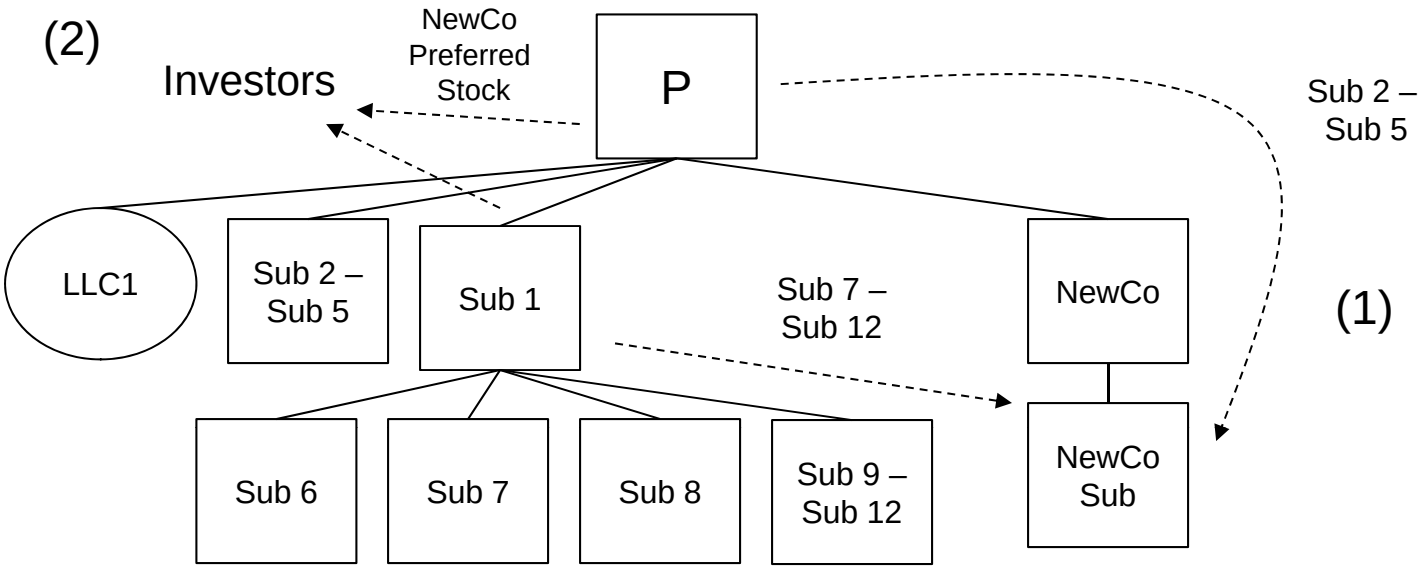
PLR 201126003



Step 5: Parent will distribute 100% of the NewCo 1 common membership interests to the Current Shareholders. The distribution is intended to constitute a dividend pursuant to sections 301 and 316.

Step 6: Current Shareholders will sell their parent stock to REIT and Parent and Business B will elect REIT status. Upon exercise of an option, REIT may acquire 9.9% of NewCo 1's common interests from NewCo 1.

PLR 201145007

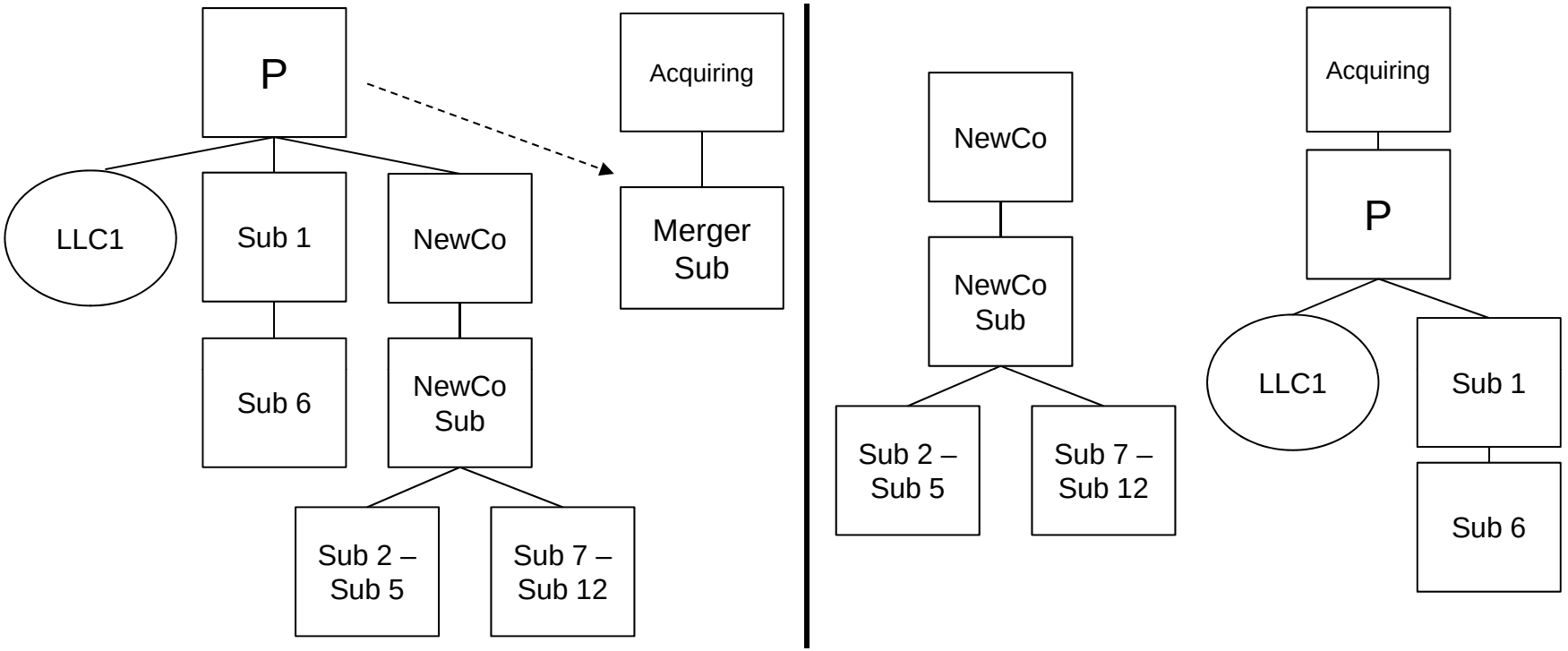


Facts: Parent was the parent of an affiliated group of corporations filing a life-nonlife consolidated return that conducted Business A and Business B. Parent owned all of the stock of Sub 1. Parent also owned (i) all of the interests in LLC1, a disregarded entity that conducted a part of Business A, and (ii) the stock of Subs 2 through 5. Sub 1 owned (i) all of the outstanding stock of Sub 6, which conducted the majority of Business A and a portion of Business B; (ii) Sub 7, which conducted a part of Business B and a part of Business A; (iii) Sub 8, which conducted a part of Business B; and (iv) the stock of Subs 9 through 12.

Parent formed NewCo, which formed NewCo Sub. NewCo issued NewCo common stock and NewCo preferred stock to NewCo Sub. All assets and liabilities relating to Business A were transferred and consolidated in S1, LLC1, and Sub 6, and all assets and liabilities relating to Business B were transferred and consolidated into the remaining applicable Subs.

To separate Business B from Business A, Parent transferred Subs 2 through 5 to NewCo Sub, and Sub 1 transferred Subs 7 through 12 to NewCo Sub. In exchange, Parent and Sub 1 each received a pro rata share of the NewCo common and preferred stock held by NewCo Sub. Parent and Sub 1 immediately sold the NewCo preferred stock to certain investors for cash pursuant to a preexisting agreement, which Parent used to repay certain indebtedness (Sub 1 distributed the cash and NewCo common stock it received to Parent).

PLR 201145007



Facts (cont'd): Acquiring formed Merger Sub, which merged with Parent, with Parent surviving. In the merger, (i) holders of Parent common and preferred stock received NewCo common stock and cash in exchange for their Parent stock, and (ii) Acquiring's membership interests in Merger Sub were converted into shares of Parent common stock. Immediately after the Merger, Acquiring owned 100% of Parent, the investors held all of the NewCo preferred stock, Parent's former common and preferred shareholders had received cash and held all of the NewCo common stock, and neither Parent nor Sub 1 owned any stock in NewCo.

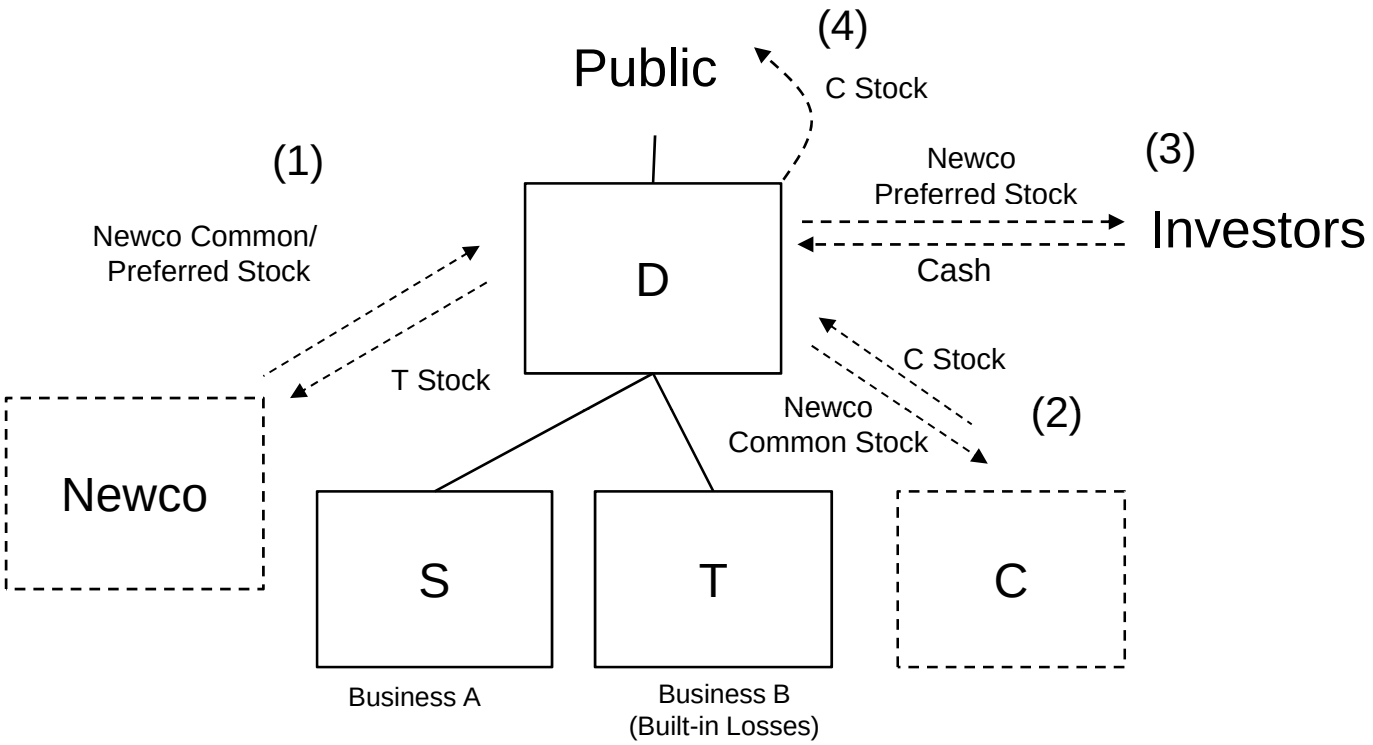
The parties intended to make section 338(h)(10) elections with respect to the transfers of the subsidiary stock made by Parent and Sub 1 (Subs 2-5 and Subs 7-12, respectively) and with respect to the deemed transfers of stock of certain direct and indirect subsidiaries owned by such subsidiaries (Subs 13-39). Parent expected that the deemed asset sales resulting from the section 338(h)(10) elections with respect to the transferred subsidiaries would generate a net ordinary loss, life insurance company loss from operations, or both, and net capital gain.

PLR 201145007

Rulings

- NewCo Sub's acquisitions of the stock of the subsidiaries transferred by Parent and Sub 1 qualify as "qualified stock purchases" under section 338(d)(3), and, assuming a section 338(h)(10) election is made with respect to its direct shareholder, the deemed sale of the stock of each of the lower-tiered subsidiaries (Subs 13-39) resulting from the deemed asset sale of the respective transferred subsidiary will qualify as a QSP.
- Parent (as the common parent of the selling consolidated group) and NewCo Sub (by the common parent of its consolidated group) will be eligible to make section 338(h)(10) elections with respect to such QSPs.
- Parent's group will be entitled to deduct in the taxable year ending on the closing date of the Merger, to the extent otherwise deductible, losses recognized by the subsidiaries transferred (directly and indirectly) by Parent and Sub 1 on the deemed sales of their assets.
- Neither NewCo nor NewCo Sub will be a successor to Parent for purposes of section 1504(a)(3), and NewCo and its direct and indirect subsidiaries that are includible corporations and that satisfy the ownership requirements of section 1504(a)(2) will be members of an affiliated group of corporations entitled to file a consolidated federal income tax return immediately following the Merger.

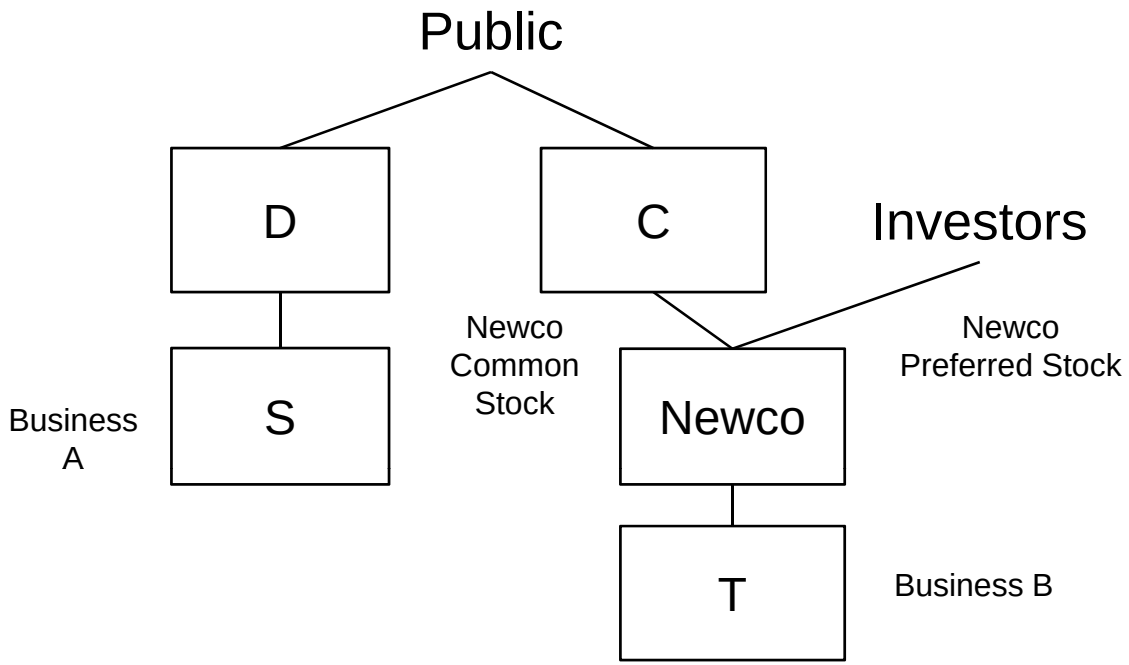
PLR 201203004



Facts

- D, a publicly-traded corporation, owns all of the stock of S (which operates Business A) and T (which operates Business B). T's assets have built-in loss.
- To separate Business A from Business B, D engages in the following steps:
  - D forms Newco and transfers the T stock to Newco in exchange for all of the stock in Newco, which includes common stock and non-voting preferred stock. D and Newco file a section 338(h)(10) election. D expects to recognize substantial tax losses with respect to the Business B assets held by T in connection with the contribution to Newco.
  - D forms C and contributes all of the Newco common stock to C in exchange for all of the stock of C.
  - D sells all of the Newco non-voting preferred stock to unrelated Investors.
  - D distributes all of the C stock to its shareholders (pro rata).

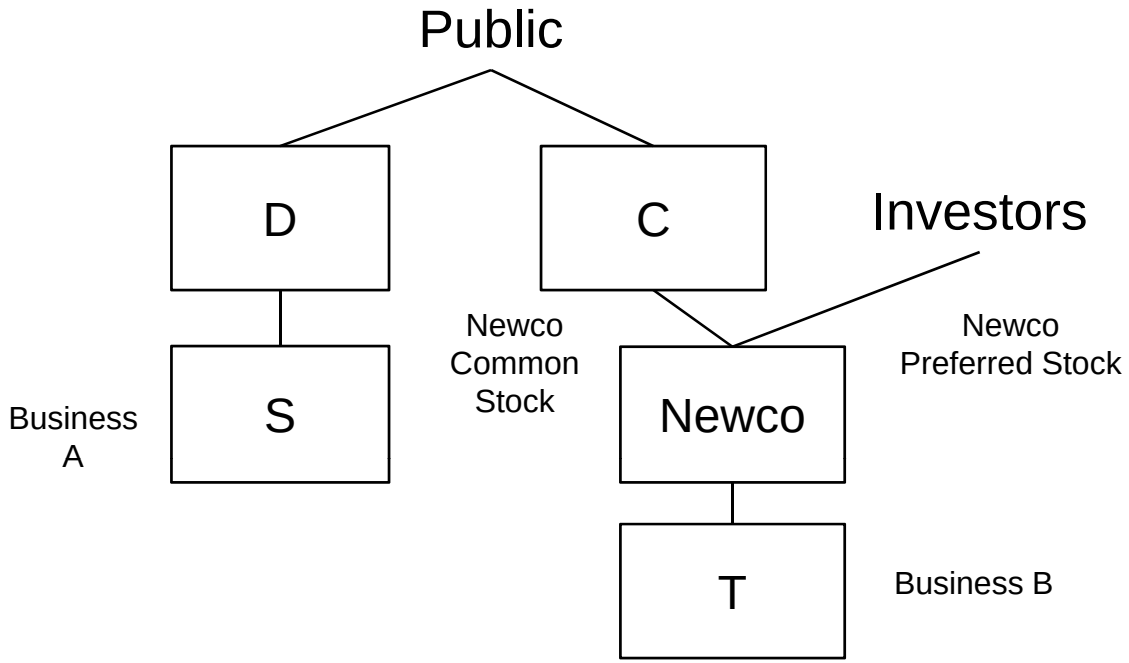
PLR 201203004



Rulings

- D's transfer of the T stock to Newco is a sale, Newco's acquisition of T will be a "qualified stock purchase," and D and Newco will be eligible to make a section 338(h)(10) election. Section 338(d)(3), (h)(3).
  - The transaction is a "busted" section 351 exchange, and thus taxable, because of D's sale of the Newco preferred stock. Section 338(h)(3)(A)(i), (ii).
  - No attribution of ownership (section 318(a)) from D to Newco (section 338(h)(3)(A)(iii)), because relatedness is determined immediately after the spin-off of C. Treas. Reg. § 1.338-3(b)(3) (Stock acquired from a related corporation is generally not considered acquired by purchase).
  - T recognizes built-in loss on deemed asset sale to New T. Treas. Reg. §§ 1.338(h)(10)-1(d)(2)-(4).
  - T's loss is taken into account immediately before the spin-off of C. Treas. Reg. §§ 1.267(f)-1(a)(2), 1.1502-13(d).

