

TAXABLE ASSET ACQUISITIONS: RECENT DEVELOPMENTS

**Robert H. Wellen
Ivins, Phillips & Barker
Washington, D.C.**

**Forty-Eighth Annual
Southern Federal Tax Institute
October 21-25, 2013
Atlanta, Georgia**

The slides in this deck relating to §336(e) are based on slides prepared by Timothy S. Shuman, of McDermott, Will & Emory LLP. Jasper L. Cummings, Jr., of Alston & Bird LLP, and Brian Rogers, a J.D. candidate at Stanford Law School, also provided substantial assistance.

Copyright © 2013 Robert H. Wellen. All rights reserved.

CONTENTS

SECTION 336(e) REGULATIONS.....	3
BACKGROUND, OVERVIEW AND TERMINOLOGY.....	4
SECTION 338(h)(10) MODEL.....	13
STOCK SALES.....	20
RELATED PERSONS.....	30
CONSISTENCY RULES.....	34
TAXABLE STOCK DISTRIBUTIONS—GENERAL.....	38
SPECIAL RULES FOR STOCK DISTRIBUTIONS SUBJECT TO §355(d) OR 355(e).....	52
MAKING A §336(e) ELECTION.....	58
ADADP, AGUB AND GAIN RECOGNITION ELECTION.....	62
INTERNATIONAL ASPECTS.....	74
OPEN ISSUES.....	79
TAX AND TRANSACTION PLANNING.....	88
OTHER RECENT DEVELOPMENTS.....	93
COURTS.....	94
INTERNAL REVENUE SERVICE.....	103
LEGISLATION PROPOSED IN 2014 ADMINISTRATION BUDGET.....	112
NON-DEVELOPMENTS.....	116

SECTION 336(e) REGULATIONS

BACKGROUND, OVERVIEW AND TERMINOLOGY

Background

- Section 336(e) was enacted in 1986 as part of *General Utilities* repeal and amended in 1988.
- Section 336(e) provides that, “under regulations,” an election may be made to treat a sale, exchange or distribution of $\geq 80\%$ of the stock of a Target corporation as a sale of Target’s assets.
- The Government’s position is that §336(e) is not self-executing, and that the election is available only upon adoption of regulations.
- Regulations providing for §336(e) elections were proposed on August 25, 2008. 73 Fed. Reg. 49965.
- Final regulations were adopted on May 10, 2013 (TD 9619), effective for stock Dispositions with a Disposition Date on or after May 15, 2013 (which may include certain stock Dispositions before that date).

Asset Sale Mechanisms

- The tax treatment:
 - Asset sale by a corporate subsidiary or S corporation (**Target**) includes taxable gain or deductible loss on assets with no double tax.
 - For buyer, basis step-up and a “fresh start,” *i.e.*, no inheritance of Target’s tax attributes, such as accounting elections and E&P.
 - Target’s tax attributes generally are transferred to Target’s parent or, in the case of an S corporation Target, Target’s attributes are eliminated.
- Several mechanisms are available to obtain this tax treatment.
 - “Longhand” deeding of individual assets and assumption of liabilities.
 - Forward merger of Target into a corporate subsidiary of Purchaser for cash.
 - Conversion or merger of Target into a limited liability company or other entity that can be disregarded for tax purposes under Reg. §301.7701-2 (“check-the-box”) and sale of equity interest in Target.
- Each has disadvantages resulting from the need to dispense with the Target’s corporate history, such as disruption of Target’s contractual relationships and increased exposure to veil piercing. Longhand asset transfers can also involve substantial administrative cost.
- A “qualified stock purchase” with an election under §338(h)(10) eliminates these business problems.
 - Sale of the Target stock is treated as a sale of Target’s assets only for tax purposes.
 - But availability is limited: $\geq 80\%$ of the Target stock must be sold to a single corporation or consolidated group.
 - In regulations and rulings, IRS has added considerable flexibility, but the restrictions remain confining.

Overview of Regulations

- The §336(e) regulations allow deemed asset sale treatment for a taxable Disposition or series of Dispositions of $\geq 80\%$ of the stock of a domestic Target corporation, within a 12 Month Disposition Period, to any person or persons other than Related Persons, by—
 - By a domestic Parent corporation (or the members of a consolidated group) or
 - By the Shareholders of an S Corp Target.
- Modeled on §338(h)(10), but—
 - Section 338(h)(10) looks to a “purchase” of $\geq 80\%$ of the Target stock by one corporate Purchaser (with an affiliated group treated as a single corporation).
 - Section 336(e) looks to a Disposition of $\geq 80\%$ of the Target stock to any Purchaser or Purchasers.
 - Section 336(e) applies to taxable distributions as well as sales of Target stock.
- The election generally has the following consequences:
 - Seller recognizes no gain or loss on a Disposition of the Target stock.
 - Target is deemed to dispose of all its assets to “New Target” in a taxable sale.
 - Target is deemed to distribute the price received for the Target stock to Seller in a liquidating distribution.
 - Target’s tax attributes are generally transferred to Seller.

Terminology: Disposition, QSD and Seller

- **Disposition** or **Disposed of** refers to a sale, exchange or distribution of Target stock.
 - The following stock transfers are not Dispositions:
 - A transferred basis exchange (e.g., gift or §721 transfer to partnership).
 - Transfer at death (transferee's basis determined under §1014(a)).
 - Transfer to which §351, §354, §355 or §356 applies.
 - Transfer described in regulations in which the transferor does not recognize all gain or loss realized.
 - Transfer to a Related Person, based on §338 principles.
 - Disposition includes a distribution by Parent to a Shareholder that is not a Related Person, if either—
 - The distribution is not subject to §355 or §361 and thus would be taxable to Parent.
 - The distribution qualifies under A §355, but gain would be recognized to Parent under §355(d) or §355(e).
- Stock disposed of and reacquired by Parent or a member of Parent's consolidated group during 12-Month Disposition Period is not considered disposed of.
- **QSD**. “Qualified stock disposition,” *i.e.*, a Disposition or series of Dispositions totaling $\geq 80\%$ of the Stock of Target, within the 12-Month distribution Period, by Parent or by S Corp Shareholders (a “**Seller**”), to any person or persons other than Related Persons.

Terminology: Related Person

- A sale, exchange or distribution of Target stock to a person that is a **Related Person** to Seller is not a Disposition and so cannot be part of a QSD.
- A person is a Related Person to Seller if stock owned by the person would be attributed to Seller (or vice versa) under §318(a), except that—
 - Section 318(a)(4) (option attribution) does not apply.
 - Sections 318(a)(2)(A) and 318(a)(3)(A) do not attribute stock ownership from a partnership to a partner or vice versa if the partner owns, directly or indirectly, a <5% interest in the partnership, by value.
- Section 338 principles apply in determining whether a person is a Related Person.
 - Relatedness generally is tested immediately after the Disposition.
 - Exception: If there is a series of Dispositions, relatedness is tested immediately after the last Disposition in the series.
 - Exception: If there is “a series of transactions effected pursuant to an integrated plan to dispose of target stock,” the Related person determination is made “after the last transaction in such series.” Reg. §1.338-3(b)(3)(C).
- Regulations do not specify whether, to be a Related Person, Purchaser must be related to its own Seller or could also be related to another Seller (as could occur with an S Corp Target).

Other Terminology—I

- **12-Month Disposition Period.** 12-month period beginning on the date of the first Disposition of Target stock included in a QSD. Reg. §1.336-1(b)(7).
- **Disposition Date.** The first day on which there is a QSD with respect to the Target stock. Reg. §1.336-1(b)(8).
- **New Target.** Hypothetical corporation deemed to purchase the assets of Target in a QSD with a §336(e) election, other than a distribution of stock subject to §355(d) or 355(e), which involves a “sale-to-self”.
- **Parent.** Domestic corporation that sells or distributes Target stock in a QSD, a QSP or a similar transaction (*i.e.*, Seller). References to Parent generally include any other members of its consolidated group that own Target stock.
- **Pre-Deemed Sale Period.** Portion of the 12-Month Disposition Period before the Disposition Date.
- **Purchaser(s).** Person or persons that purchase Target stock in a QSD, a QSP or a similar transaction.