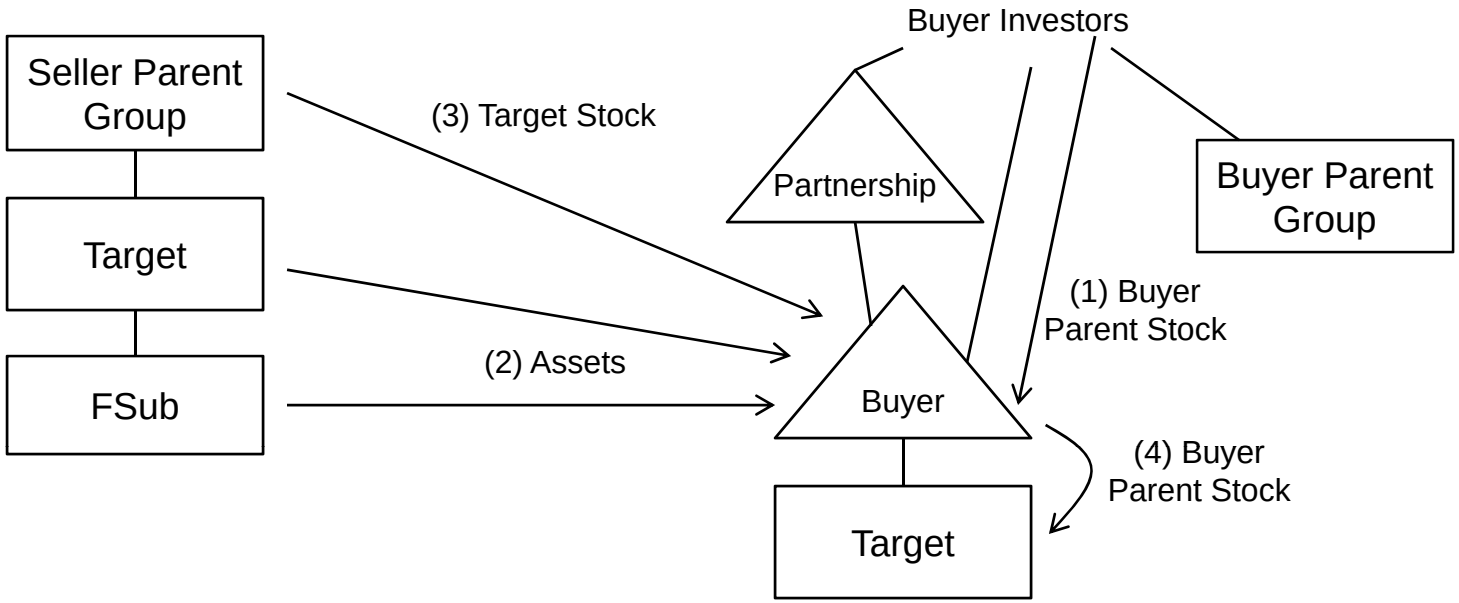
PLR 201203004



Rulings

- D's contribution to C and its distribution of the C stock qualify as a "D" reorganization.
  - No gain or loss is recognized by D's shareholders or D on the distribution of C stock. Sections 355, 361.
  - D controls C under section 368(c); it does not matter that C does not control Newco.
  - S's Business A qualifies as D's active trade or business ("ATB"), because S is a member of D's separate affiliated group ("SAG"). Section 355(b)(3); Prop. Treas. Reg. § 1.355-3(b)(1)(ii).
  - T's Business B qualifies as C's ATB (T is a member of C's SAG). Section 355(b)(3); Notice 2007-60.

PLR 201213013



Facts

- Seller Parent Group and its shareholders wish to sell the stock of Target.
- Buyer Investors want to purchase the assets of Target.
- (1) Buyer Investors transfer stock of Buyer Parent Group to Buyer. Buyer and Partnership were formed for purposes of the transaction.
- (2) Buyer purchases for cash consideration certain assets of Target and FSub.
- (3) Buyer purchases for cash consideration the stock of Target.
- (4) Buyer transfers Buyer Parent into Target

Outcome

- Because there is no corporate purchaser, there is no qualified stock purchase and section 338 and its consistency rules will not apply.
- The section 1060 allocation will only apply to the purchased assets, so Buyer can choose the assets which will be subject to section 1060.

Proposed Regulations Under Section 336(e)

Proposed Regulations Under Section 336(e)

- Section 336(e), adopted as part of *General Utilities* repeal in 1986, provides that, "under regulations prescribed by the Secretary," a corporation ("Parent") may treat a disposition of stock of a subsidiary ("Target") as a disposition of the assets of Target (not a disposition of the Target stock), if –
  - Parent owns enough stock in Target to satisfy section 1504(a)(2), i.e., 80 percent of total voting power and 80 percent of fair market value, and
  - Parent sells, exchanges or distributes all of such Target stock.
- This provision is viewed as an expression of section 338(h)(10) principles beyond situations in which –
  - Parent sells 80 percent or more of the stock of Target to another corporation, or
  - S corporation shareholders sell more than 80 percent of their stock to a corporation.
- IRS has made clear its position that section 336(e) is not self-executing, i.e., that no election can be made until regulations become effective. CCA 201009013 (March 5, 2010).
- On August 25, 2008, IRS and Treasury issued proposed regulations under section 336(e). 73 Fed. Reg. 49965.
  - Based on recent comments from IRS officials, it is anticipated that final regulations under section 336(e) will be issued in early 2013.

Proposed Regulations Under Section 336(e)

- The proposed regulations would expand the scope of elective deemed asset sale treatment to cover any taxable "disposition" (a term with a meaning similar to "purchase" under section 338 but broader, to include distributions as well as sales) or series of dispositions by a domestic Parent (or its consolidated group) of stock of a domestic Target, if the total stock disposed of, to non-related persons within 12 months, satisfies section 1504(a)(2). Parent would not need to dispose of all of its Target stock.
- Examples of covered transactions include:
  - Sale of Target stock to a partnership, individual or group of individuals, domestic or foreign.
  - Distribution of Target stock to shareholders to which section 355 does not apply, either a pro rata dividend or a non pro rata redemption.
  - Distribution of Target stock to which section 355 applies but is taxable to Parent under section 355(d) or section 355(e), either a pro rata dividend or a non pro rata redemption.
  - Combinations of the above within 12 months.
- Unlike the section 338(h)(10) election, the election to apply the section 336(e) regime is not joint but is unilateral to Parent. The Acquiror or Acquirors of the Target stock would have to require (or prevent) this election by agreement.
- The election does not apply to sales or distributions of Target stock to persons related to Parent. A person is treated as related if stock owned by that person would be attributed to Parent under section 318(a) (other than the option rule in section 318(a)(4)), i.e., generally a 50-percent-or-more overlap in ownership, directly, indirectly or through family relationships. Related party status is determined after the disposition: if there is a series of dispositions making up a "qualified disposition," after the last disposition; or, if there is a series of transactions "effected pursuant to a plan to dispose of [T]arget stock," after the last transaction. Prop. Treas. Reg. §1.336-1 (b)(4)(iii); Treas. Reg. §1.338-3(b)(3)(ii). Query: What is the scope of such a series of transactions?

Proposed Regulations Under Section 336(e)

- The consequences of the related person rule include the following:
  - Section 336(e) cannot change an intercompany stock sale under section 304 into an all-cash type-D reorganization.
  - A taxable intra-group spin-off (either fully taxable or taxable to Parent alone under section 355(d) or section 355(e)) would not qualify for the election. As the preamble states, section 355(f) aggravates this situation by "turning off" section 355 for intra-group spinoffs that are followed by external spin-offs subject to section 355(e).
- IRS and Treasury have requested comments as to whether the section 336(e) election should be made available for related-party stock dispositions and, if so, how to prevent abuse (*e.g.*, use of loss carryovers, manipulation of earnings and profits and changes in accounting methods), and how to deal with section 355(f).
- The section 336(e) election would not be available if either Parent or Target is foreign. Some or all of the acquirors of the Target stock may be foreign persons. IRS and Treasury have requested comments on how the rules should be modified to take into account international tax policies if the election were made available in any of these situations.

Proposed Regulations Under Section 336(e)

- If Parent makes a section 336(e) election in a stock sale, the construct is similar to that of a section 338(h)(10) stock sale. The following transactions are deemed to occur:
  - Target is deemed to sell all its assets to "New Target."
  - Target's amount realized is equal to the aggregate deemed asset disposition price ("ADADP"), allocated among the assets, as under sections 1060 and 338. ADADP is the sum of:
    - Amount realized on the sale of the Target stock (or, in the case of a distribution of Target stock, the fair market value of the distributed stock).
      - Grossed up to take into account the stock not disposed of.
    - Plus Target's liabilities.
- New Target's asset basis is determined by adjusted gross up basis of recently purchased stock ("AGUB"), as under section 338. But only non-recently purchased stock owned by 10-percent stockholders is used in the AGUB formula.
- Thereafter Target is deemed to transfer the consideration received in the deemed asset sale to Parent, generally in a section 332 liquidation.
- If the assets deemed sold include the stock of a subsidiary ("Sub"), the deemed sale of the Sub stock is eligible for a section 336(e) election (not a section 338(h)(10) election).
- Parent's sales of Target stock are disregarded so long as they occurred during the 12 months ending on the day the election became available (the "disposition date").

Proposed Regulations Under Section 336(e)

- If Parent retains any Target stock, Parent is treated as buying the stock so retained from New Target at fair market value on the disposition date. It appears that no gain or loss is recognized on this deemed transaction.
  - A non-selling minority shareholder has no tax consequences, unless it makes a "gain recognition election" to recognize gain on the stock and obtain a stepped-up basis.
  - A selling minority shareholder is treated like any other stock seller.
  - An acquirer of Target stock is treated like any other stock buyer or distributee.
  - If a minority shareholder buys Target stock, it has a mandatory gain recognition election. The result is the same as the result in a section 338(h)(10) sale of stock to a minority shareholder. Treas. Reg. §1.338(h)(10)-1(d)(1).
- If Parent makes a section 336(e) election for a taxable (non-section 355) stock distribution (pro rata or non-pro rata), the deemed transactions are similar to those in a sale, with twists:
  - Target is deemed to sell all its assets to New Target.
  - Gains are recognized, but losses are disallowed in proportion to the amount of stock distributed (vs. sold) to implement the policy of section 311(b).
  - Target is deemed to distribute the consideration deemed received for the assets to Parent (generally a section 332 liquidation).
  - Parent's earnings and profits are adjusted to reflect gain or loss on the deemed asset sale and transfer by Target.

Proposed Regulations Under Section 336(e)

- Parent is deemed to purchase from New Target the New Target stock that is distributed.
  - No gain or loss is recognized to Parent in the stock distribution.
  - The distributees take fair market value basis, as in any other taxable distribution.
- If Parent distributes Target stock in a distribution subject to section 355(d) or section 355(e), the section 336(e) election is available. If the election is made, the deemed transactions are as follows:
  - Target is deemed to sell all its assets to an unrelated person and then re-acquire the assets ("sale-to-self" treatment).
    - Target's amount realized on the deemed sale is determined under ADADP principles.
    - Target's basis in the assets deemed sold and re-acquired is determined under AGUB principles.
  - In a spinoff under section 355(d) or section 355(e), the distributee shareholders do not take a cost basis in the stock, and the AGUB formula would produce a mismatch between amount realized and basis in the deemed asset sale.

Proposed Regulations Under Section 336(e)

- There is no deemed liquidation of Target or any other deemed transfer of asset sale consideration.
- Parent's distribution of the Target stock is given effect.
  - Thus, Target's tax attributes remain intact. Target's earnings and profits are adjusted to reflect gain or loss on the deemed asset sale.
- Target's gains in the deemed asset sale are recognized in full, but Target's losses are disallowed in proportion to the amount of stock distributed.
  - If Target's assets include stock of Sub, that stock is deemed sold. The section 336(e) election is available for that transaction. The deemed transactions are those for a stock sale.

Requirements for Section 336(e) Election

- Seller is a domestic corporation.
- Qualified stock disposition.
  - One or more dispositions of stock if the stock disposed of, in total, meets the requirements of section 1504(a)(2) (80 percent vote and value).
  - Taxable sale, exchange or distribution.
  - During 12-month disposition period.
- Not a qualified stock purchase under section 338(d)(3).
- Election filed under Prop. Treas. Reg. § 1.336-2(h).

Section 338(h)(10) vs. Section 336(e)

- The proposed regulations rely on the structure and principles of section 338(h)(10) when they are consistent with the purposes of section 336(e). Prop. Treas. Reg. § 1.336-1(a).
- Unlike the section 338(h)(10) election, the election to apply the section 336(e) regime is not joint but is unilateral to the seller. However, the election affects both the seller and Target (and therefore the acquiror of the Target stock). Thus, the acquiror would have to require or prevent this election by agreement.

Section 338(h)(10) vs. Section 336(e)

338(h)(10)	336(e)
Election jointly made by Seller and Buyer	Unilateral election by Seller (may necessitate inclusion of a covenant if representing Buyer)
Seller must be a corporation or Target must be an S Corp	Seller must be a corporation – thus election unavailable for disposition of an S Corp
Buyer must be a corporation	Buyer need not be a corporation
Requires a sale of 80%	Requires any combination of sales and distributions totaling 80%
Sale – *see* Slide 68 for deemed transaction	Sale/Exchange – treated similarly to 338(h)(10)
Distribution – not available	Distribution – *see* Slide 74 for normal distrib and 77 for 355 distrib when 355(d)(2) or (e)(2) applies
Not available for a disposition to related person	Not available for a disposition to related person
Not available if Seller or Target is foreign	Not available if Seller or Target is foreign
If eligible for 338(h)(10) and 336(e), can only elect under (h)(10)	

Section 336(e) vs. Section 338(h)(10) Modifications to terms in Treas. Reg. §1.338-5

338	**336(e)**
■ Section 338 or 338(h)(10) election	■ Section 336(e) election
■ Purchasing corporation	■ Purchaser
■ Selling consolidated group/affiliate	■ Seller
■ Qualified stock purchase	■ Qualified stock disposition
■ Acquisition date	■ Disposition date
■ 12-month acquisition period	■ 12-month disposition period
■ Recently/nonrecently purchased stock	■ Recently/nonrecently disposed stock
■ Aggregate deemed sales price (ADSP)	■ Aggregate deemed asset disposition price (ADADP)

Proposed Section 336(e) Regulations – Tax Consequences

- Sale of assets by Old T to New T at aggregate deemed asset disposition price (ADADP) =

  Amount realized on sale or exchange of target stock (or deemed amount realized on distribution of target stock), grossed up to take into account disposition of less than all of the target stock

  - Selling costs

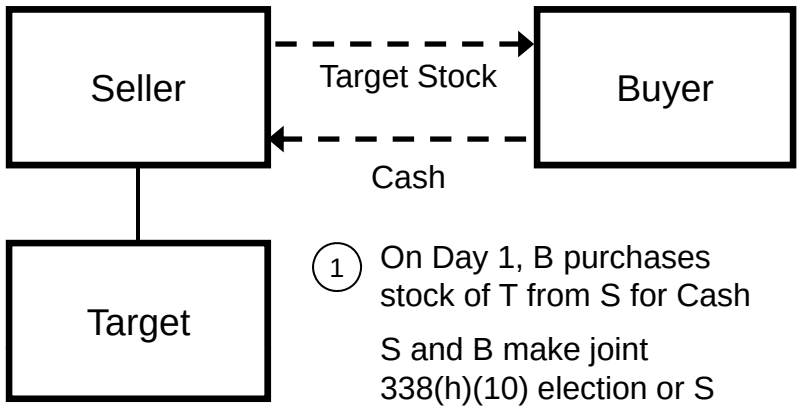
  + Liabilities of Old Target

  – Gains are recognized, but losses are disallowed in proportion to the amount of stock distributed (vs. sold) to implement the policy of section 311(b).
  – If the assets deemed sold include the stock of a subsidiary ("Sub"), the deemed sale of the Sub stock is eligible for a section 336(e) election (not a section 338(h)(10) election).
- New T's asset basis is adjusted grossed-up basis (AGUB).
- Deemed liquidation of Old Target generally treated as section 332 liquidation.

Proposed Section 336(e) Regulations – Tax Consequences to Minority Shareholders

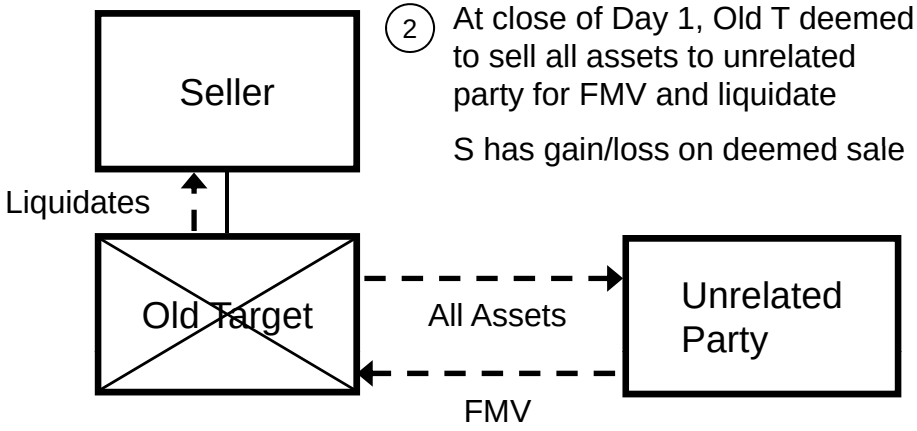
- A non-selling minority shareholder has no tax consequences, unless it makes a "gain recognition election" to recognize gain on the stock and obtain a stepped-up basis in the stock retained.
- A selling minority shareholder is treated like any other stock seller.
- An acquirer of target stock is treated like any other stock buyer or distributee.
- If a minority shareholder buys target stock, it has a mandatory gain recognition election. The result is the same as the result in a section 338(h)(10) sale of stock to a minority shareholder. Treas. Reg. §1.338(h)(10)-1(d)(1).

Sales



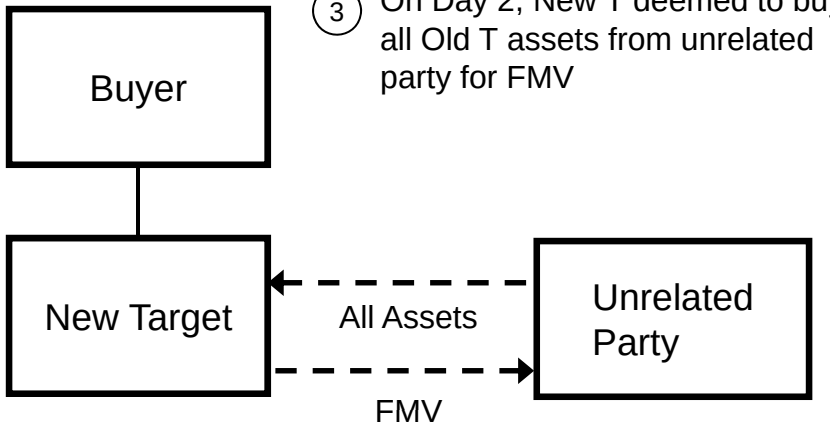
1 On Day 1, B purchases stock of T from S for Cash