Other Terminology—2

- **S Corp Target.** Target that is an S corporation.
- **S Corp Target Shareholder(s).** Shareholder(s) of an S Corp Target.
- **Seller(s).** Domestic C or S corporation that sells and/or distributes Target stock (*i.e.*, Parent or members of its consolidated group) or S Corp Target Shareholder that sells stock, in either case in a QSD, a QSP or a similar transaction.
- **Shareholder(s).** Shareholders of Parent.
- **Target.** Domestic C or S corporation the stock of which is Disposed of in a QSD, a QSP or a similar transaction.
- **Target Sub.** Corporation of which Parent owns $\geq 80\%$ of the Stock (a domestic corporation, if the Target stock is disposed of in a QSD; a domestic or foreign corporation if the Target stock is sold in a QSP).
- **$\geq 80\%$ of the Stock.** $\geq 80\%$ of the stock of Target or Target Sub (as the case may be), by both vote and value, excluding plain vanilla nonvoting preferred stock.
- Additional terms are defined in Slides 62-73, “ADADP, AGUB and Gain Recognition Election.”

More on QSD and Qualified Stock Purchase (QSP)

- A transaction or series of transactions could meet the definition both of a QSD and of a Qualified Stock Purchase (**QSP**) (§338(d)(3)).
- Every QSP is also meets the QSD definition, with Purchaser being a single corporation or affiliated group (whether or not consolidated).
- In general, QSP status trumps QSD. If a transaction qualifies as both a QSD and a QSP, the transaction is a QSP.
 - As an exception, if there is a deemed sale of stock of a Target Sub by reason of a QSD of Target stock with a §336(e) election, QSD trumps QSP.
 - As the exception to the exception, if there is a deemed sale of stock of a *foreign* Target Sub by reason of a QSD of Target stock with a §336(e) election, the deemed sale is a QSP, because it cannot be a QSD.

SECTION 338(h)(10) MODEL

Restrictions Like Those Under §338(h)(10)

- Reg. §1.336-1(a)(1) states:

Generally, except to the extent inconsistent with §336(e), the results of §336(e) should coincide with those of §338(h)(10). Accordingly, to the extent not inconsistent with §336(e) or these regulations, the principles of §338 and the regulations under §338 apply for purposes of these regulations.

- Many of the restrictions on §338(h)(10) elections also apply to §336(e) elections:
 - Disposition of Target stock must be fully taxable (but for the election)—no §351 transfers (including §304 sales), §721 transfers or reorganizations.
 - Neither Seller nor Target may be a foreign corporation (compare §338(g) election, available to foreign Seller and/or Target).
 - Disposition of Target stock to Related Persons does not qualify.
- Consistency rules apply, but only to Target assets owned by purchasers of $\geq 5\%$ of the Target stock in the QSD. Reg. §1.336-1(a)(2). See Slides 34-37.

Deemed Asset Sale as Under §338(h)(10)

The deemed asset sale model under §336(e) is similar to the §338(h)(10) model:

- Deemed sale of Target assets is fully taxable (e.g., no §1031 exchange even if consideration includes like-kind property).
- Installment method is available for deemed asset sale.
- ADADP is similar to ADSP in §338(h)(10).
- AGUB similar to AGUB in §338(h)(10).
- Treatment of minority Target shareholders is similar to §338(h)(10).
- Treatment of Target stock retained by Seller is similar to §338(h)(10).

Deemed Distribution as Under §338(h)(10)— General

Deemed distribution model in §336(e) is similar to the §338(h)(10) model:

- Target is deemed to distribute—
 - The consideration deemed received in the deemed asset sale to Seller.
 - Any Target assets not wanted by Purchaser(s) and distributed to Seller before sale of Target stock, as part of the “plan of liquidation”.
- If Seller is a corporation, the distribution ordinarily is a tax-free liquidation under §§332 and 337.
- If Sellers are S Corp Target Shareholders, the deemed distribution ordinarily is a taxable liquidation under §§331 and 336, with Seller(s)’ stock basis adjusted to reflect the gains and losses recognized in the deemed asset sale.
- As in a §338(h)(10) sale, deemed distribution could be an acquisitive §368(a)(1)(D) reorganization, if Seller transfers the stock sale proceeds and/or unwanted assets to another subsidiary. Could cause a triggered excess loss account in the “nominal share” of Target stock. Reg. §1.368-2(l)(2).

Deemed Distribution as Under §338(h)(10)— Consolidated Group Sellers

- **More Than One Selling Group Member.** If Sellers are more than one member of a consolidated group—
 - All group members “are treated as a single seller.”
 - But §337(c) provides that a liquidating group member may distribute its assets tax-free only to one actual $\geq 80\%$ Parent. Section 332 still applies to the distributee shareholder.
 - If Target is deemed to distribute only sale proceeds (cash or a note), there is no concern, because no gain is realized.
 - If Target distributes assets unwanted by Purchasers, as part of its deemed “plan of liquidation,” and the distributee is not an actual $\geq 80\%$ Parent, §337(c) will trigger gain recognition to Target.
- **Intercompany Sale or Distribution of Target Stock.** Reg. §1.1502-13(f)(5)(ii)(C) relief is available for a taxable intercompany stock sale or distribution if followed by a sale or distribution of the stock outside the group with a §336(e) election. See Slides 51 and 57.

Other §338(h)(10) Principles

Section 338(h)(10) principles may apply, even if not explicitly stated in the §336(e) regulations:

- Anti-churning rule (§197(f)(9); Reg. §1.197-2(h)(8)):
 - “Special” rule for §338 deemed asset acquisition: New Target is not considered the person that held or used the assets.
 - Anti-churning rule “may nevertheless apply to a deemed asset purchase resulting from a §338 election if new target is related...to old target.”
 - IRS officials have indicated that the intention is to apply these rules to §336(e) transactions.
 - See Slide 113, describing proposed repeal of §197(f)(9).
- Does Reg. §1.338-3(b)(5) (testing 80% QSP after taking into account redemptions by target corporation) apply, or do redemptions of Target stock themselves constitute Dispositions (so long as the redemption is treated as a sale of the Target stock, and the redeemed Shareholder is not a Related Person to the Target)? See Slides 28-29.
- Section 172(h)(3)(B)(ii): For CERT purposes, the term “major stock acquisition” does not include a QSP to which a §338 election applies. Does a similar rule apply to a stock Disposition subject to a §336(e) election?
- Is any excess loss account in the stock of Target or its subsidiaries triggered?

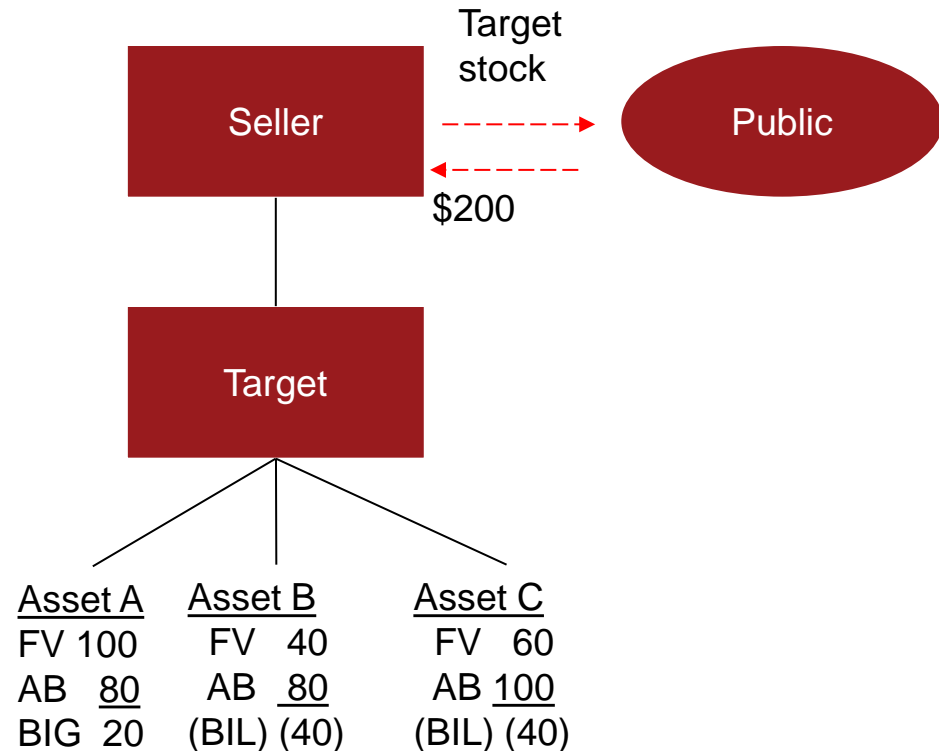
Section 338(h)(10) vs. Section 336(e)