S and B make joint 338(h)(10) election or S makes 336(e) election

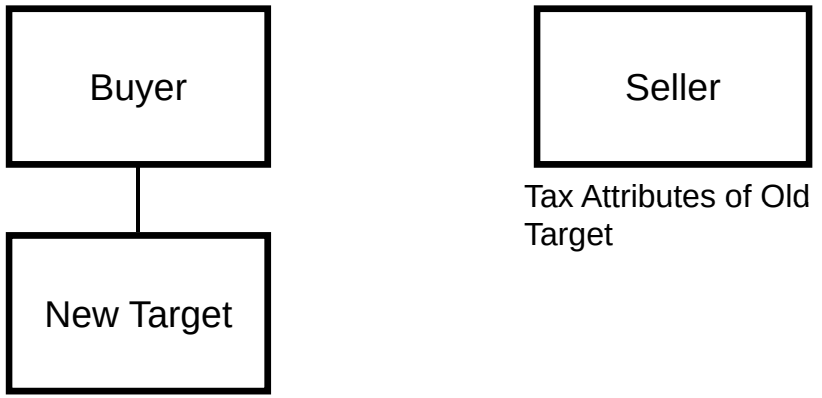


2 At close of Day 1, Old T deemed to sell all assets to unrelated party for FMV and liquidate

S has gain/loss on deemed sale

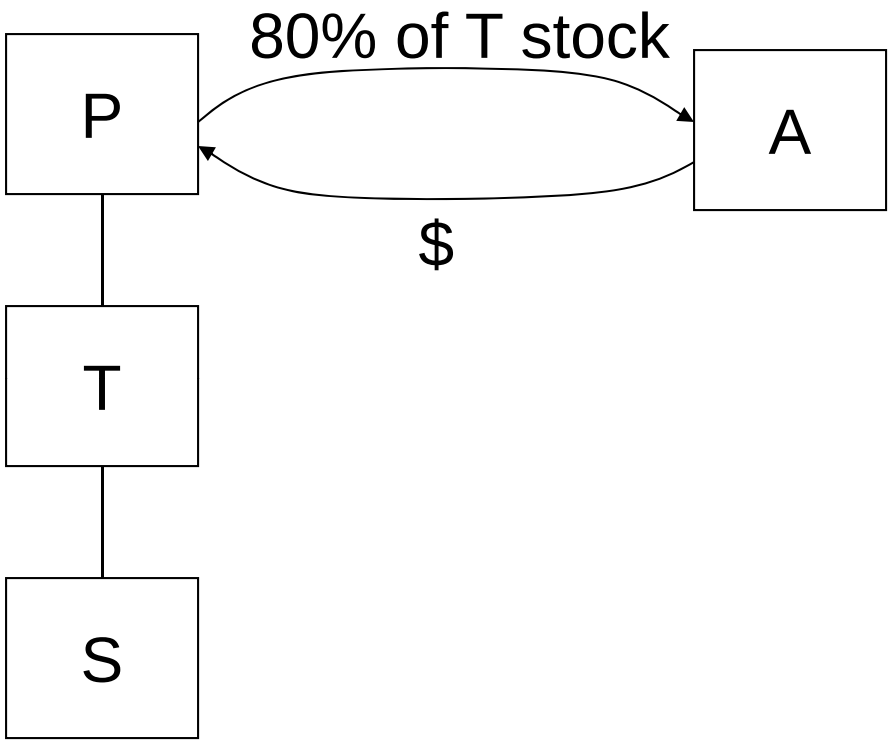


3 On Day 2, New T deemed to buy all Old T assets from unrelated party for FMV



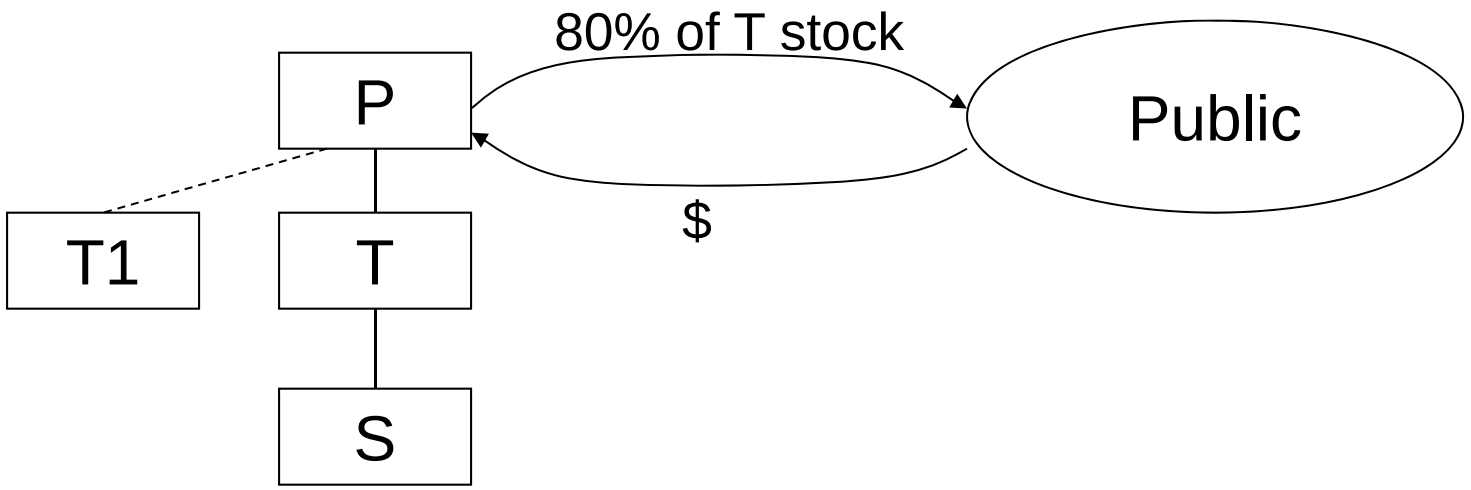
Stepped Up Basis in Assets
No Tax Attributes

Qualified Stock Purchase



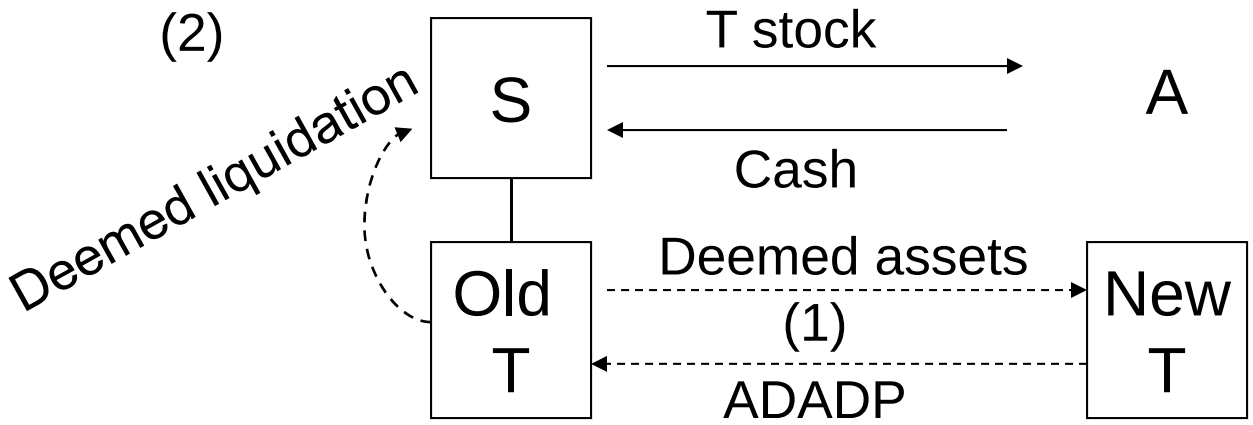
- P sells all the T stock to A for cash.
  - Joint section 338(h)(10) election available at T and S levels.
  - Because the joint section 338(h)(10) election is available, no election would be available under section 336(e). Prop. Treas. Reg. §1.336-1(b)(5)(ii)(A).

Qualified Stock Disposition – Sale – General



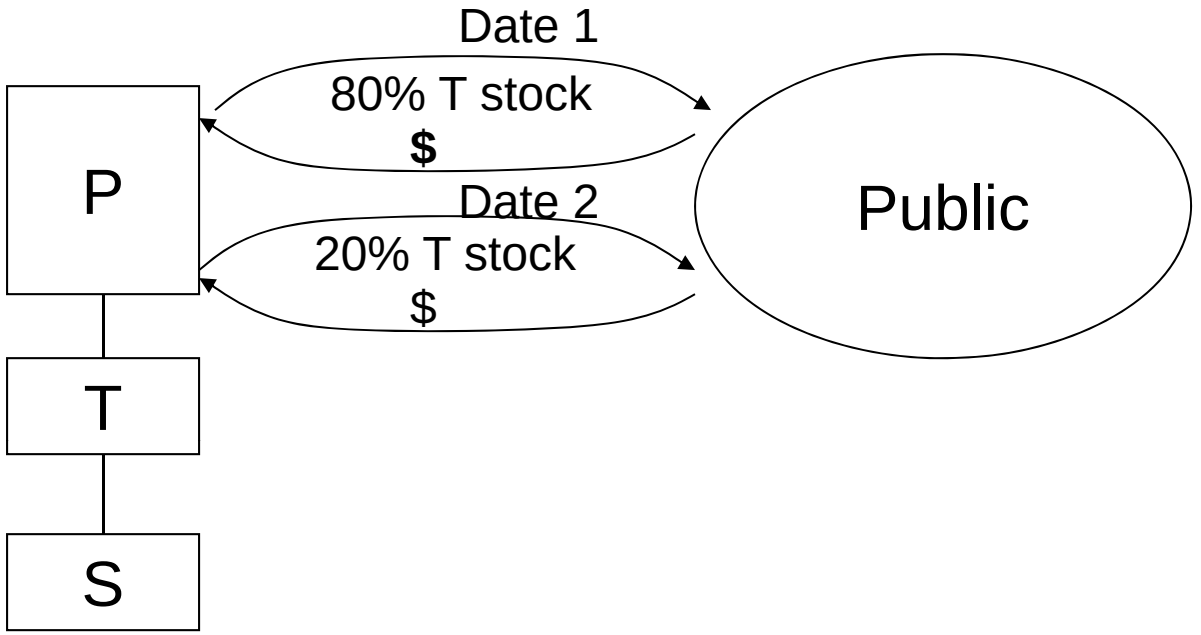
- If P sells its T stock directly to Public, there is no corporate purchaser and so no qualified stock purchase. Thus, no joint section 338(h)(10) election is available.
- Treas. Reg. §1.338-3(b)(3)(iv) *Example (1)* provides a way to accomplish this transaction, by P transferring the T stock to T1 in a taxable "busted B/busted 351" transfer and selling the T1 stock to the Public. These transactions, however, are complex and have pitfalls.
- Under Prop. Treas. Reg. §1.336-2(a), P would be able to elect to treat a sale of the T stock directly to Public as a sale of T assets to "New T" and a generally tax-free liquidation of T. P would make this election unilaterally.
- P would need to determine if more than 20 percent of the T stock is sold to related persons. If so, no section 336(e) election would be available.
- Since the T assets include the S stock, that stock would be deemed sold to New T. This deemed sale is subject to a section 336(e) election, not a section 338(h)(10) election. Prop. Treas. Reg. §1.336-1(b)(5)(ii)(B).

Stock Sale with Section 336(e) Election



- S disregards the sale of Old T stock.
- Instead Old T is deemed to sell its assets to New T and liquidate into S.
- New T has no tax attributes.
- A is still treated as purchasing Old T stock.

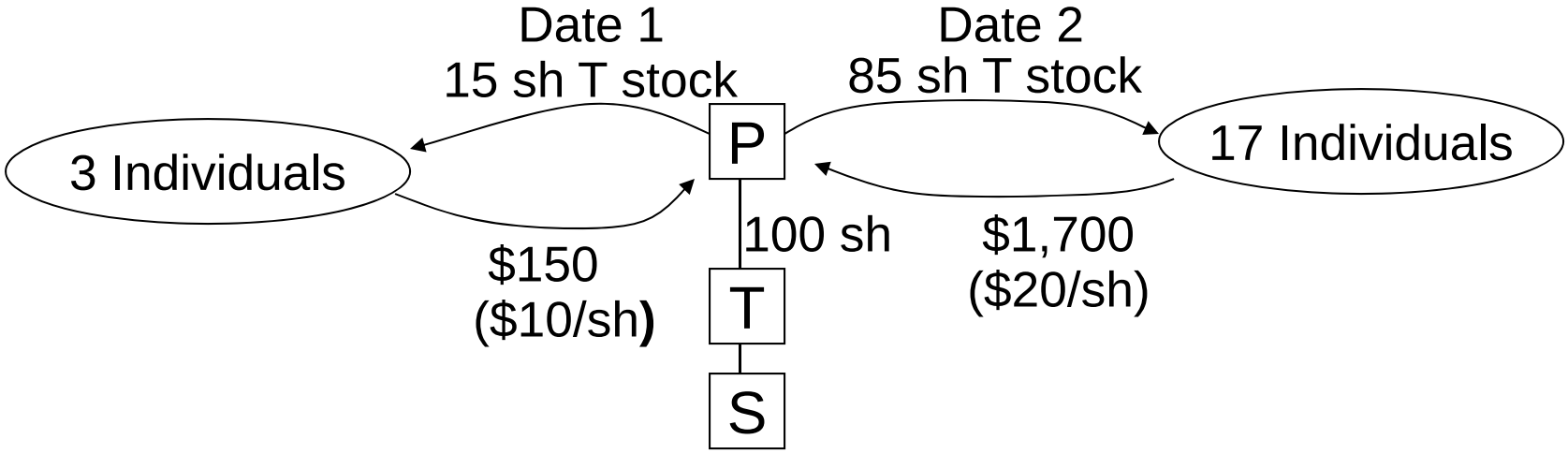
Qualified Stock Disposition – Sale – Timing



- P sells 80 percent of the T stock to the Public on Date 1 and the remaining 20 percent to the Public on Date 2 (less than 12 months after Date 1).
- If P makes a section 336(e) election, T would be deemed to sell all its assets (including the S stock) to New T. T would recognize its gains and losses on asset sale.
- P's Date 1 sale of T stock would be disregarded.
- P's Date 2 sale of T stock would be a taxable sale, but P's gain or loss would be the appreciation or depreciation in the T stock between Date 1 and Date 2.

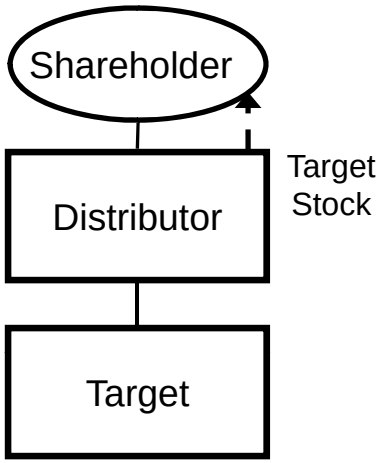
Prop. Treas. Reg. §1.336-2(b)(2)(iv).

Qualified Stock Disposition – Sale – Asset Basis



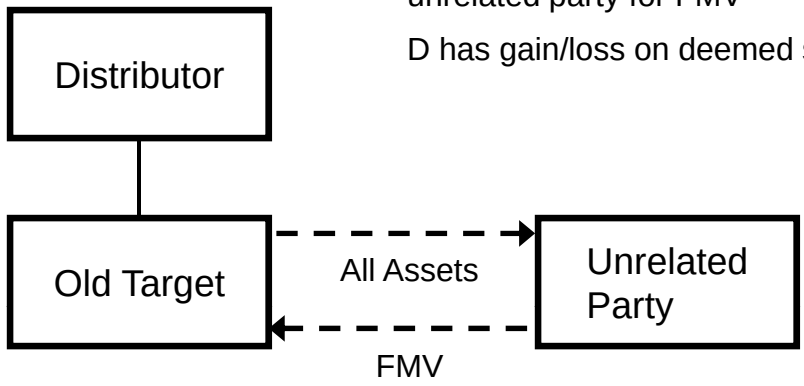
- On Date 1, P sells 15 shares of T stock to 3 unrelated individuals, 5 shares each, for a total of $150 ($10/share).
- On Date 2 (more than 12 months after Date 1) P sells the remaining 85 shares of T stock to 17 unrelated individuals, 5 shares each, for a total of $1,700 ($20/share).
- If P makes a unilateral section 336(e) election, T is deemed to sell all its assets to "New T" and liquidate. T recognizes all its gains and losses on this sale.
- Among the assets deemed sold is the stock of S. This transaction is also eligible for a section 336(e) election.
- T's amount realized on the deemed asset sale is based on ADADP principles – here equal to the sale price for the stock plus T's liabilities.
- T's basis for its deemed purchased assets is based on AGUB principles, but the only non-recently purchased stock that counts is stock owned by more-than-10-percent shareholders (none here).
- Variation: The 3 individuals who buy T stock on Date 1 pay $300 ($30/share) and form a partnership to buy the T stock immediately before Date 1.

Distributions



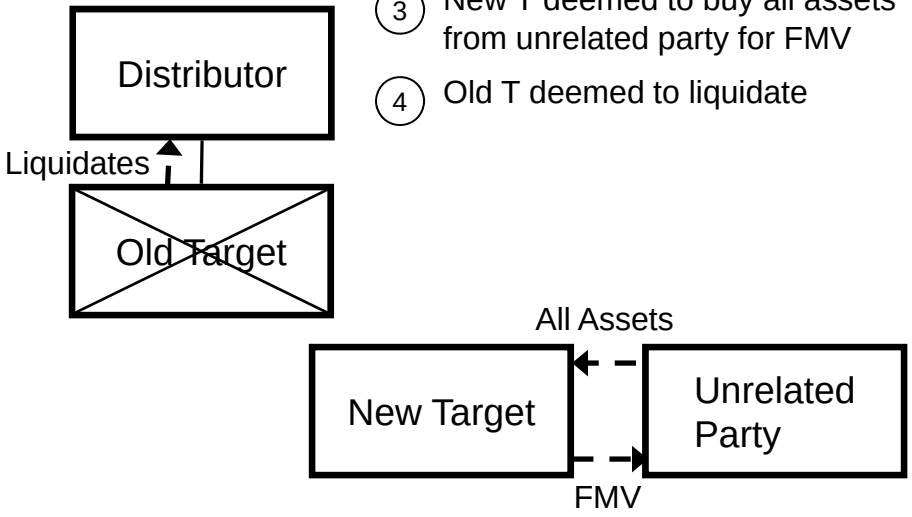
1 D distributes stock of T to S/H

D makes a 336(e) election



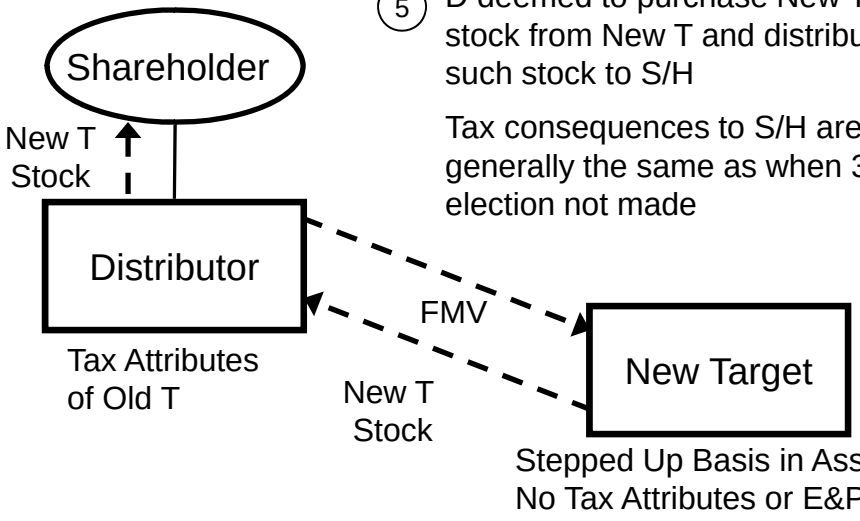
2 Old T deemed to sell all assets to unrelated party for FMV

D has gain/loss on deemed sale



3 New T deemed to buy all assets from unrelated party for FMV

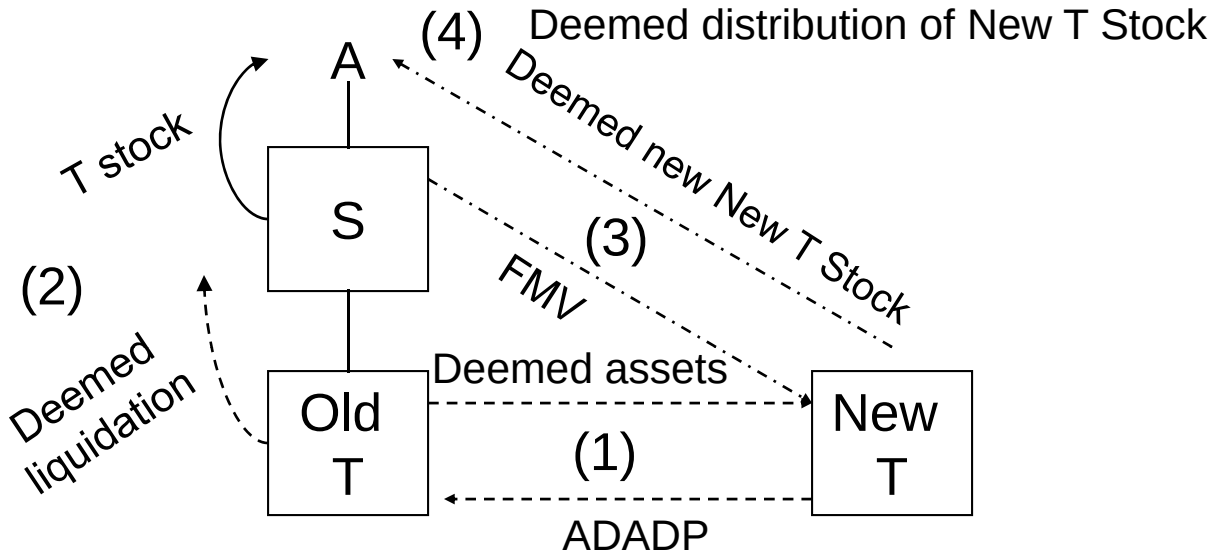
4 Old T deemed to liquidate



5 D deemed to purchase New T stock from New T and distribute such stock to S/H

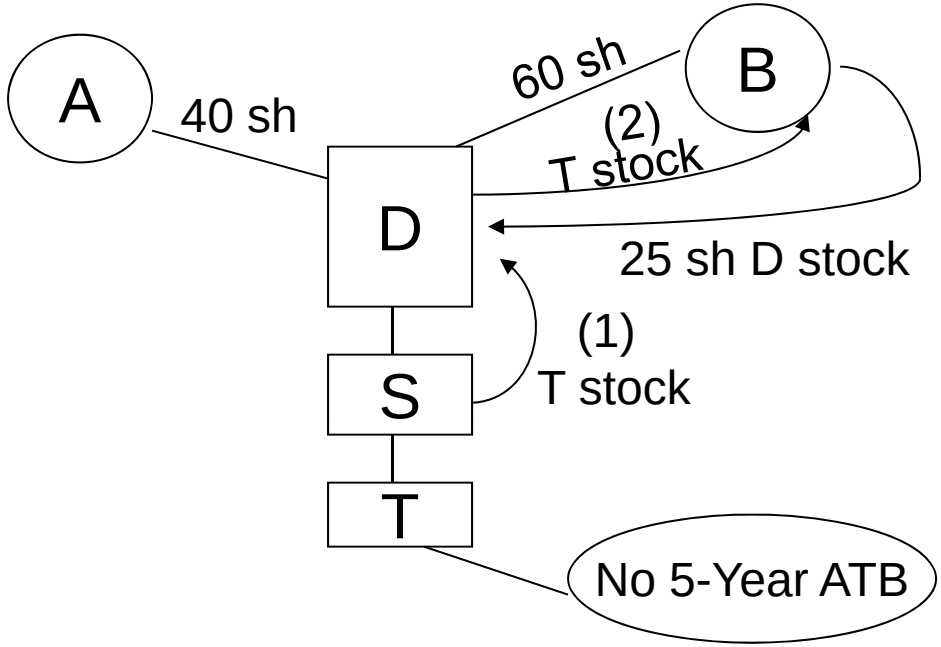
Tax consequences to S/H are generally the same as when 336(e) election not made

Taxable Stock Distribution with Section 336(e) Election



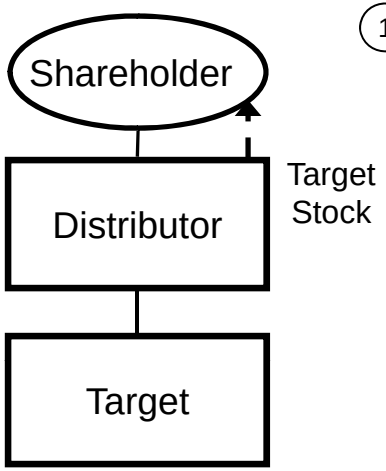
- S disregards distribution of Old T stock.
- Instead Old T is deemed to sell its assets to New T and liquidate into S. Old T recognizes gain but losses are disallowed in proportion to the amount of stock distributed.
- S is deemed to purchase an amount of New T stock distributed to A in the qualified stock disposition and distribute that stock to A.
- New T has no tax attributes.
- A is treated as receiving Old T stock in the distribution with a fair market value basis.