Section 338(h)(10)	Section 336(e)
Joint Seller and Purchaser election	Seller and Target election by agreement
Election filed on separate form filed within 8.5 months after closing	Election on tax return(s)
One domestic or foreign corporate Purchaser (or affiliated group)	Any number of corporate or non-corporate Purchasers
Seller must be a U.S. corporation (or affiliated group) with Target as $\geq 80\%$ sub; or S Corp Target	Same
“12-month acquisition period”	“12-Month Disposition Period”
Sales of Target stock with $\geq 80\%$ vote and value (excluding §1504(a)(4) stock) to one Purchaser—corporation or affiliated group	Sales and/or taxable distributions (including distributions subject to §355(d) or §355(e) totaling $\geq 80\%$ of the Stock
Related Person restriction—§318(a) attribution, excluding option attribution under §318(a)(4)	Same, except no attribution between partnership and $< 5\%$ partner
Not available if Seller or Target is foreign	Same
Target’s amount realized on deemed asset sale is “aggregate deemed sale price” (ADSP)	Target’s amount realized on deemed asset sale is “aggregate deemed asset disposition price” (ADADP)
New Target’s basis in assets deemed purchased is “adjusted grossed up basis” (AGUB)	Same, except that stock held by $< 10\%$ shareholder is not “nonrecently purchased stock”
Consistency rules	Same, but only for Target assets owned by Purchasers of $\geq 5\%$ of the Target stock in QSD.

STOCK SALES

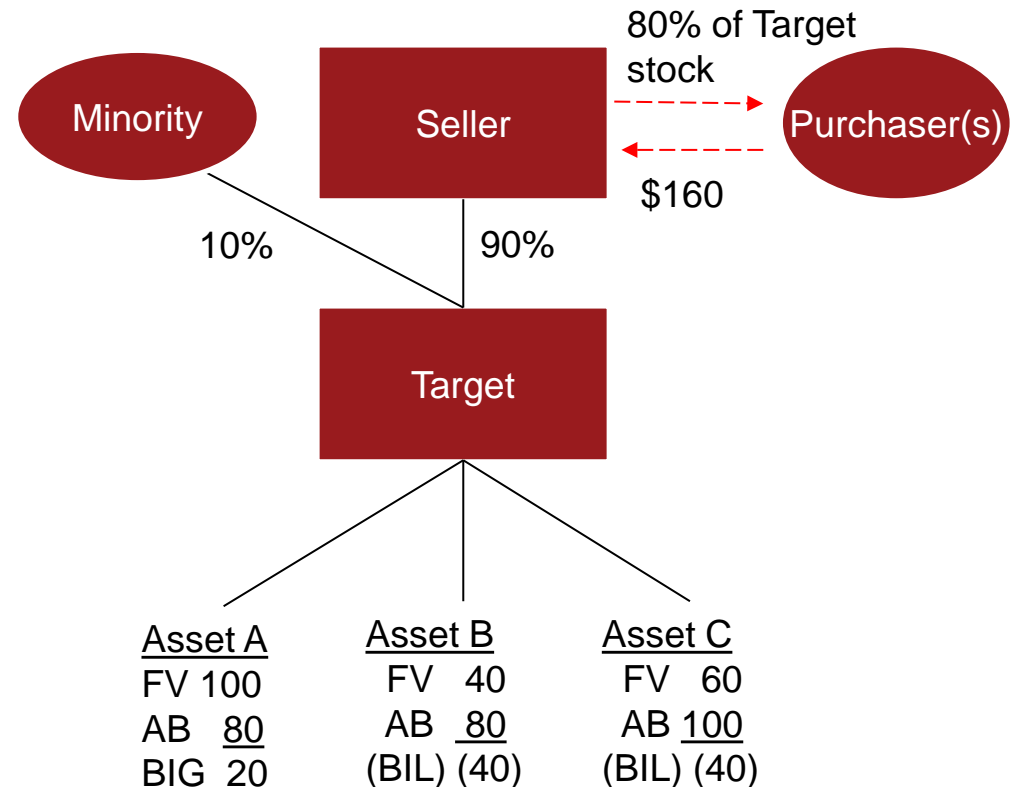
Sale of Target Stock to One or More Purchasers

- Seller sells the Target stock to the Public for \$200 and makes a §336(e) election.
- Target is deemed to sell all its assets to an unrelated person for ADADP (\$200).
- Target realizes \$20 gain on Asset A, \$40 loss on Asset B, and \$40 loss on Asset C—\$60 net loss.
- Because all the Target stock is sold (not distributed), none of the net loss is disallowed.
- New Target is deemed to purchase the assets from an unrelated person for AGUB.
- Target is deemed to distribute the consideration deemed received for the assets to Seller (§332/337 liquidation).
- This transaction accomplishes the same result as a “busted” §351 exchange that can be a QSP.
 - Section 336(e) election eliminates need for a preliminary transfer of Target to a Newco.
 - On the other hand, a busted §351 transaction allows Seller to retain (and/or sell to a Related Person) up to just under 50% of the Newco stock (i.e., up to just under 50% interest in Target).
 - But anti-churning rules prevent amortization of intangibles if Seller retains >20% of the Newco stock.



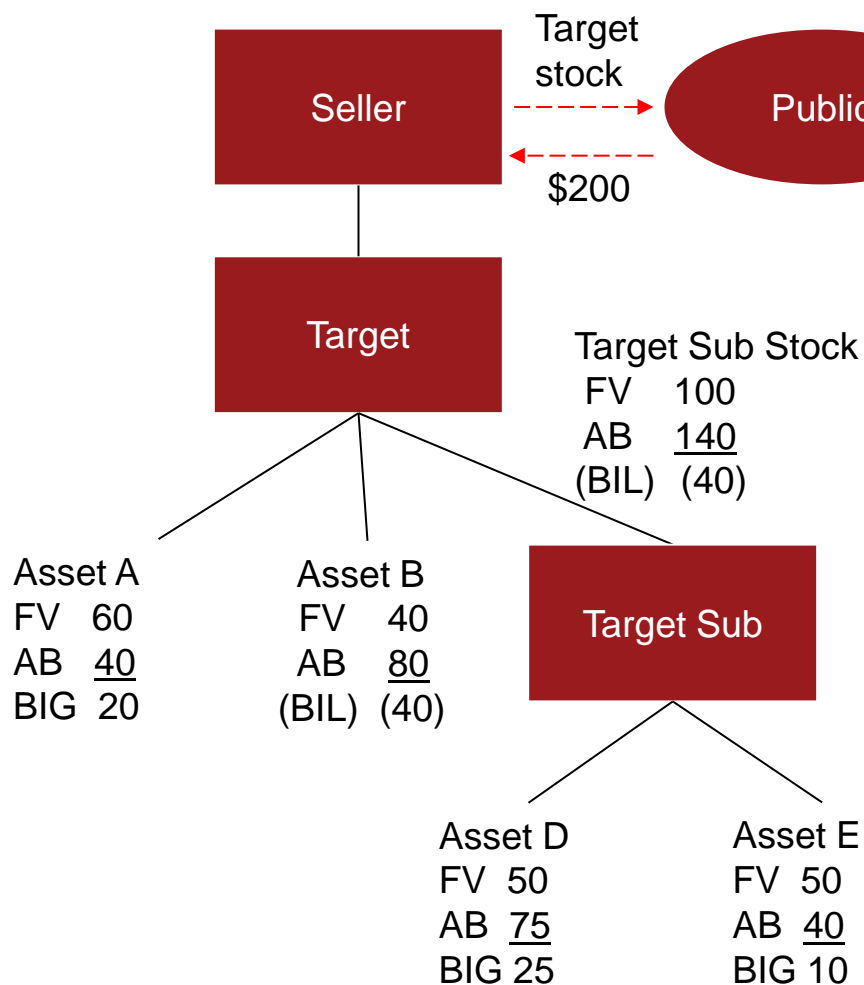
Sale of 80% of Target Stock to Public, 10% Retained by Seller, 10% by Minority

- Seller sells 80% of Target stock to Public for \$160 (QSD). Seller makes §336(e) election.
- Seller retains 10%, and unrelated Minority retains 10%.
- Target deemed to sell all its assets to an unrelated person (New Target) for ADADP (\$200).
- New Target deemed to purchase the assets from an unrelated person for AGUB.(\$200).
- Seller is deemed to purchase its retained stock from an unrelated person on the day after the Disposition Date for FMV, with new holding period.
- No gain or loss to Minority; its basis and holding period not affected.
- Target deemed to distribute consideration deemed received for the assets to Seller (§332/337 liquidation).