Qualified Stock Disposition – Non-Section 355 Intra Group and Non Pro Rata External Distributions



- S distributes the T stock to D.
- D distributes the T stock to its shareholder B.
- T has no 5-year active trade or business, and so both distributions flunk section 355 and are taxable.
- The first distribution is not eligible for a section 336(e) election, because S and D are related. Prop. Treas. Reg. §1.336-12(k) *Example (9).*
- The second distribution is eligible for a section 336(e) election, because thereafter D and B are not related persons. Prop. Treas. Reg. §1.336-1-2(k) *Example (8).* In the deemed asset sale, T recognizes its gains, but its losses are disallowed. Prop. Treas. Reg. §1.336-2(b)(1)(i)(B).
- Variation: In the second distribution, D distributes the T stock to A and B pro rata. The second distribution would not qualify for a section 336(e) election, because B and D are related persons. Only the distribution to A is a " disposition" of T stock, and it involves less than 80 percent of the T stock.

355 Distributions

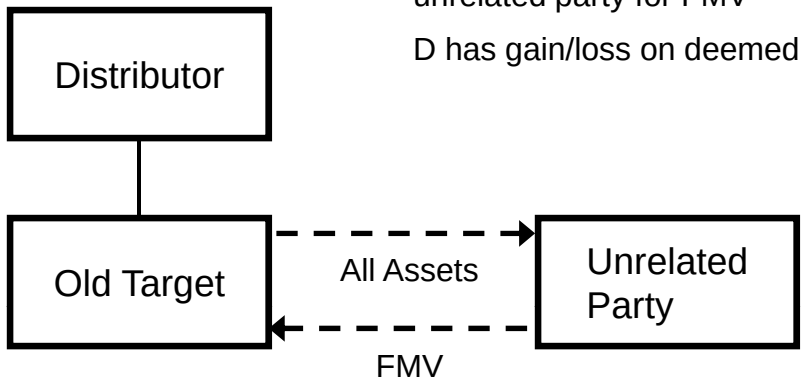


1 D distributes stock of T to S/H in a 355 distribution to which 355(d)(2) or (e)(2) applies (taxable to D, not to S/H)

D makes a 336(e) election

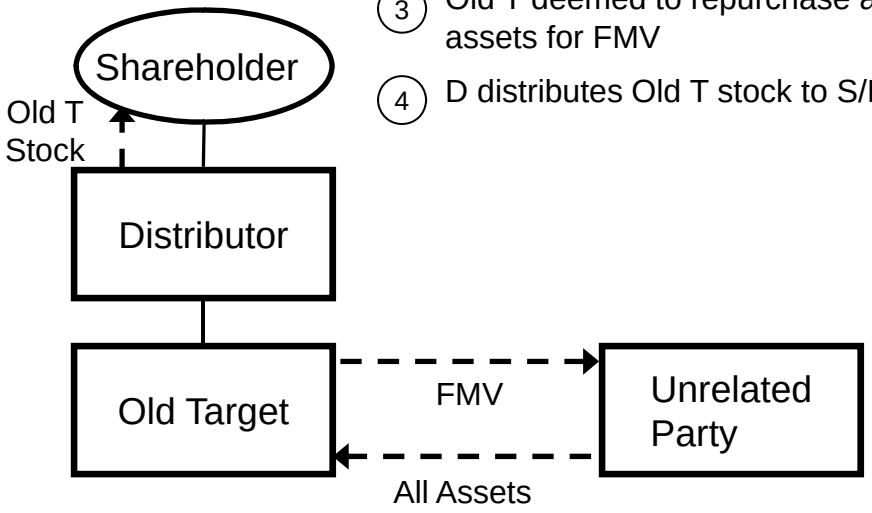
2 Old T deemed to sell all assets to unrelated party for FMV

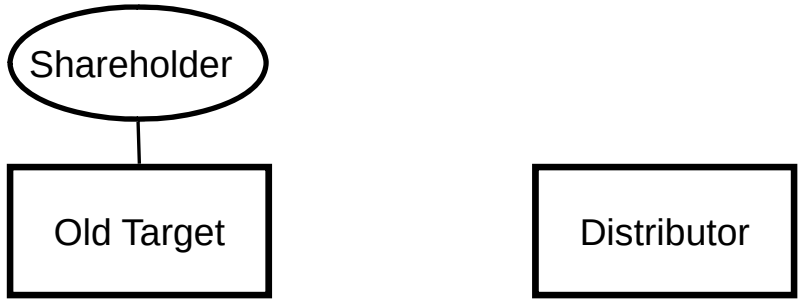
D has gain/loss on deemed sale



3 Old T deemed to repurchase all assets for FMV

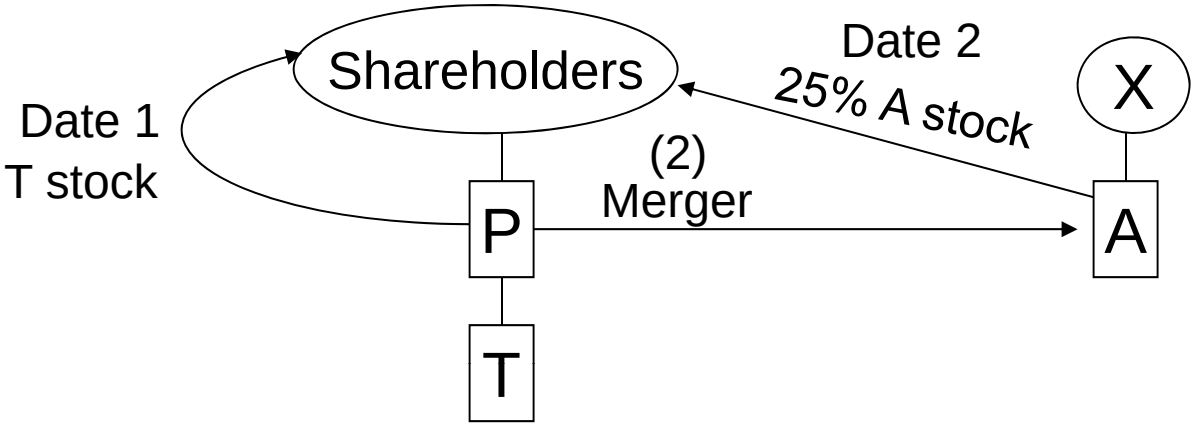
4 D distributes Old T stock to S/H





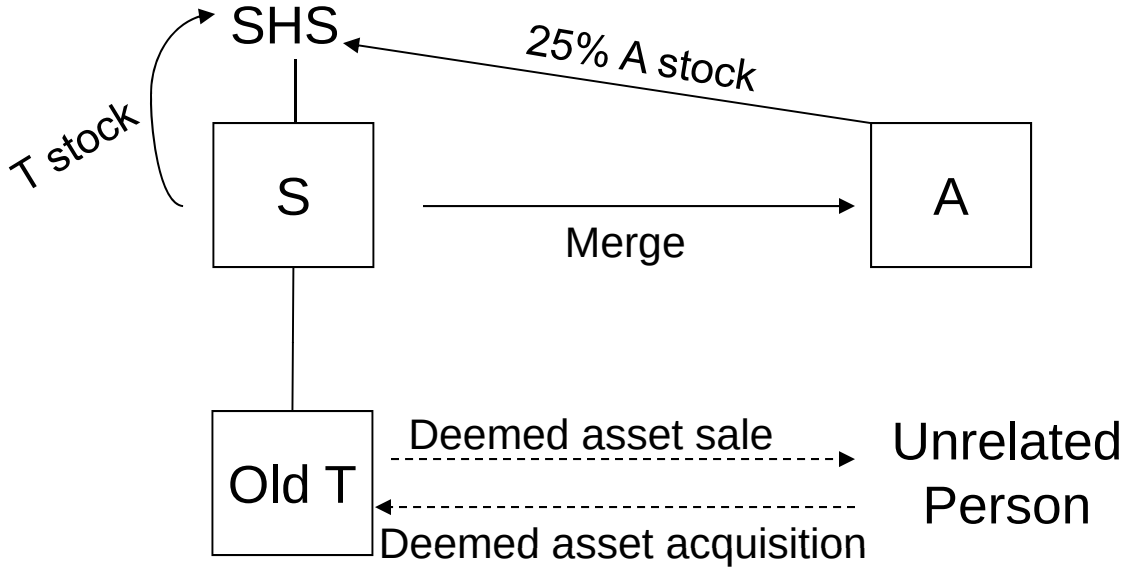
Stepped Up Basis in Assets
Retains Tax Attributes
and E&P

Qualified Stock Disposition – Spin-Off Subject to Section 355(d) or (e)



- On Date 1, P distributes the T stock to Shareholders, pro rata, in a spin-off qualifying under section 355.
- On Date 2, as part of the same "plan," P is merged into A. Shareholders receive 25 percent of the A stock.
- Shareholders receive the T stock tax-free under section 355 and then the A stock tax-free under section 354(a). Their basis in their P stock is allocated between their P stock and their T stock, and their basis in their A stock is the same as their basis in their P stock after the T spin-off.
- Under section 355(e), T recognizes its gain on the distribution of the T stock. Thus T would be eligible to make a section 336(e) election, if more than 80 percent of the stock was distributed to non-related persons. Suppose a "related" P shareholder becomes not "related" as a result of the merger?
- If P makes the election, T is deemed to sell its assets and repurchase them. No liquidation.
- T recognizes its gains, but its losses are disallowed.
- T's basis in the assets is determined by AGUB. Prop. Treas. Reg. §1.336-2(b)(2)(ii)(A). Note that Shareholders' basis in their T stock is not fair market value.
- Variation: P sells 20 percent of the T stock and distributes 80 percent of the T stock at the same time.

Section 355(d) or (e) Stock Distribution with Section 336(e) Election

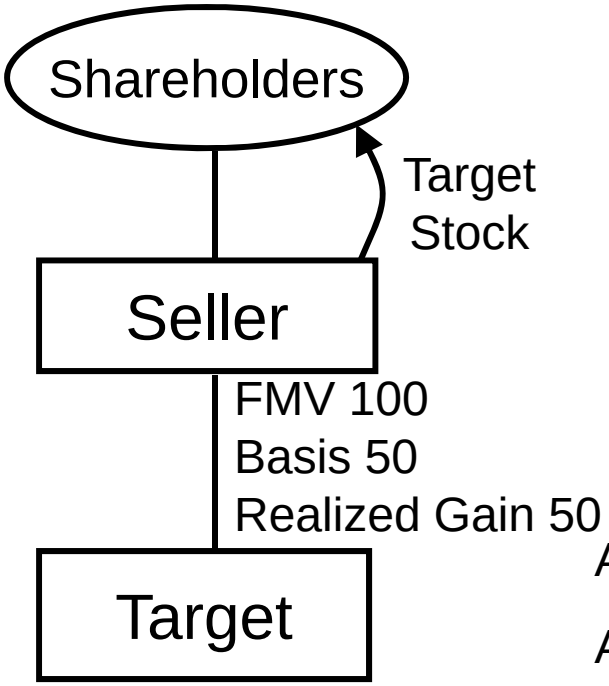


- The controlled corporation, Old T, is deemed to sell its assets to an unrelated person and reacquire those assets (sale-to-self treatment).
- Then the distributing corporation, S, is treated as distributing the stock of Old T to its shareholders in the spin-off. Old T recognizes gain but losses are disallowed in proportion to the amount of stock distributed. The shareholders determine their basis under section 358.
- Old T retains its tax attributes.
- The deemed sale and reacquisition will not cause the transaction to fail to satisfy the requirements of section 355.

Deemed Treatment as a Result of a Section 336(e) Election

	Sales and Exchanges	Taxable Spins	Section 355(d) and (e) Spins
Deemed Asset Sale by Target	**Yes**	**Yes**	**Yes**
Losses Recognized	**Yes**	**No**	**No**
Deemed Liquidation of Target	**Yes**	**Yes**	**No**

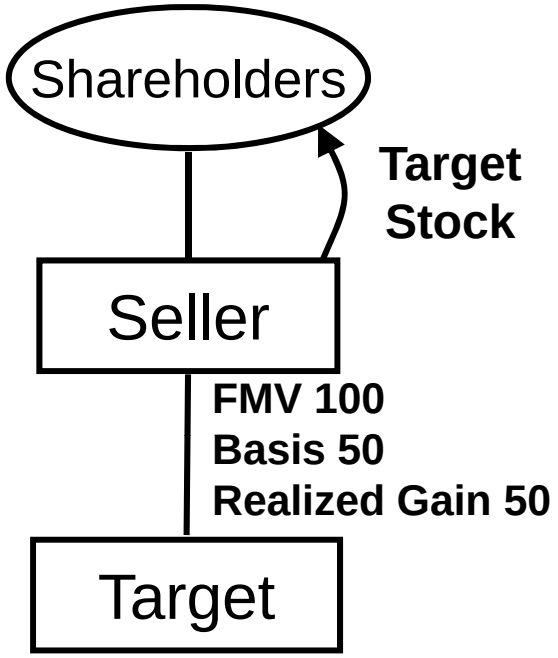
Loss Disallowance — Facts



	Basis	FMV	Section 336 (e) Realized Gain or Loss
Asset 1	40	10	(30)
Asset 2	10	90	80

– On Date 1, Seller forms Target and contributes Asset 1 and Asset 2 to Target. Asset 1 has a basis and fair market value of 40, Asset 2 has a basis and fair market value of 10. Seller takes a 50 basis in the stock of Target, which is worth 50. On Date 2, when Asset 1 is worth 10 and Asset 2 is worth 90, Seller distributes all the Target stock to Seller shareholders in a transaction to which a section 336(e) election applies. At the time of the distribution, the stock of Target is worth 100.

Loss Disallowance — Results



	Basis	FMV	Section 336 (e) Realized Gain or Loss
Asset 1	40	10	(30)
Asset 2	10	90	80

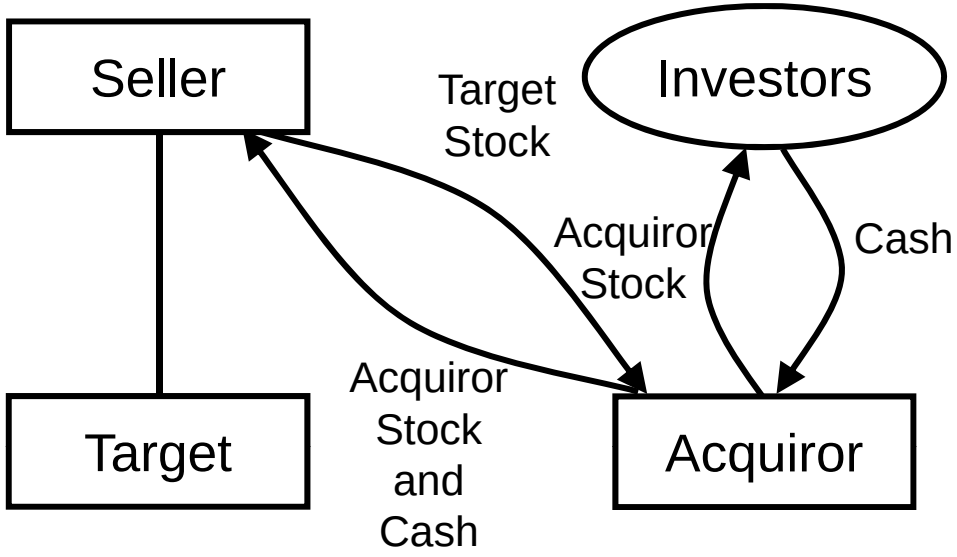
- If no section 336(e) election is made, 50 of gain under section 311(b).
- Under proposed section 336(e) regulations, 80 of gain. 30 loss is disallowed.
- Under a “netting” approach, the 30 loss would be allowed to be used up to the amount of the gain. Thus, all 30 would be allowed for an overall gain of 50 (equal to 80 of gain on Asset 2 less 30 of loss on Asset 1).
- Under a “gross loss” approach, all loss would be recognized regardless of the amount of gain. Here, same result as under netting approach.

Section 351 Transactions

- Following section 338 and a reference in the legislative history to permitting section 336(e) elections in the case of "taxable" transactions, the proposed regulations require that, in order to make a section 336(e) election, the Target stock may not, in general, be "sold, exchanged, or distributed in a transaction to which section 351, 354, 355, or 356 applies." Prop. Treas. Reg. § 1.336-1(b)(4)(i)(B).

- However, unlike section 338, the statute does not impose this "purchase" requirement for section 336(e) elections. Thus, the IRS could expand the regulations to permit a section 336(e) election in the case of a disposition covered by section 351.

Section 351 Transactions



- Seller owns the stock of Target.
- Investors form Acquiror by contributing cash to Acquiror.
- Seller transfers its Target stock to Acquiror in exchange for Acquiror stock and cash.
- The transaction is a section 351 transaction. As a result, no section 338 election may be made. Under the proposed regulations, no section 336(e) election could be made either.
- Absent a section 336(e) election, Seller would recognize all the gain on its Target stock up to the amount of cash received (but no loss).
- If a section 336(e) election were permitted and were made, Target would recognize the gain and loss in its assets and then would be deemed to liquidate into Seller.

Dispositions to Related Persons

- The legislative history contemplates that a disposition to a related person could be eligible for a section 336(e) election:
  - "The conferees intend that the regulations under this elective procedure will account for appropriate principles that underlie the liquidation-reincorporation doctrine. For example, *to the extent that regulations make available an election to treat a stock transfer of controlled corporation stock to persons related to such corporation within the meaning of section 368(c)(2)*, it may be appropriate to provide special rules for such corporation's section 381(c) tax attributes so that net operating losses may not be used to offset liquidation gains, earnings and profits may not be manipulated, or accounting methods may not be changed."

Dispositions to Related Persons

- The proposed regulations preclude a section 336(e) election if the stock is sold, exchanged or distributed to a related person. Prop. Treas. Reg. § 1.336-1(b)(4)(i)(C).
- The definition of related person is imported from section 338 and provides that two persons are related if stock owned by one of the persons would be attributed under section 318(a) (other than section 318(a)(4)) to the other. Prop. Treas. Reg. § 1.336-1(b)(ii).
- That definition of relatedness can have unanticipated consequences because section 318(a)(3) attributes from partners to partnerships regardless of how little the partner owns in the partnership.
  - Example: A widely held Seller Corp owns Target. Seller Corp wants to sell Target to a Buyer Corp owned by a private equity fund that is treated as a partnership for tax purposes. Seller Corp owns a small stake (say 0.5 percent) in the private equity fund. The sale might not be eligible for a section 338(h)(10) election. Under section 318(a)(3)(A), stock in *any corporation* owned by Seller Corp would be attributed to the private equity fund, and then (if the private equity fund owns at least 50 percent in value of the stock of Buyer Corp), under section 318(a)(3)(C), from the private equity fund to Buyer Corp.