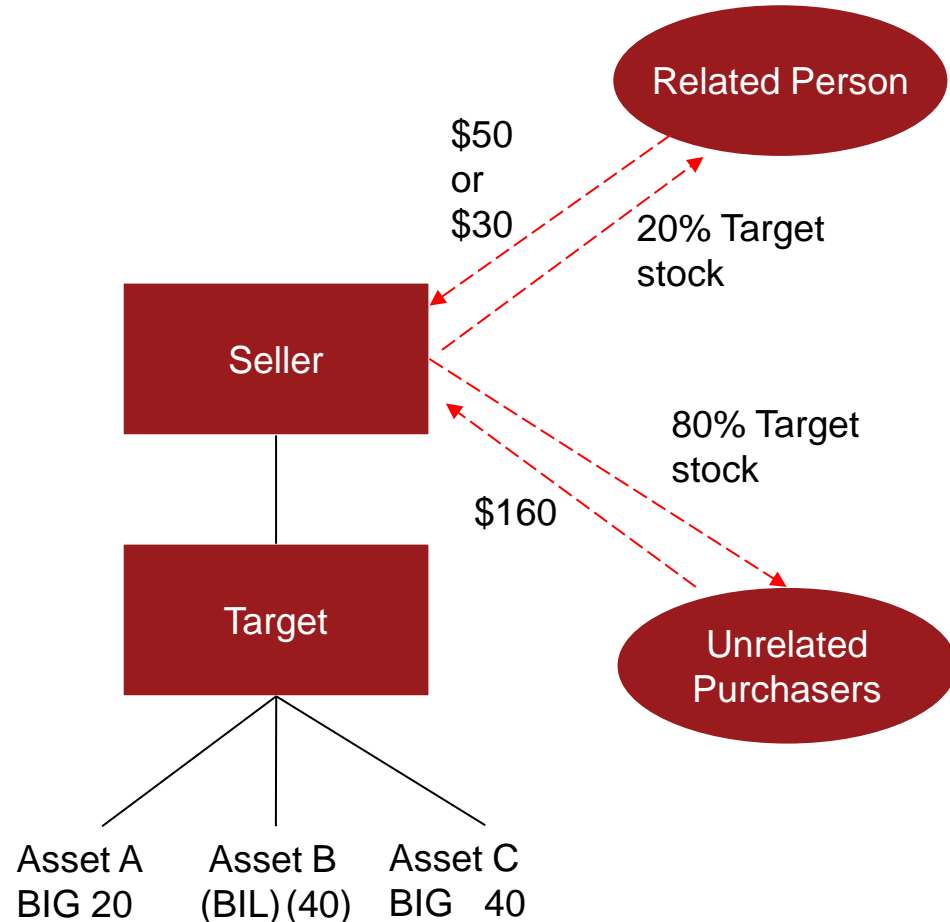
Sale of Target Stock to Public; Target Sub

- Seller sells all the Target stock to Public for \$200 and makes §336(e) election for Target and Target Sub.
- Deemed asset sale by Target excludes stock of Target Sub.
- Deemed asset sale by Target is considered to precede deemed asset sale by Target Sub.
- Deemed asset sale by Target Sub and liquidation of Target Sub are treated as occurring before deemed liquidation of Target.