Intragroup Sale or Spin followed by External Sale or Spin

- If the stock of Target is transferred within an affiliated group and then transferred to a third party in a transaction for which a section 336(e) election is made, there could potentially be a double tax at the corporate level. Treas. Reg. § 1.1502-13(f)(5)(ii)(C) should ameliorate the double tax, however.
- Example:
  - Seller owns Sub 1 and Sub 2. Sub 1 owns Target. Sub 1 sells the stock of Target to Sub 2 for cash resulting in a deferred intercompany gain in the stock of Target. Then, Sub 2 sells the stock of Target in a separate transaction in which either a section 336(e) or a section 338(h)(10) election is made. The election results in recognition of gain in the assets of Target. Further, the deemed liquidation resulting from the election results in the deferred intercompany gain being taken into income. Thus, both asset level gain and stock level gain in Target are apparently recognized. However, Treas. Reg. § 1.1502-13(f)(5)(ii)(C) should permit the taxpayer to elect to treat the deemed liquidation of Target into Sub 2 as a section 331 liquidation for the sole purpose of providing Sub 2 with a loss, which offsets Sub 1's deferred intercompany gain that arose on the disposition of Target to Sub 2.

Subchapter S Corporations

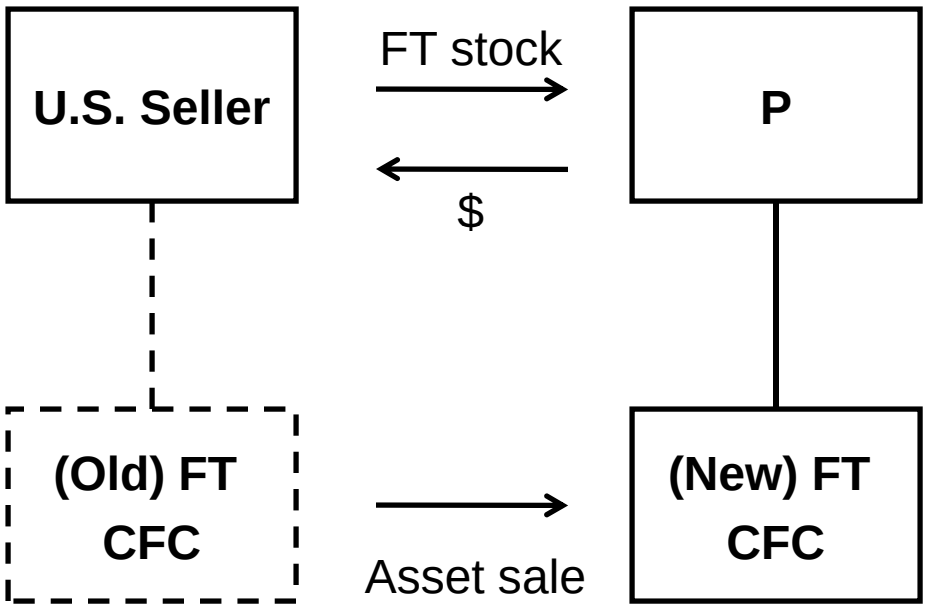
- Section 336(e) by its terms requires that stock in the target meeting the requirements of section 1504(a)(2) be owned by another corporation, and thus on its face does not apply to S corporation targets.
- The proposed regulations do not allow a section 336(e) election in the Subchapter S context. If a section 336(e) election were permitted in the case of a target S corporation, the election would avoid double tax on S corporation earnings, just as the election avoids triple tax on C corporation earnings.
- Section 338(h)(10) similarly requires the target to be a member of a "selling consolidated group," which would preclude a section 338(h)(10) election in the case of a target S corporation. Treas. Reg. § 1.338(h)(10)-1(c) nevertheless permits section 338(h)(10) elections for target S corporations.
- Section 338(i) could provide authority for a section 336(e) election for a target S corporation.

Section 336(e) Elections involving Foreign Corporations

- Under the proposed regulations, a section 336(e) election is only available where both the Seller and the Target are domestic corporations. Prop. Treas. Reg. §§ 1.336-1(b)(1) and (3).
- Section 338 elections apply to foreign and domestic target corporations. Is there a principled way to distinguish the section 336(e) election in this regard?
- Issues: U.S. Seller – Foreign Target
  - Gain on inbound section 332 liquidation (section 367(b))
  - Sourcing of earnings and profits for foreign tax credit purposes?
  - Application of section 338(h)(16) principles?
- Issues: Foreign Seller – U.S. Target
  - FIRPTA purge?
  - Avoid Subpart F income where Seller is a CFC?
  - Double taxation on "carried over" earnings and profits?
- Issues: Foreign Seller – Foreign Target
  - Expand the *Dover Corp. v. Commissioner* results to situations where a check-the-box election is unavailable?

Cross-Border Acquisitions

Section 338 and Foreign Targets



Section 338 and Foreign Targets

- A section 338(g) election historically has been generally favorable upon the acquisition of a foreign target, especially where foreign target is not:
  - Engaged in U.S. trade or business; or
  - A U.S. real property holding corporation.
- The election may not be favorable if corporation has valuable attributes.
- A U.S. seller of a non-CFC foreign corporation generally is not affected by a section 338(g) election made by a buyer unless the non-CFC foreign corporation was a passive foreign investment company (PFIC) and has income as a result of the deemed sale.

Section 338 and Foreign Targets

- Tax consequences to U.S. Seller
  - Gain (not loss) from the stock sale is treated as dividend income to the extent of FT's E&P attributable to the stock sold: the section 1248 amount.
    - The remainder is capital gain.
    - Dividend is foreign source, and 10% corporate shareholders may reduce U.S. tax on sale by deemed paid foreign tax credits.
      - Section 902.
  - Gain recognized on the deemed asset sale increases the section 1248 amount
    - The increase cannot be used to benefit the foreign tax credit position of U.S. Seller.
      - Section 338(h)(16)
  - U.S. Seller is required to include Subpart F income for the taxable year including the amount resulting from the deemed asset sale.
    - Section 951(a)
  - May increase U.S. Seller's basis in the Old FT stock prior to sale, thereby possibly affecting the character of U.S. Seller's income.
    - Section 961(a)

Section 338 and Foreign Targets

- Tax consequences to P
  - No carryover of foreign attributes for utilization by P.
    - Foreign tax credits, E&P and previously taxed income (PTI) amount
  - A section 338 election may be desirable where FY has significant passive assets
    - The passive assets may cause P to recognize Subpart F inclusion without a section 338 election.
  - For creeping sales where P owns 10% or more of Old FT at the close of the taxable year,
    - Required to include into income its pro-rata share of Old FT's Subpart F income
      - Including the amount resulting from the deemed asset sale
      - Treas. Reg. §1.338-9(b)(2)
    - FT must have been a CFC for at least 30 days.

Section 338 and Foreign Targets

- Tax consequences to Old FT
  - Foreign source income from the sale is generally not subject to U.S. tax
    - Foreign personal holding company income is taxable
    - Otherwise nontaxable as long as FT has no U.S. effectively connected income
  - Old FT's tax year ends for U.S. tax purposes
  - All Old FT attributes are purged in connection with the sale
  - Foreign income taxes are allocated between Old FT and New FT where a foreign tax year of Old FT does not close in connection with the acquisition.
    - Treas. Reg. §§1.338-9(d) and 1.1502-76(b)

Covered Asset Acquisitions –Section 901(m)

- General rule
  - A portion of foreign income tax attributable to income from foreign assets acquired in a "covered asset acquisition" is non-creditable
- Disqualified portion equals:

$$\frac{\text{Aggregate basis differences allocable to such taxable year with respect to all relevant foreign assets}}{\text{Income on which the foreign income tax is determined}}$$

- Amortization related to a covered asset acquisition remains deductible for E&P purposes, as do the non-creditable foreign taxes

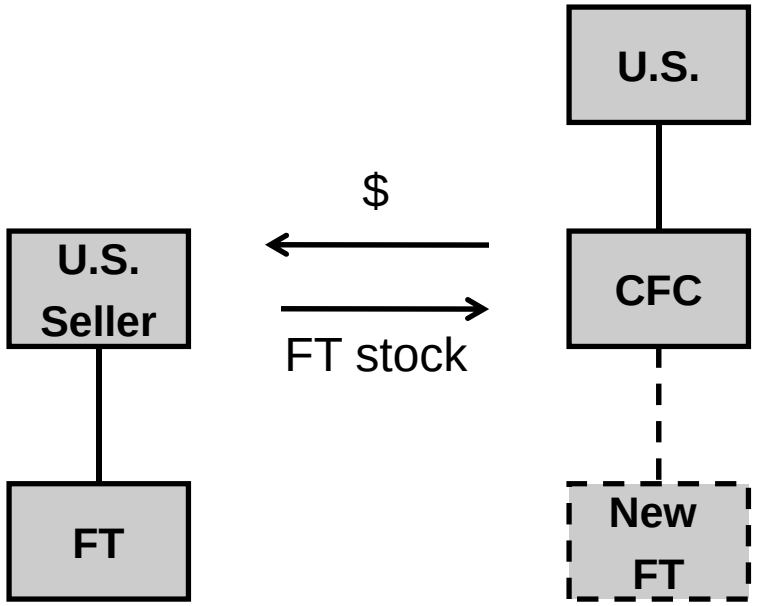
Covered Asset Acquisitions

- Definitions:
  - "Covered asset acquisitions" include:
    - Qualified stock purchases to which section 338(a) applies
    - Transactions which are treated as acquisitions of assets for U.S. tax purposes and as acquisitions of stock (or are disregarded) for foreign tax purposes
    - Acquisitions of partnership interests (where the partnership has a section 754 election in effect)
    - Any other similar transaction
  - "Basis difference" means, with respect to any relevant foreign asset, the excess of (1) the adjusted basis of such asset immediately after the covered asset acquisition, over (2) the adjusted basis of such asset immediately before the covered asset acquisition
    - U.S. tax basis
    - Allocated basis difference to a taxable year using the applicable cost recovery method under U.S. tax rules
  - "Relevant foreign asset" means with respect to any covered asset acquisition, an asset only if any income, deduction, gain, or loss attributable to such asset is taken into account in determining foreign income tax in the relevant jurisdiction.

Covered Asset Acquisitions

- The JCT Explanation provides as follows:
  - It is the tax basis for U.S. tax purposes that is relevant, and not the basis as determined under the law of the relevant jurisdiction
  - It is anticipated that the Secretary will issue regulations:
    - Identifying those circumstances in which, for purposes of determining the adjusted basis of such assets immediately before the covered asset acquisition, it may be acceptable to utilize the basis of such asset under the law of the relevant jurisdiction or another reasonable method
    - Clarifying, in a covered asset acquisition that involves either (1) both U.S. assets and relevant foreign assets, or (2) assets in multiple relevant jurisdictions, the manner in which any relevant foreign asset (such as intangible assets that may relate to more than one jurisdiction) will be allocated between those jurisdictions
    - Clarifying the extent to which income is considered attributable to a relevant foreign asset, as well as the treatment of an asset that ceases to be taken into account in determining the foreign income tax in the relevant jurisdiction by some mechanism other than a disposition

Covered asset acquisitions – Overview of provision



- CFC purchases Target after 12/21/2010 and makes a section 338 election
- Total stepped-up basis is $1,500,000 (all assets have a 15-year life)
- Basis immediately prior equals 0
- Target foreign income for year = $1 million, pays taxes of $500,000

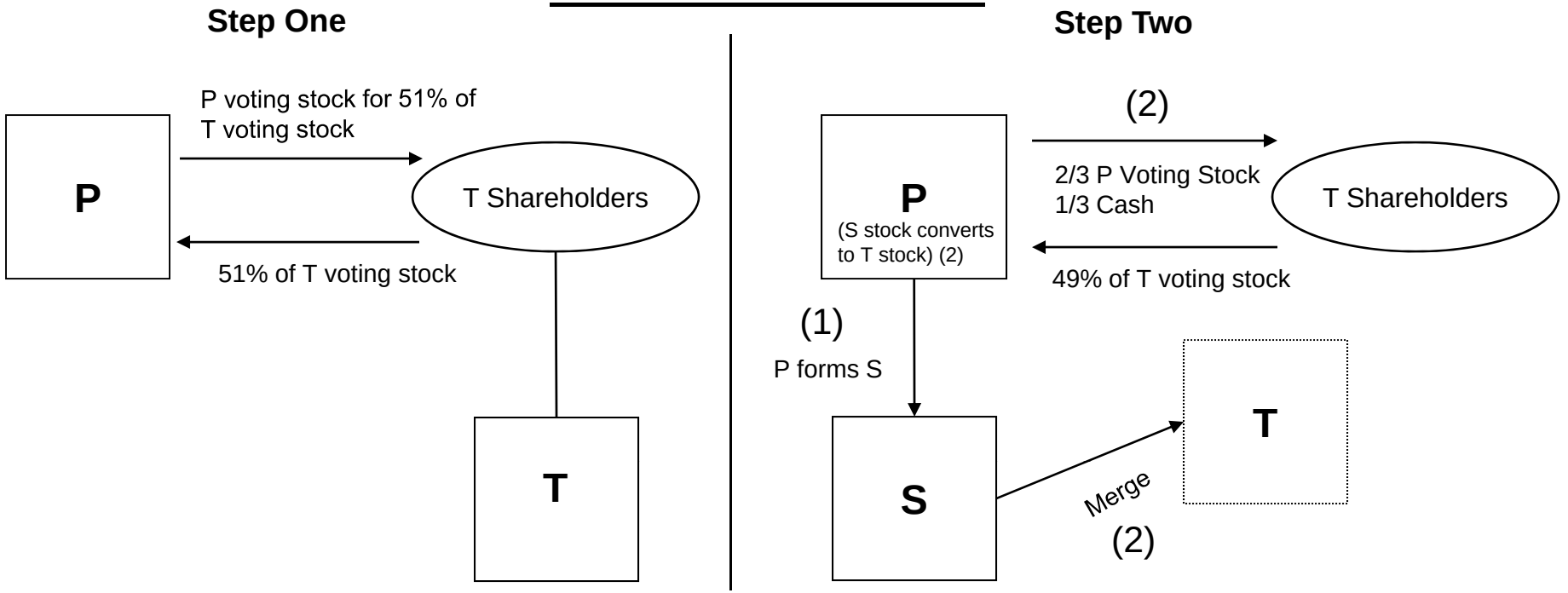
Disqualified portion of tax =

$$\frac{\$100{,}000\ [\$1{,}500{,}000 \div 15]}{\$1{,}000{,}000\ [\text{foreign income}]} \times \$500{,}000\ [\text{foreign taxes}]$$

Result: $50,000 of foreign taxes disallowed

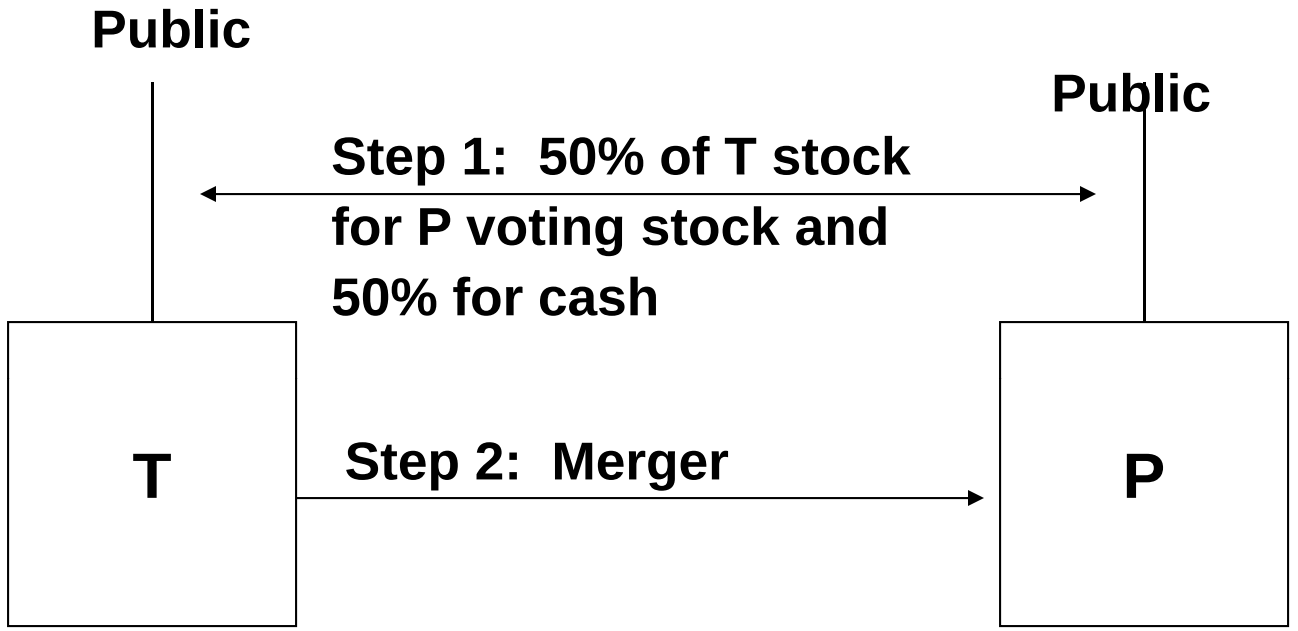
Step Transaction and Section 338

Rev. Rul. 2001-26



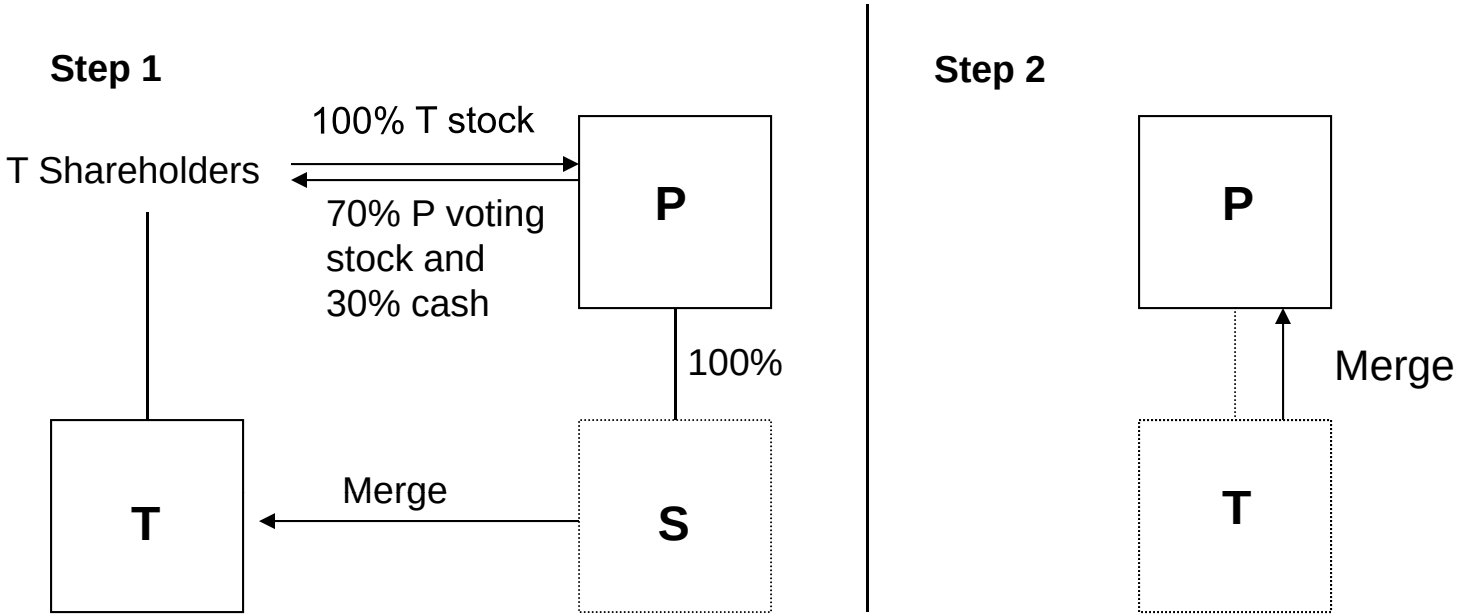
Facts: P and T are widely held manufacturing corporations organized under the laws of state A. T has only voting common stock outstanding, none of which is owned by P. P seeks to acquire all of T's outstanding stock. For valid business reasons, the acquisition will be effected by a tender offer for at 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 mergers 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 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, 2001-1 C.B. 1297.

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 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.

Treas. Reg. § 1.338(h)(10)-1(c)(2), (e)

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

- 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.*

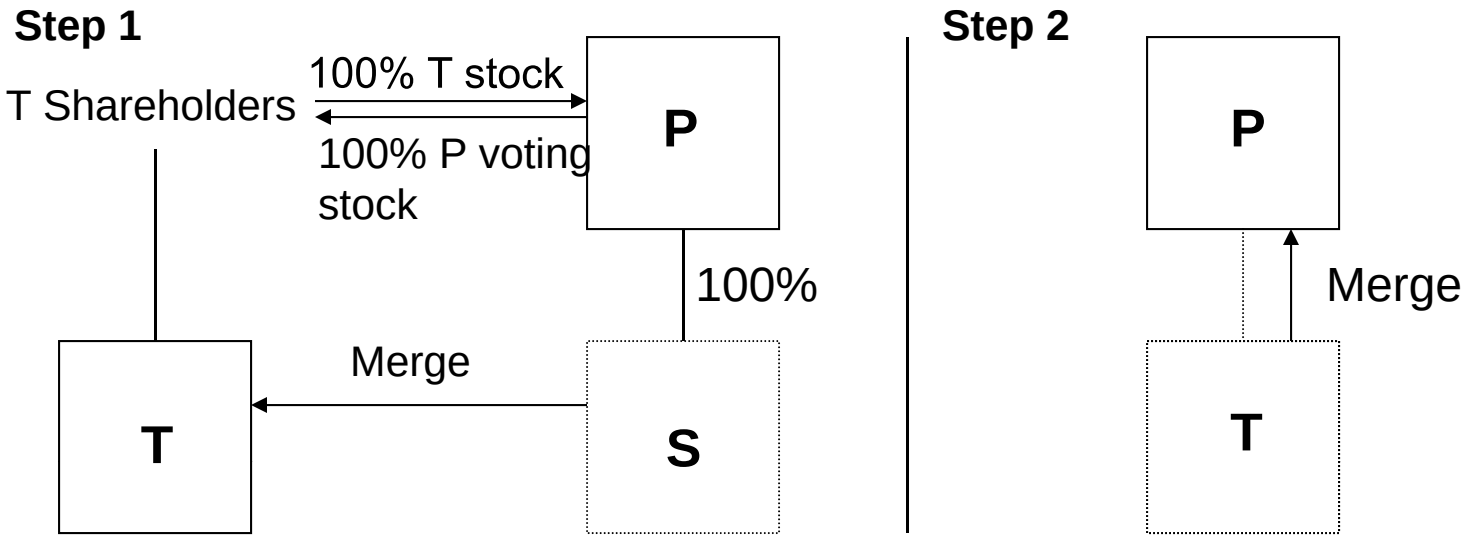
- If a section 338(h)(10) election is made under these facts, P's acquisition of T stock will be treated as a QSP for all Federal tax purposes and will not be treated as a reorganization under section 368(a). *See* Treas. Reg. § 1.338(h)(10)-1(e), Ex. 12 & 13.

- 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.

- In light of potential whipsaw and other concerns, the final regulations continue to apply only to section 338(h)(10) elections, not section 338(g) elections.

- The regulations are effective for stock acquisitions occurring on or after July 5, 2006. The temporary regulations, which are substantially similar to the final regulations, are effective for acquisitions occurring on or after July 8, 2003 and before July 5, 2006.

Rev. Rul. 2001-46 – Situation 2

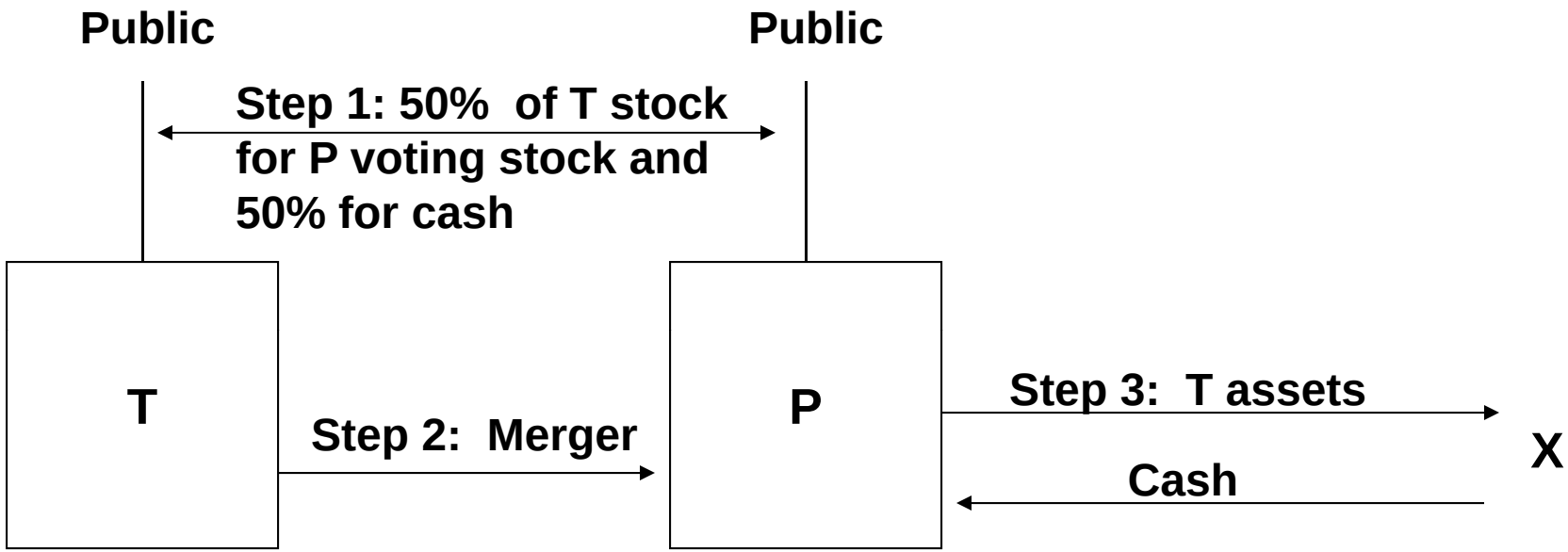


Facts: Same facts as in Situation 1, except that the T shareholders receive solely P stock in exchange for their T stock, so that the merger of S into T, if viewed independently of the upstream merger of T into P, would qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

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

Note: The taxpayers cannot 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

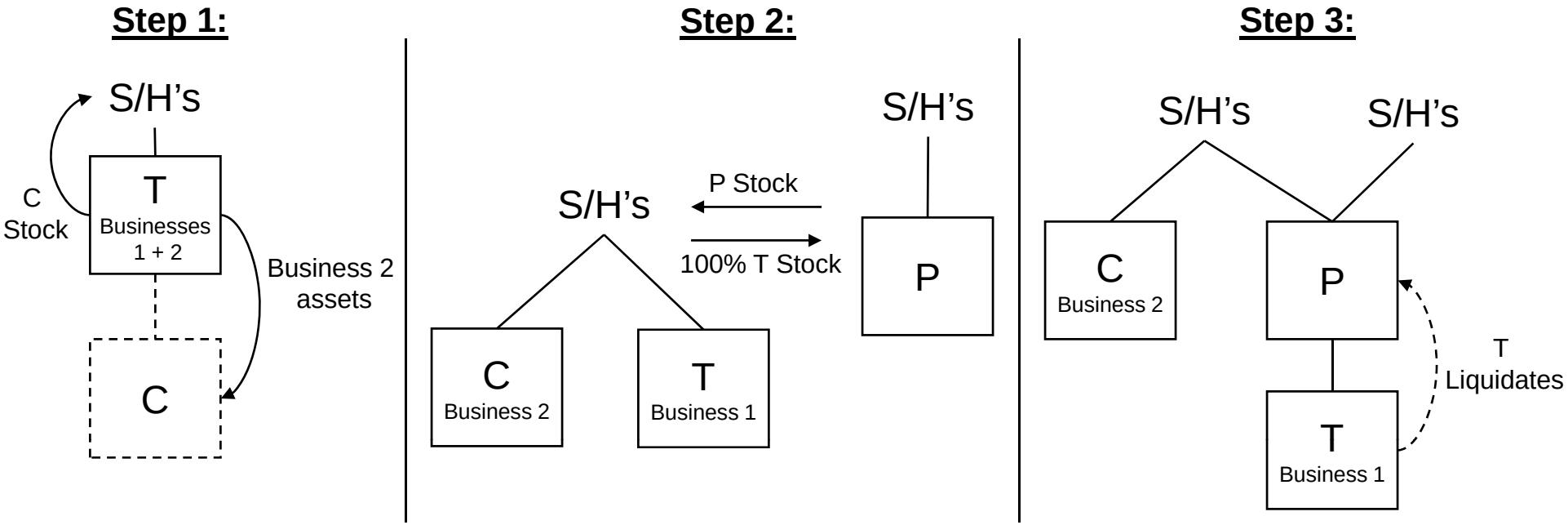


Facts: Same facts as in Variation 1, except P sells T's assets to X a third party immediately after the merger of T into P.

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



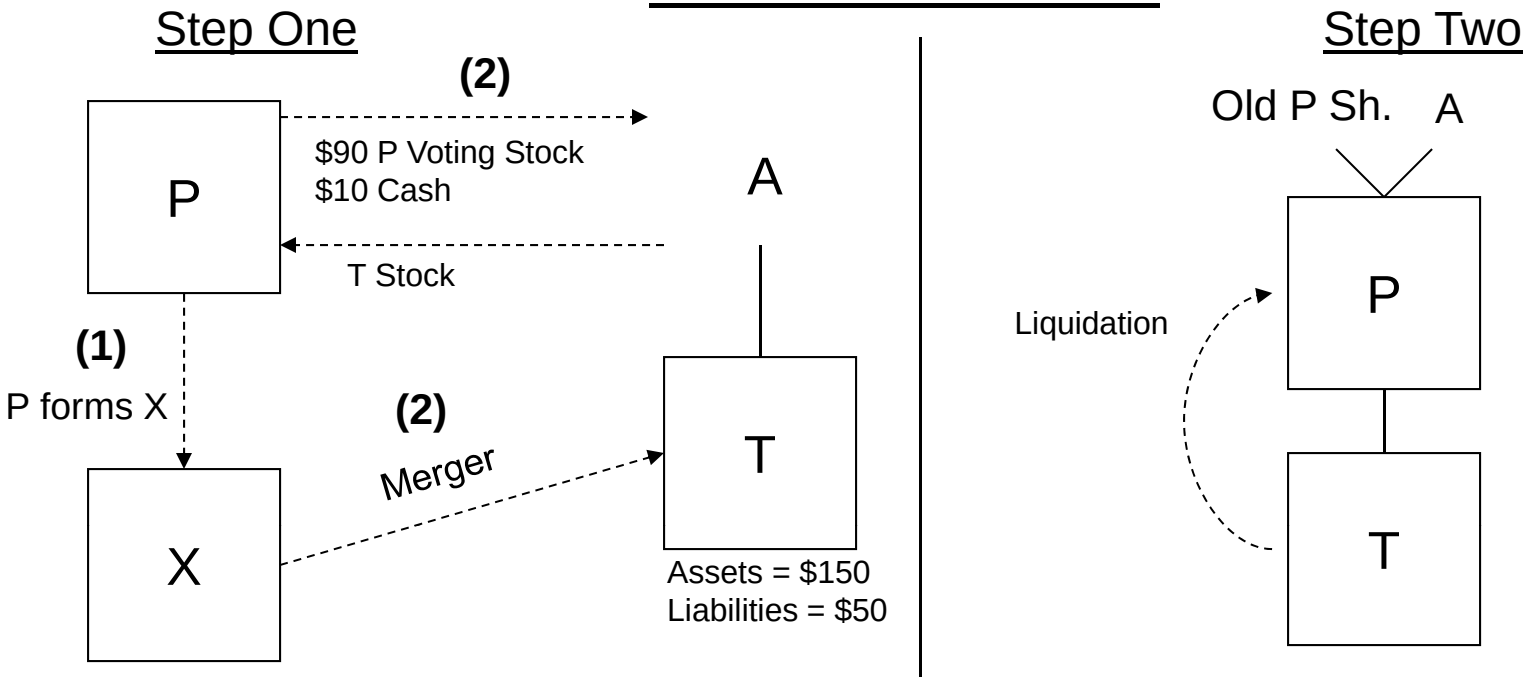
Facts: T currently operates two businesses. T contributes all of its Business 2 assets to C, a newly formed wholly owned subsidiary. T distributes the stock of C to T shareholders in a spin-off. P acquires T from the T shareholders in exchange for P stock. Immediately thereafter, T is liquidated into 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); Treas. Reg. § 1.338(h)(10)-1(c)(2), (e).

Rev. Rul. 2008-25



Facts: A, an individual, owns all of the stock of T. T holds assets worth $150 and has $50 of liabilities. P, an unrelated corporation, has net assets worth $410. P forms X for the sole purpose of acquiring the stock of T in a reverse subsidiary merger. In the merger, P acquires all of the stock of T, and A exchanges the T stock for $10 in cash and P voting stock worth $90. Following the merger and as part of an integrated plan that included the merger, T completely liquidates into P. In the liquidation, T transfers all of its assets to P, and P assumes all of T's liabilities.

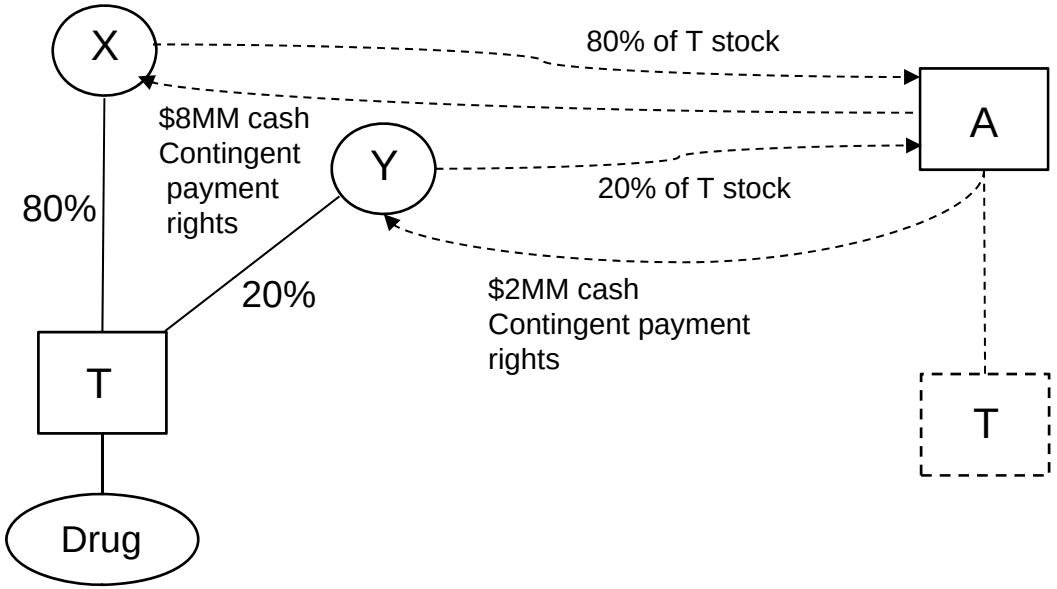
Result: The merger does not constitute a tax-free reorganization because T's liquidation does not fall within the safe harbor from the application of the step transaction doctrine (*i.e.*, Treas. Reg. § 1.368-2k). When the merger and liquidation are integrated, the transaction fails the requirements of a tax-free reverse subsidiary merger set forth in section 368(a)(2)(E) because T does not hold substantially all of its properties and the properties of the merged corporation. Moreover, viewing the merger and the liquidation as integrated steps does not cause the transaction to be treated as a tax-free "A", "C" or "D" reorganization or a section 351 exchange. For example, the transaction would not constitute a tax-free "C" reorganization because 40% of the consideration exchanged by P is not solely P voting stock (*i.e.*, $50 assumption of liabilities and $10 cash). The deemed taxable exchange of T assets to P would not permit P to obtain a cost basis in the T assets because Rev. Rul. 90-95 and Treas. Reg. § 1.338-3(d) reject the step transaction approach in so far as a taxpayer may obtain a cost basis in assets acquired in a stock purchase in absence of a section 338 election.

Contingent Purchase Price in Taxable Acquisitions

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences

- Closed transaction method
- Open transaction method
- Installment method

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Discussion Problem—Facts



- T is a C corporation has owned 80%, and Y has owned 20%, of the T stock for five years. X's and Y's stock basis = $0
- T has developed Drug that could cure a dreaded disease, but no clinical trials leading to regulatory approval have been held
- X and Y sell the T stock to P for:
  - $10 million cash
  - Right to payments up to $100 million as regulatory landmarks are reached
  - Right to percentage of sales of Drug with no maximum
- In its financial statement, A reports a $25 million liability for the contingent payments to X and Y

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Discussion Problem
Analysis

- **Closed transaction**
  - Gain taxed at closing = cash received + FMV of contingent payment right
    X's gain = $8MM + $20MM (?). All long-term capital gain
    Y's gain = $2MM + $5MM (?). All long-term capital gain
  - Gain or loss on contingent payments
    - Recovery of basis up to FMV taxed at closing
    - Gain to extent contingent payments received > FMV taxed at closing — probably ordinary income
    - Loss to extent payments received < FMV taxed at closing — probably ordinary loss
    - Imputed interest taxed as ordinary income as cash is received
- **Open transaction**
  - Gain taxed at closing = cash received; all long-term capital gain
  - Gain on contingent payments taxed as received; all long-term capital gain except imputed interest
- **Installment method**
  - Gain taxed at closing = cash received; all long-term capital gain
  - Gain on contingent payments taxed as received; all long-term capital gain except imputed interest
  - Section 453A deferral charge on deferred gain >$5MM
  - How is "deferred gain" determined?
- *See also* section 1202

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Closed Transaction Method
Treatment at Closing

- Treas. Reg. §1.1001-1(g)(2)
  - Amount realized on sale includes FMV of contingent payment right
  - In determining FMV, restrictions on transfer of payment right are not taken into account
  - FMV of contingent payment right cannot be < FMV of property sold, less other amounts realized
  - Taxable at closing of sale
- Old case law suggested that cash method Seller could defer tax until receipt of "cash equivalent," but regs reject this case law
  - *Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir. 1975), *rev'g* 60 T.C. 663 (1973)
  - Treas. Reg. §15a.451-1(d)(2)(i)

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Closed Transaction Method
Gain or Loss on Receipt of Contingent Payment

- Each payment is treated as part-principal and part-interest, if adequate interest is not stated (section 483 or section 1274; Treas. Reg. §§1.483-4 and 1.1275-4(c)(4))
  - In most acquisitions, interest portion of payment is ordinary income to Seller and deductible to Buyer, but only when contingency is fixed
  - No OID or other interest income accrual before contingency is fixed
  - Principal first goes to recover basis of contingent payment right (FMV included in amount realized at closing)
  - Excess of principal payments received over basis of contingent payment right = gain
  - Excess of basis in contingent payment right over principal payments received = loss, but loss may be taken only when no more contingent payments are expected
- Character of gain or loss
  - Character of gain or loss on sale to may govern character on contingent payment right (*Arrowsmith v. Commissioner*, 344 U.S. 900 (1952))
  - If *Arrowsmith* does not govern, character is uncertain and may depend on whether contingent payment right is a “debt instrument” or a “contract right”

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Closed Transaction Method
Character of Gain or Loss
Debt Instrument or Contract Right?

- In a number of cases, courts have tried to determine—
  - If a contract right to receive ordinary income (*e.g.*, winning lottery ticket, real property lease by owner, right to sell or purchase electric power) is a capital asset, resulting in capital gain or loss on sale
  - If a transaction in which a contract right holder is paid under the contract or in settlement thereof is "sale or exchange" resulting in capital gain or loss
- Section 1234A may allow capital gain and require loss
  - Is payment received under terms of contract a payment in "cancellation, lapse, expiration or other termination" of contract?
  - Case for capital gain or loss under section 1234A is weakened where contract calls for stream of payments, not a single payment (unless right to each payment is treated as a separate contract)

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Closed Transaction Method
Character of Gain or Loss
if Debt Instrument

- Section 1271(a) imposes exchange treatment at maturity, overruling *Fairbanks v. United States*, 306 U.S. 436 (1939)
- This treatment would produce capital gain or loss
- "Debt instrument" broadly defined in section 1275 regulations
- But uncertainty remains under debt vs. contract case law, where right to future payments is contingent on future events

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Closed Transaction Method
FMV of Contingent Payment Rights Underestimated
Character of Gain

- What happens if little is expected but much is received from contingent payment right?
- Possible conversion of contingent sale price from capital gain to ordinary income
  - Contingent payment right is determined to be contract right, not debt instrument
  - *Arrowsmith v. Commissioner*, 344 U.S. 900 (1952) does not govern

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Closed Transaction Method
FMV of Contingent Payment Rights Overestimated
Character of Loss

- What happens if much is expected but little or nothing is received from the contingent payment right?
- If gain from an underestimated FMV of contingent payment right would be ordinary income, loss from overestimated FMV should be ordinary loss
- If the loss is a capital loss, the loss can be orphaned if capital gains are not available:
  - Gain recognized on the sale may not be available from loss carryback
  - If Seller is an individual, no carryback
  - If Seller is a C corporation, 3-year carryback

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Open Transaction Method
General

- Based on *Burnet v. Logan*, 283 U.S. 404 (1931); *see also Inaja Land Co. v. Commissioner*, 9 T.C. 727 (1947), *acq*. 1948-1 C.B. 2
- Available only in "rare and extraordinary" cases where FMV of contingent payment right is not reasonably ascertainable (Treas. Reg. §1.1001-2(g)(2)(ii))

– *Compare Dorsey v. Commissioner*, 49 T.C. 606 (1968) and *MacDonald v. Commissioner*, 55 T.C. 840 (1971) (open transaction method allowed) with *In re Steen v. United States*, 509 F.2d 1398 (9th Cir. 1975) (open transaction method partially allowed)

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Open Transaction Method
Comparison with Other Methods

- Advantages compared with installment method:
  - Full front-end asset basis recovery
  - No section 453A deferral charge
- Compared with closed transaction method:
  - Advantage: All proceeds, other than imputed interest, eligible for capital gain treatment
  - Disadvantage: No loss until remaining basis exceeds possible remaining payments

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Open Transaction Method
Recent Support

- Despite hostility in the regulations and recent commentary, the open transaction method is still available in some situations
- Recent court decisions are surprisingly supportive:
  - *Fisher v. United States*, 82 Ct. Fed. Cl. 780, 102 AFTR 2d 2008-5608 (Aug. 6, 2008), *aff'd without opinion*, 2009 WL 3241381 (Fed. Cir. 2009) (in life insurance company demutualization, policyholders who received cash in lieu of stock entitled to allocate *all* premium costs to basis in stock, on open transaction theory)
  - *Anschutz Company v. Commissioner*, 135 T.C. 78 (2010), *aff'd* 108 AFTR 2d 2011-7590 (10th Cir. 2011) (Tax Court allows open transaction treatment for contingent purchase price in complex financial transaction treated as sale)

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
General

- Defers tax on gain from future payments until received
- Applies only to gain, not loss
- General rule is *pro rata* basis recovery
- If there is a maximum selling price, recover basis on assumption that maximum price will be received
- If there is no maximum selling price, but there is a time limitation, recover basis straight-line over maximum time for payments
- If there is neither maximum selling price nor time limitation—
  - Basis recovery is straight-line over 15 years unless general rule would inappropriately accelerate basis recovery:
    - Seller may request PLR
    - IRS may require basis recovery on non-straight-line basis
  - Losses are deferred until all amounts have been recovered
  - Is the transaction really a sale?
- Each payment is treated as part-principal and part-interest.

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Method
Limitations

- Applies only to gain, not loss
- Not available for—
  - Sale of inventory property (including bulk sale)
  - Sale of marketable securities
  - Depreciation recapture
- Limited security on installment obligation allowed without ending deferral
- Sale to related party followed by second sale within 2 years ends deferral
- Disposition of installment obligation by holder ends deferral
- Modification of installment note may constitute a disposition, but some modifications are permitted.

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Multiple Assets—Allocation of Cash and Installment Obligation

- In sale of multiple assets, can installment obligation be allocated to low-basis assets and cash to high-basis assets?
  - Results: accelerate basis recovery, defer more gain and accelerate loss on some assets
  - *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945); *Monaghan v. Commissioner*, 40 T.C. 680 (1963), *acq*. 1964-2 C.B. 6; Rev. Rul. 68-13, 1968-1 C.B. 195
  - In LAFA 20080101F, LB&I concluded that the above authorities apply only to determine character of gain or loss and exclude assets not eligible for installment method (*e.g.*, inventory)—not to thwart ratable basis allocation or allow immediate loss and deferred gain
  - Compatibility with §§ 1060 and 338(h)(10) of allocation of installment notes to some assets and cash to other assets with sections 1060 and 338(h)(10)?
- Similarly, can different installment obligations be allocated to different assets, each with its own “gross profit ratio”?

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Allocation to Services or Covenants

- May contingent purchase price be allocated to services provided by Seller or to Seller's covenant not to compete?
- Payment for services—
  - Taxed to Seller on accrual or receipt (cash method) with no basis offset and no deferral charge
  - Usually currently deductible to Buyer as accrued or paid, but deferred compensation rules (sections 404(a)(5) and 409A) may defer deduction
- Payment for covenant–
  - Taxed to Seller on accrual or receipt with no basis offset and no deferral charge
  - Amortizable to Buyer under section 197

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Deferral Charge—Computation, Etc.

- Section 453A imposes a charge for deferring taxable gain under installment method
- Computation:
  - Amount of deferred gain = tax at "maximum rate" on capital gain
    - "Maximum" section 1(h) rate for individuals is the 28% rate on sales of collectibles, etc., even though the effective rate on the gain from the sale is lower
    - Section 1201 determines maximum rate for C corporations
  - Interest rate is the floating underpayment rate
- Deferral charge is treated as interest (section 453A(c)(5))
  - Deductible to corporations
  - Not deductible to individuals
- Seller generally may not elect to pay deferred tax early and avoid further deferral charges
  - Installment method has no provision to elect out later, *e.g.*, if interest rates increase (Treas. Reg. §15a.453-1(d)(3)(ii))
  - Seller may be able to avoid deferral charges by self-help—disposition (sale or pledge) of installment obligation triggers gain on installment sale
  - Modification of installment note not necessarily a disposition (Rev. Rul.75-457; PLR 201144005

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Deferral Charge—*De Minimis* Amounts

- Deferral charge applies only to—
  - Installment sales of property > $150,000 sale price
  - > $5MM aggregate face amount of installment obligations held by Seller at year end (excluding obligations subject to $150,000 exclusion
- *De minimis* amounts apply separately to each partner or S corporation shareholder (Notice 88-81, 1988-2 C.B. 397)

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Deferral Charge—Contingent Payments—General

- Regulations are to be issued on application of section 453A to contingent payments (section 453A(c)(6)), but no regulations have been issued or proposed
- Can section 453A be ignored until regulations become effective?
  - Many contingent obligations do not have a "face amount," and so *de minimis* rule may apply (or there may be no "installment obligation")
  - FSA 199941001 (section 453A self-executing without regulations)

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Deferral Charge—Contingent Payments—Possible Computation Methods

- Until section 453(c)(6) regs become effective, how is deferral charge computed?
  - FSA 199941001 (deferral charge based on FMV of contingent payment right at closing)
  - TAM 9853002 (no refund of deferral charge based on FMV of contingent payment right at closing, even if contingent payment is never received)
  - If FMV of contingent payment right cannot be determined at closing, is there no deferral charge, even if Seller does not elect out of installment method?
- LAFA 20080101F suggests another method called “look back”
  - Look back method is not described
  - Would Seller pay deferral charge on contingent purchase price when received, regardless of FMV of contingent payment right at closing?

Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Election Out—General

- Seller may elect out by reporting sale under either of the other methods:
  - Closed transaction
  - Open transaction
- Does assumption of contingent obligations alone put Seller on installment method unless Seller elects out?
  - Election out of installment method is irrevocable except with IRS consent
  - Seller may not elect out after filing original return except for good cause with IRS consent, to be granted in "rare circumstances" (Treas. Reg. §15a.453-1(d)(3)(ii))

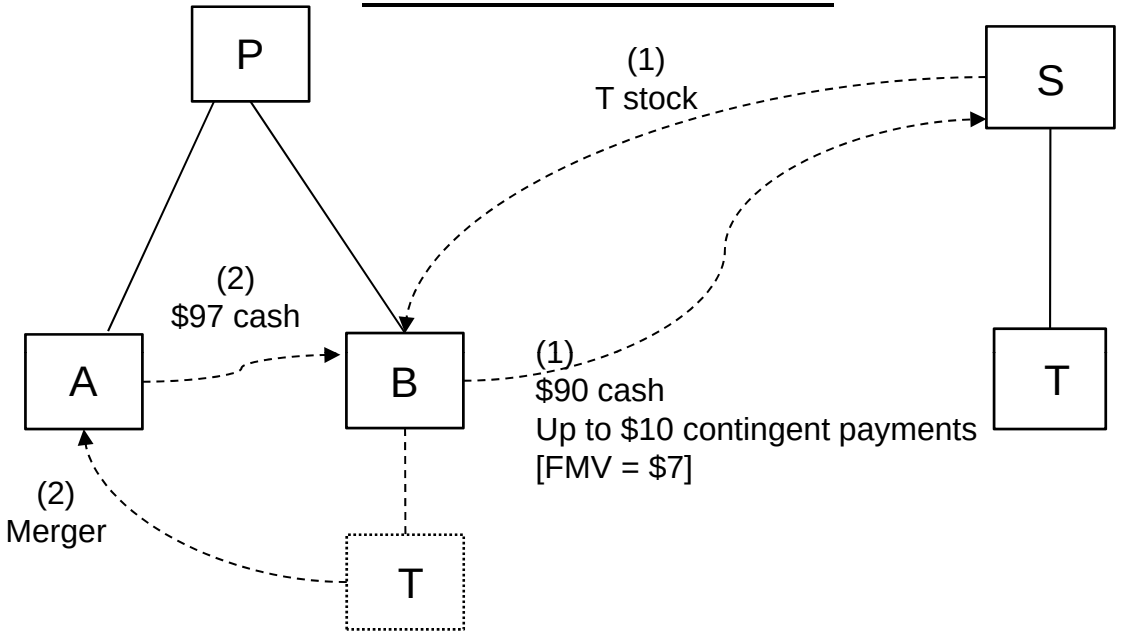
Contingent Purchase Price in Taxable Acquisitions
Seller Consequences
Installment Sale
Election Out—Erroneous Open Transaction Method

- Consequences of electing out of installment method to claim open transaction method and being wrong:
  - Because of election out, no deferral charge
  - Regulations do not allow late revocation of election out
  - Result is closed transaction method
  - Capital gain character of contingent payments in excess of FMV at closing is jeopardized
- *But see Mamula v. Commissioner*, 346 F.2d 1016 (9th Cir. 1965)
  - Taxpayer erroneously used open transaction method for fixed-amount note on accountant's advice
  - IRS disallowed open transaction method, and taxpayer tried to elect installment method after the fact, but IRS disallowed the election
  - *Held*, IRS could not refuse to allow taxpayer to elect installment method (distinguishing *Pacific National Co. v. Welch*, 304 U.S. 191 (1938), in which original method was permissible)
  - Does IRS get to choose new method if taxpayer has selected impermissible method?

Contingent Purchase Price in Taxable Acquisitions
Buyer Consequences

- Buyer gets no asset basis for contingent purchase price until fixed or paid
- Makes no difference which method Seller uses to report sale—even if Seller reports difference between amount realized at closing and amount collected as gain or loss in separate transaction (and so does not adjust its section1060 allocation)
- As Buyer pays contingent purchase price, asset basis is increased—usually increases basis in section197 assets

Contingent Purchase Price in Taxable Acquisitions
Buyer Consequences
Discussion Problem



- B buys the T stock from S for $90 cash and a right to contingent payments up to $10 (FMV = $7)
- B's basis in T stock = $90.
- T is merged into A for $97 cash in an all-cash D reorganization (Treas. Reg. §1.368-2(l))
- Consequence to B is $97 "boot," taxable to the extent of B's $7 realized gain on the T stock
- What happens if B pays $7 of contingent purchase price to S after the year of closing? $10?

Escrows in Taxable Acquisitions

Escrows in Taxable Acquisitions
Issues

- Is Seller deemed to receive escrowed proceeds upon establishment of escrow at closing (installment sale, closed transaction or open transaction)?
- Who is taxed on income earned by the escrowed funds during the escrow period?

Escrows in Taxable Acquisitions
Timing of Inclusion in Seller's Amount Realized

- If escrow protects Seller (*e.g.*, to secure Buyer's payment of purchase price), Seller is deemed to receive escrow proceeds in year of sale
- If escrow is under Seller control (*e.g.*, investment authority), Seller's amount realized includes escrowed funds
  - *Chaplin v. Commissioner*, 136 F.2d 298 (9th Cir. 1943)
  - *Bonham v. Commissioner*, 89 F.2d 725 (8th Cir. 1937)
- If escrow protects Buyer (*e.g.*, to secure Seller indemnities), amount realized for escrow proceeds is deferred until payment to Seller becomes fixed
  - IRS agrees that sale with escrow for Buyer's benefit is eligible for installment method (Rev. Rul. 77-294, 1977-2 C.B. 173, *amplified* Rev. Rul. 79-91, 1979-1 C.B. 179; IRS Pub. 537 (citing "substantial restriction" requirement); PLR 200521007)
  - Case law supports contrary argument (*Granneman v. Unites States*, 649 F. Supp. 949 (E.D. Mo. 1986) (note intended to be paid by Buyer, not out of escrow))
  - Section 453A deferral charge applies if installment method is used
  - If escrow with "substantial restrictions" can be reported on open transaction method, section 453A does not apply

Escrows in Taxable Acquisitions
Taxation of Escrow Income

- "Homeless income"
- Congressional response: section 468B(g)(1)
- 1999 proposed regulations would tax *Buyer* on the income from escrowed funds until Seller's right to the funds becomes fixed
- Until regulations are finalized, either Buyer or Seller may be allocated the escrowed income by contract (Query: Must this allocation have economic substance?)
- Parties' agreement as to which party reports income does not impact timing of Seller's gain recognition on sale, or vice versa (Prop. Treas. Reg. §1.468B-8(d); *Anderson v. Commissioner*, 20 T.C.M. 697 (1961))

Contingent Obligations in Taxable Asset Acquisitions

Assumption of Contingent Obligations in Taxable Asset Acquisitions Possible Tax Treatments

- Almost every acquisition involves contingent obligations of the acquired business
  - Environmental obligations
  - Tort liabilities
  - Warranty claims
  - Retiree medical expenses
- Issue arises when Buyer business assets and then pays or incurs a liability attributable to acquired business
- Three tax treatments possible
  - Buyer expense, usually deductible by Buyer when paid or accrued
  - Seller contingent obligation assumed, *i.e.*, Seller expense paid by Buyer
    - Capitalized by Buyer in price paid for purchased assets
    - Added to Seller's amount realized on sale, with offsetting deduction
  - "Fee" analysis

Assumption of Contingent Obligations in Taxable Asset Acquisitions Consequences Buyer Expense Treatment

- Buyer “steps into shoes” of Seller and deducts or capitalizes obligation
- Buyer’s deduction or asset basis increase occurs when obligation is accrued or paid (economic performance) under general tax accounting rules
- No gain, income or deduction to Seller

Assumption of Contingent Obligations in Taxable Asset Acquisitions
Consequences
Assumed Contingent Liability Treatment
General

Seller

– Inclusion in amount realized on sale

– Offsetting deduction

– Imputed interest income

• Installment reporting

Buyer

– Capitalize payment but only when accrued and economic performance occurs

– Imputed interest expense

Assumption of Contingent Obligations in Taxable Asset Acquisitions Consequences Assumed Contingent Liability Treatment Seller

Inclusion in Amount Realized

- Seller is relieved of an obligation and so has an economic benefit
- Seller's amount realized is increased
  - One approach is to value the obligation at closing and increase the amount realized at closing by that amount, with adjustments later ("closed transaction")
  - Other approach is to increase amount realized only when contingency becomes fixed and determinable ("open transaction")

Is Interest Imputed on Deemed Payment?

- Arguably there is no imputed interest, because section 1274 does not apply to assumed debt (section 1274(c)(4))
- Does section 483 require imputed interest upon payment?

Installment Reporting

- If open transaction approach is taken, is the sale an installment sale because of possible future payment?
  - Section 453 regulations do not discuss assumption of contingent obligations
  - If payment of obligation is treated as payment of purchase price, sale literally falls within definition of contingent payment installment sale
  - Could lead to deferral charge

Assumption of Contingent Obligations in Taxable Asset Acquisitions Consequences Assumed Contingent Liability Treatment Seller (cont'd)

Does Seller get offsetting deduction against amount realized?

– Seller should get a deduction (*Commercial Security Bank v. Commissioner,* 77 T.C. 145 (1981); *James M. Pierce Corp. v. Commissioner*, 326 F.2d 67 (8th Cir. 1964))

- o Both courts said that obligation assumed by Buyer reduced cash received by Seller
- o Such a reduction in cash received is treated as if Seller received more cash and paid the obligation with that cash
- o Seller gets a deduction to offset income

Assumption of Contingent Obligations in Taxable Asset Acquisitions Consequences Assumed Contingent Liability Treatment Seller (cont'd)

When does Seller get offsetting deduction against amount realized (cont'd)?

- Treas. Reg. §1.461-4(d)(5)) provides that, in a sale of a business, if Buyer "expressly assumes" a fixed liability, economic performance occurs as the liability is included in Seller's amount realized
- Regulation is too narrow to provide much comfort
  - It requires an express assumption
  - It covers only the economic performance requirement, not the all-events test
    - It requires an express assumption
    - It covers only the economic performance requirement, not the all-events test
  - Treas. Reg. §1.461-4(j) reserves treatment of contingent obligations
- If the regulation test is failed, Seller may have income with no matching deduction until later
  - Presumably deduction is deferred until Buyer makes payment, or amount is fixed
  - This is the wrong answer—in acquisition context Seller should not be subject to economic performance
    - Section 461(h) was intended to prevent premature accrual. If Seller has income recognition, accrual is not premature
    - If Seller does not get deduction at closing, no clear reflection of income
    - Does *Commercial Security Bank* apply if section 461(h) requirements are not met?

Assumption of Contingent Obligations in Taxable Asset Acquisitions Consequences Assumed Contingent Liability Treatment Seller (cont'd)

When does Seller get offsetting deduction against amount realized (cont'd)?

– Similar problem arises where obligation is to pay nonqualifying deferred compensation

  o Section 404(a)(5) – employer gets deduction when employee has income

  o IRS position: deemed payment found in *Commercial Security Bank*, etc. does not support a deduction until income to employee (TAM 8939002)

Assumption of Contingent Obligations in Taxable Asset Acquisitions
Consequences
Assumed Contingent Liability Treatment
Buyer

- Treat assumed obligation as cost of purchased assets and add to asset basis
- Capitalization approach has greater support in case law
  - *Webb v. Commissioner,* 77 T.C. 1134 (1981), *aff'd*, 708 F.2d 1254 (7th Cir. 1983)
    - Unfunded pension obligation assumed in asset acquisition
    - Payments treated as cost of acquired assets
  - *Holdcroft Transportation Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946)*, Pacific Transport; M. Buten & Sons v. Commissioner*, T.C. Memo 1972-44
- Uncertain whether Buyer may treat a portion of the payments as currently-deductible interest when made (no OID)
  - Section 1274 does not apply to obligation assumptions
  - Does section 483 apply?
- Addition to asset basis is delayed to when obligation becomes fixed (accrual and economic performance)
- But, if Buyer sells asset subject to the same contingent obligation before the obligation is added to asset basis, assumption of the obligation from Buyer is excluded from Buyer's amount realized on this later sale (Treas. Reg. §1.1001-2(a)(3))

Assumption of Contingent Obligations in Taxable Asset Acquisitions Consequences Fee Treatment

- In *James M. Pierce Corp. v. Commissioner,* 326 F.2d 67 (8th Cir. 1964), Seller owned a newspaper and received prepaid subscription fees
  - Seller initially set up a reserve and deferred the income under section 455
  - Court held that when Seller sold the business, it had to recapture the reserve into income
  - But the court also gave Seller a deduction
    - Buyer paid cash for reserve
    - Seller is deemed to turn around and pay Buyer a fee for assuming obligation to fill newspaper subscriptions
    - Thus Seller's income from the reserve was offset with a deduction for the "fee"
  - Deemed receipt of fee would be currently taxable to Buyer
  - Deemed reduction in purchase price for assumption of obligation is added back to Buyer's basis in purchased assets at closing
  - Payment of obligation should be currently deductible
  - *See also* Rev. Rul. 71-450

Assumption of Contingent Obligations in Taxable Asset Acquisitions Consequences Fee Treatment Other Authorities

- *TFH Publications v. Commissioner*, 72 T.C. 623 (1979): Acquisition of publishing company assets with agreement to provide future advertising services at a discount
- TAM 9823992: Prepaid subscription income treated as obligation assumed
- Fee approach has not received much support outside publication industry
- But preamble to a consolidated return regulation (T.D. 9376 (Jan. 16, 2008)) implies that fee theory applies in section 332 liquidation if shareholder assumes obligation to provide future services (but supporting example involves prepaid subscription income)
- Different approach is implied in *In re Steen v. United States*, 509 F.2d 1398 (9th Cir. 1975) (buyer of uranium mine paid seller additional purchase price due to favorable state tax decision; *held*, open transaction; fee income to buyer not asserted)

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors in Determining Treatment

- Does the obligation result from Seller's or Buyer's activities
- Does the obligation arise out of pre-acquisition or post-acquisition events
- Did legal obligation arise before or after closing?
- Is there is express assumption by Buyer of the obligation and reflection in price?
- Was Buyer aware of obligation (balance sheet reserve) at closing?

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

First Factor: Results from Seller or Buyer Operations—*Holdcroft*

- Whether the obligation arises from—
  - Seller's or Buyer's operation of the business
  - Activities performed by Seller or Buyer
  - Events under Seller's or Buyer's control
  - Seller's or Buyer's decisions
- *Holdcroft Transportation Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946):
  - Buyer buys assets for stock and assumption of obligations—including tort claims
  - Buyer pays claims and deducts payments
    - Buyer argues that it steps into Seller's shoes and may deduct payments
    - Buyer also argues it may deduct payments because claims were contingent
  - Court holds:
    - Claims arose out of Seller's business
    - Buyer may not deduct costs relating to Seller
    - Fact that obligation was contingent does not matter
    - Buyer assumed obligations part of costs of assets

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

First Factor: Results from Seller or Buyer Operations—Other Authorities

- *Albany Car Wheel v. Commissioner*, 333 F.2d 653 (2nd Cir. 1964) – obligation arose after acquisition due to Buyer's decision to close plant
- Rev. Rul. 76-520 – Buyer acquired newspaper business
  - Costs of filling prepaid subscriptions was assumed obligation because it relates to Seller operations
  - Costs of selling newspapers at newsstands deductible because they related to Buyer operations
- TAM 9721002 – acquisition and severance pay
  - "[A]lthough severance payments here were coincidental with Buyer's acquisition of Target, the severance payments had their origin in Buyer's termination of Target employees. While the acquisition may have been the catalyst for the employees' receipt of the severance payments, the acquisition was not itself the basis for the payments. Accordingly, the severance payments need not be capitalized and added to the basis of the stock purchased."
- *Illinois Tool Works v. Commissioner*, 355 F.3d 997 (7th Cir. 2004)
  - Because the taxpayer knew of the pending patent infringement lawsuit, and agreed to pay that contingent obligation in exchange for purchasing the company, the taxpayer was not entitled to currently deduct the judgment as a business expense

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

Second Factor: Arises Out of Pre-Acquisition or Post-Acquisition Events

- A factor closely related to the first factor is whether the obligation arises out of pre- or post-acquisition events
- For example, employee benefit cases:
  - Where there is a contract in place at time of acquisition to pay death benefits to employees
  - If employee dies after closing, obligation should be a Buyer obligation
  - If employee has died and Seller is obligated to pay, Buyer assumes obligation—no deduction to Buyer
- *M. Buten & Sons, Inc. v. Commissioner*, T.C. Memo 1972-44
  - Corporation agreed to assume liabilities of partnership in section 351 transaction, including death benefits to surviving widows
  - No deduction for payments to widow of employee who died before the acquisition
  - Payments were deductible if employee died after the acquisition
- *David R. Webb Co., Inc. v. Commissioner,* 708 F.2d 1254 (7th Cir. 1983)
  - Buyer assumed Sellers obligation to make pension payments to wife of deceased employee
  - No deduction to Buyer

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

Third Factor: When did Legal Obligation Arise?

- Courts have held that legal obligation for a tort arises when the tort occurs
  - *Holdcroft* and *Pacific Transport* support the idea that contingent nature of tort is not relevant
- Compare cases where obligation represents contract claim, not tort (*Albany Car Wheel*)
  - Collective bargaining agreement required severance payments to employees upon plant shutdown
  - Purchase agreement called for express assumption of the severance obligation
  - After assets were transferred, plant was shut down, and Buyer made severance payments
  - Court held that obligation did not arise until after closing when plant shut down, and obligation arose on Buyer's side

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

Fourth Factor: Was Buyer Aware of Obligation?

- *Pacific Transport v. Commissioner*, 483 F.2d 209 (9th Cir. 1973)
  - Parent corporation liquidated subsidiary (old section 334(b)(2)) and took assets and assumed liabilities, including a lawsuit
  - Parent believed its risk on the claim was remote.
  - Parent's risk assessment was wrong, and it ultimately paid claim.
  - Tax Court held that deduction was allowed, because claim was speculative and remote
  - Appeals court reversed and held that contingency was irrelevant
    - Because Buyer was aware of obligation, payment of claim was a cost of acquiring assets
    - No exception to capitalization for bad bargains
- Reserve for liability on Seller's balance sheet would make Buyer aware of obligation
- *But see Holdcroft Transportation Co. v. Commissioner,* 153 F.2d 323 (8th Cir. 1946)

Assumption of Contingent Obligations in Taxable Asset Acquisitions Factors

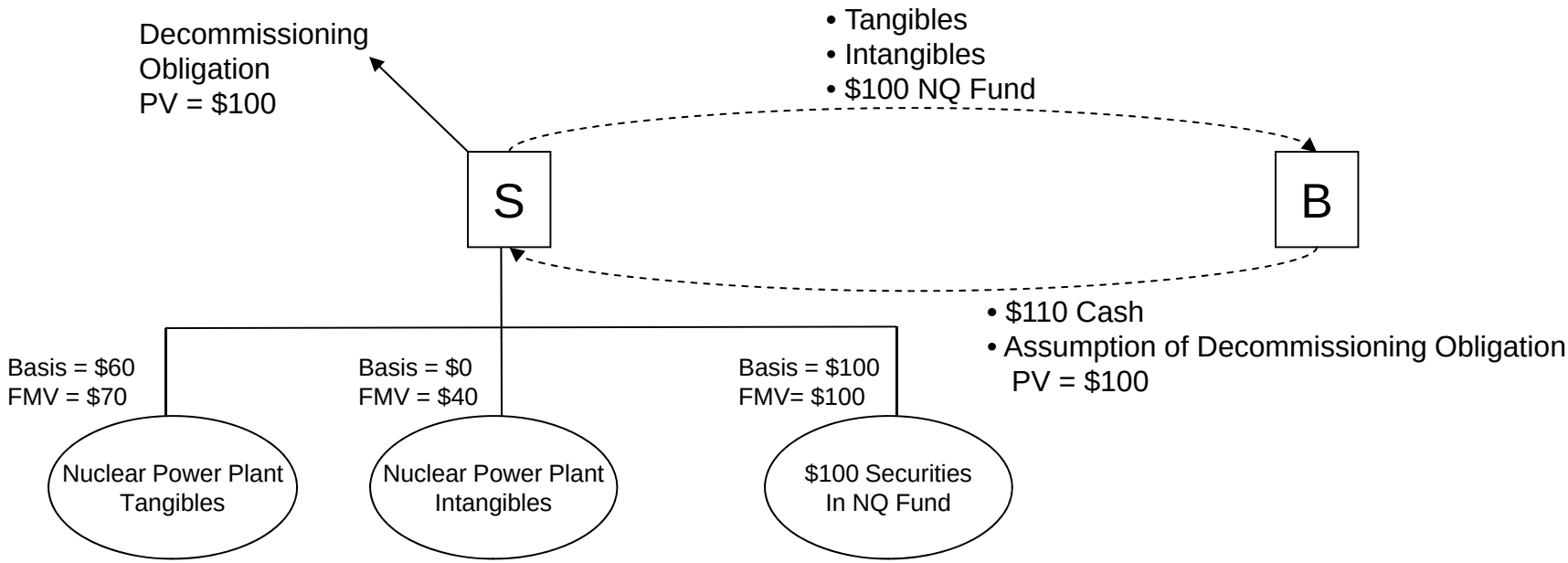
Fifth Factor: Obligation Expressly Assumed by Buyer and Reflected in Price

- Was purchase price reduced on account of the contingent obligation? If so, the obligation looks like an assumed liability
- This factor comes up often where:
  - Purchase price based on balance sheet
  - Reserve on balance sheet
- Allows IRS to argue that the liability was reflected in the price
- If Buyer expressly assumes a liability of Seller, courts generally conclude that Buyer assumes the liability
- This factor alone should not be dispositive (*Albany Car Wheel*)

Assumption of Contingent Obligations in Taxable Asset Acquisitions Contracts Transferred to Buyer

- Acquired business may have favorable or unfavorable contracts, or both
- Favorability of a contract may be measured by reference to expected profit or loss on compliance or, even if profit is expected, based on baseline margin
- Under GAAP purchase accounting (PACO), Buyer must reserve for estimated costs of compliance with unfavorable contracts as additions to purchase price (FASB Statement No. 38)
- Consequently, if Buyer deducts these costs for tax purposes, Schedule M adjustments result
- Unfavorable contracts could be viewed as reduced-value assets instead of contingent liabilities under section 1060, resulting in costs deductible to Buyer
- If net costs of compliance with unfavorable contracts were treated as contingent liabilities, should net income from favorable contracts be excluded from Buyer's income and treated as reduction in purchase price?
- PLR 200730014 (July 27, 2007)
  - Purchaser of gas marketing business paid customers to terminate pre-existing contracts to supply gas at fixed price and substitute contracts at fluctuating prices
  - Payments deductible to Buyer, not capitalized as adjustments to purchase price, because—
    - Obligations contingent on customers' gas purchases and market price
    - Contracts not taken into account in determining purchase price
- *Albany Car Wheel*
  - No step-up in cost basis of business assets for Buyer's payment of severance pay
  - Buyer negotiated new collective bargaining agreement providing for severance pay
- *See also* section 1274(c)(4) (in asset purchase, interest not imputed to account for favorable or unfavorable financing)

Assumption of Contingent Obligations in Taxable Asset Acquisitions — Discussion Problem Nuclear Power Plant Decommissioning



- S owns a nuclear power plant
  - S's basis in tangibles is $60, and their FMV is $70
  - S's basis in intangibles is $0, and their FMV is $40
  - The plant is expected to be decommissioned in 2051at $500 cost (present value $100)
  - S has set aside securities ($100 basis and FMV) in a "nonqualified fund" to fund this cost
- S sells the plant to B in 2011
  - S transfers the tangibles, intangibles and nonqualified fund to B
  - B pays S $110 cash and assumes the decommissioning cost obligation
- Between the sale and 2051, the securities in the nonqualified fund increase in FMV to $500
- In 2051, the plant is decommissioned at $500 cost, paid out of the fund

PLR 200004040 (January 31, 2000) and other PLRs
Treas. Reg. §1.338-6(c)(5)

Contingent Obligations in Taxable Stock Acquisitions

Contingent Obligations in Taxable Stock Acquisitions Non-Consolidated Return Situations

- If Target stock is sold, and if contingent obligations remain with Target, the obligations should be reflected in purchase price
- Otherwise, there is no immediate tax effect to either Seller or Buyer
- Generally, there are no special consequences when the obligations become due and are paid
- Target deducts or capitalizes accrual and/or payment in accordance with usual tax accounting rules

Contingent Obligations in Taxable Stock Acquisitions Consolidated Return Regulations Transition Issues

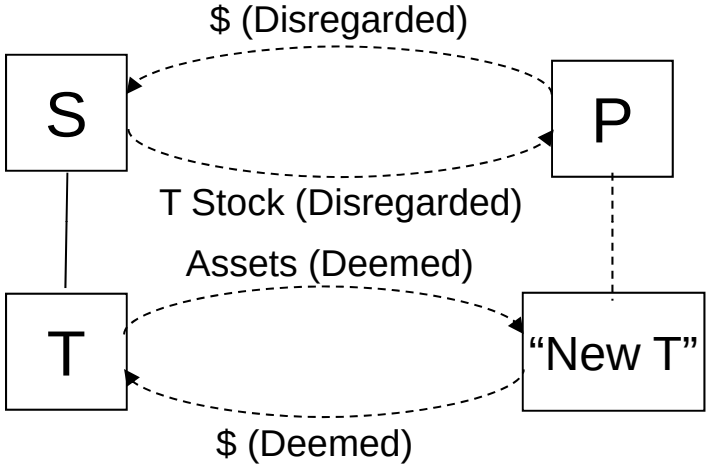
- If Seller sells Target stock during a consolidated return year, planning is needed:
  - If the contingent obligation generates a deduction on the day of sale, either the Seller's group or the Buyer's group may be claim the deduction, if the parties are consistent (Treas. Reg. §1.1502-76(b))
  - If the obligation is for deferred compensation under section 404(a)(5), the deduction may have to belong to the Buyer's group
  - *But see* GLAM 2012-010 (nonqualified stock options and stock appreciation rights payable upon change in control; IRS concludes that deductions had to be taken on pre-acquisition return)
- If Seller's group claims the deduction—
  - Seller's basis in the Target stock is reduced (Treas. Reg. §1.1502-32), and its gain on the stock sale is increased (or its loss is decreased) by the same amount
  - If Target has a separate company loss for the year, this loss would seem to shelter gain on a sale of Target stock, but it would also reduce Seller's basis in the Target stock and so increase that gain. Thus, $1 gain on the Target stock could use, or "churn and burn" all of Target's loss. The "anti-churn-and-burn" rule (Treas. Reg. §1.1502-11(b)) prevents this result by prohibiting Target's loss from offsetting gain on a sale of Target stock
- If Buyer's group is entitled to the deduction, a loss limitation under section 382(h) or a separate return limitation rule (SRLY) limitation may result

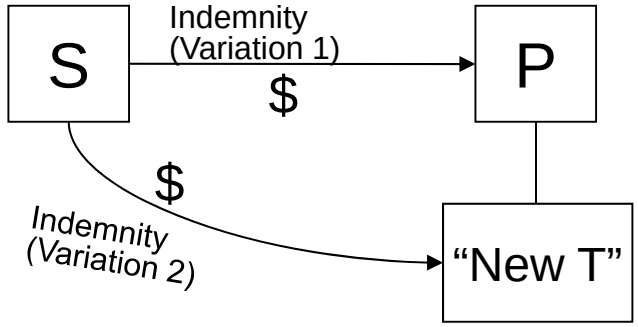
Contingent Obligations in Taxable Stock Acquisitions Consolidated Return Regulations Loss Disallowance or Attribute Reduction

- If stock of consolidated Target is sold at a loss, the loss may be disallowed (Treas. Reg. §§1.1502-36(a)-(c))
- If the loss on the stock sale is allowed, Target's tax attributes (*e.g.*, loss carryovers or asset basis in excess of FMV) may be reduced after the sale to prevent double deduction (Treas. Reg. §1.1502-36(d))
  - If Target's "attribution reduction amount" (lesser of loss on stock sale or net inside loss) is greater than the amount of Target's attributes available for reduction, and if Target has contingent obligations, the excess attribute reduction amount is suspended and applied to prevent Target from deducting or capitalizing a later accrual and/or payment of the contingent obligations (Treas. Reg. §1.1502-36(d)(4)(ii)(C))
  - This rule would apply if, *e.g.*, Target has a contingent obligation and holds cash to pay the obligation
    - The basis of the cash cannot be reduced
    - The loss otherwise could be duplicated when Target accrues and/or pays the contingent obligation and deducts payment or increases cost basis in an asset
  - Seller can prevent this rule from applying to Buyer by electing to reduce its stock basis, to reattribute Target's loss carryovers or deferred deductions, or both

Indemnities of Contingent Obligations

Indemnities of Contingent Obligations
Asset Sale or Section 338(h)(10) Stock Sale
Discussion Problem—Facts





- S owns all the stock of T, which owns a manufacturing business
- S sells T stock to P for cash with section 338(h)(10) election
  - At time of sale, T is defendant in patent infringement lawsuit
  - S agrees to indemnify P (Variation 1) or T (Variation 2) against an adverse judgment
  - Five years after closing, judgment is entered against T for damages plus interest back to three years before closing
  - S pays judgment

Indemnities of Contingent Obligations
Asset Sale or Section 338(h)(10) Stock Sale
Discussion Problem—Analysis

- If Seller indemnifies Buyer for a contingent obligation in an asset sale or a section 338(h)(10) stock sale, no assumption of the obligation is considered to occur
- If accrual or payment of obligation is otherwise deductible, Seller is entitled to deduction when all-events and economic performance tests are met, as though no acquisition had occurred
- Buyer has no taxable income and no net effect on basis of purchased assets (basis increase for payment of obligation and offsetting reduction for indemnity payment)

Flood v. United States, 133 F.2d 173 (1st Cir. 1943)

Rogers v. Commissioner, 5 T.C. 818 (1945)

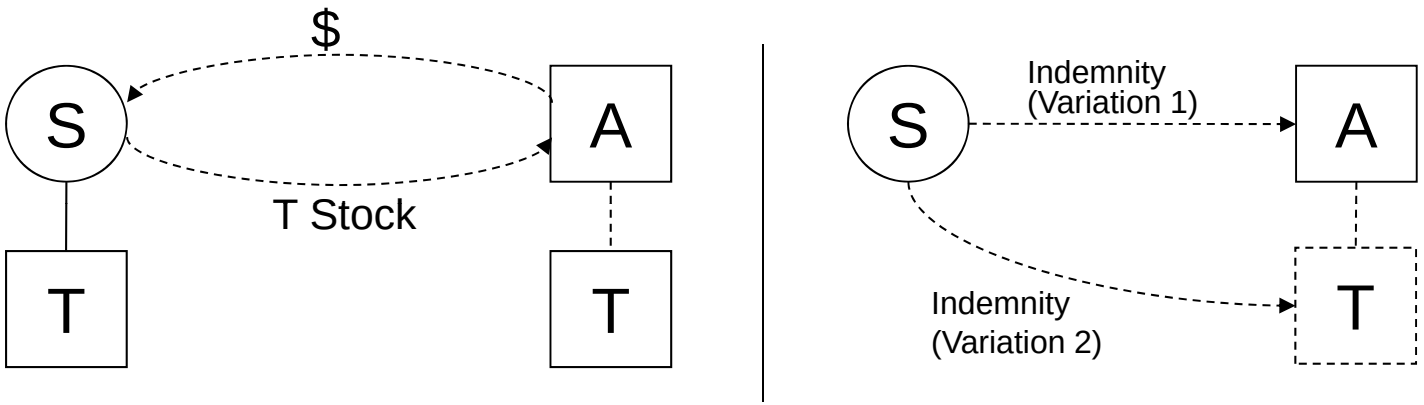
Shannonhouse Estate v. Commissioner, 21 T.C. 422 (1953)

Columbus & Greenfield Ry. Co. v. Commissioner, 42 T.C. 834 (1964)

Rev. Rul. 75-154, 1975-1 C.B. 186

FSA 200048006 (Aug. 14, 2000)

Indemnities of Contingent Obligations
Stock Sale Without Section 338(h)(10)
Discussion Problem—Facts



- S owns all the stock of T, which owns a manufacturing business
- T is defendant in a patent infringement lawsuit
- S sells the T stock to A for cash with no section 338(h)(10) election
  - S agrees to indemnify A (Variation 1) or T (Variation 2) against an adverse judgment
  - Five years after closing, judgment is entered against T for damages
  - S pays the judgment

Indemnities of Contingent Obligations
Stock Sale Without Section 338(h)(10)
Discussion Problem—Analysis

- If Seller indemnifies Buyer for Target's contingent obligation in a stock sale, Seller is deemed to contribute indemnity payment to Target's capital, relating back to immediately before sale
  - Result is retroactive increase in S's stock basis
  - Seller is entitled to capital loss when its indemnity obligation accrues, and there is economic performance
  - Target has no taxable income or gain
  - Target deducts or capitalizes (in accordance with tax accounting rules) Seller's payment, deemed paid by Target
  - No effect on Buyer's basis in Target stock
- Same analysis in tax-free reorganization

Estate of McGlothlin v. Commissioner, 370 F.2d 729 (5th Cir. 1967)

VCA Corporation v. United States, 566 F.2d 1192 (Ct. Cl. 1977)

Rev. Rul. 58-374, 1958-2 C.B. 396

Rev. Rul. 83-73, 1983-1 C.B. 84

GCM 38977 (April 8, 1982)

Indemnities of Contingent Obligations
Stock Sale With Section 338(h)(10)
Insolvent Target

- Indemnity of contingent obligation by shareholder could make the difference between Target being solvent or insolvent
- If Target was insolvent before indemnity, and Seller and Buyer elect section 338(h)(10), contribution (indemnity payment) and deemed liquidation are stepped together
  - Section 338(h)(10) election still applies
  - Buyer gets cost basis in assets deemed purchased
  - Deemed distribution does not qualify under section 332
  - Taxable distribution of any Target assets unwanted by Buyer
  - Target's loss carryovers and other tax attributes are eliminated
  - Worthless stock deduction for Seller (could be ordinary deduction if section 165(g)(3) is satisfied)

Rev. Rul. 68-602, 1968-2 C.B. 135 (contribution of intercompany debt disqualifies pre-planned actual liquidation from section 332)

CCA 200818005 (January 29, 2008) (contribution of intercompany debt in connection with stock sale disqualifies deemed liquidation under section 338(h)(10) from section 332)