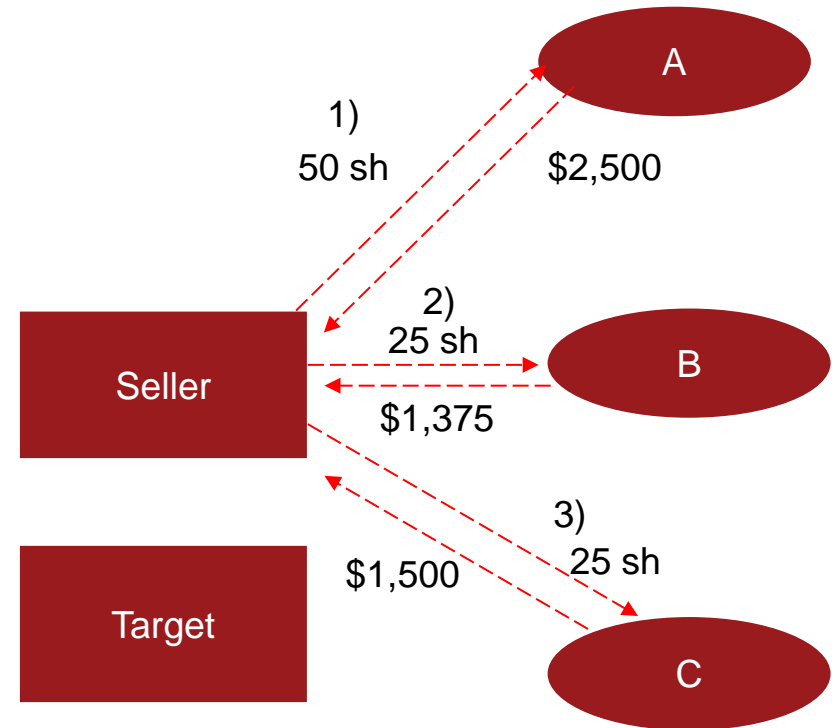
Sale of 80% of Target Stock to Unrelated Purchasers and 20% to Related Person

- Seller sells 80% of Target stock to Unrelated Purchasers for a total of \$160 (QSD) and 20% to Related Person for \$50 (or \$30). Seller makes §336(e) election.
- The stock sold to Related Person is not part of the QSD. Consideration paid for this stock is not taken into account in determining ADADP and AGUB.
- Target is deemed to sell all its assets to an unrelated person for ADADP (\$200).
- New Target is deemed to purchase the assets from an unrelated person for AGUB (\$200).
- Target is deemed to distribute the consideration deemed received for its assets to Seller (§§332/337 liquidation).



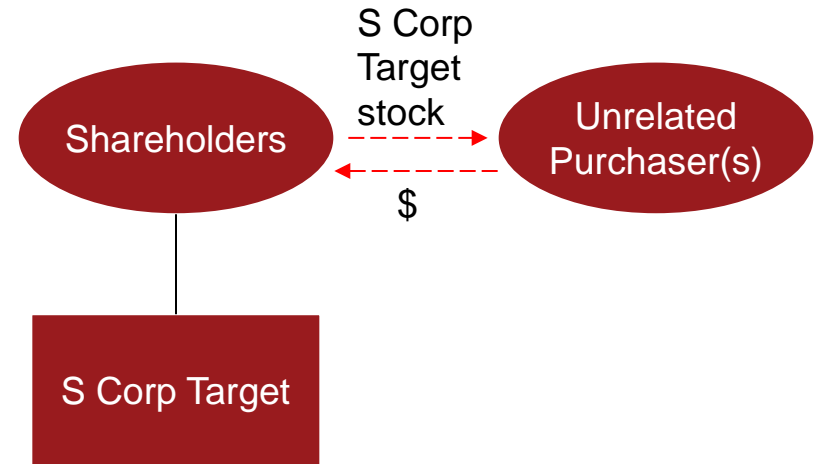
Sales of Target Stock to Multiple Persons: Multiple Sales During 12-Month Disposition Period

- Seller sells all 100 shares of Target stock to unrelated purchasers:
 - 1) 12/01/13: 50 shares to A for \$2,500 (\$50/sh).
 - 2) 04/01/14 25 shares to B for \$1,375 (\$55/sh).
 - 3) 11/01/14: 25 shares to C for \$1,500 (\$60/sh).
- Seller makes §336(e) election.
- Because Seller Disposes of $\geq 80\%$ of the Stock of Target during the 12-Month Disposition Period (beginning 12/01/13), a QSD occurs.
- 11/01/14, the first day on which there was a QSD with respect to the Target stock, is the Disposition Date.
- Target is deemed to sell all its assets to an unrelated person for ADADP (\$5,375) and liquidate.
- New Target is deemed to purchase all of Target's assets for AGUB (\$5,375).
- IRS officials have stated that—
 - Target's liquidation still qualifies under §332, and is treated as occurring on the Disposition Date.
 - If Seller and Target are consolidated group members, Target continues to be a member until the Disposition Date.
- How should Seller reflect the stock sale to A and other consolidated return items (e.g., dividends paid by Target and Target's income or loss in December) on its 2013 return?



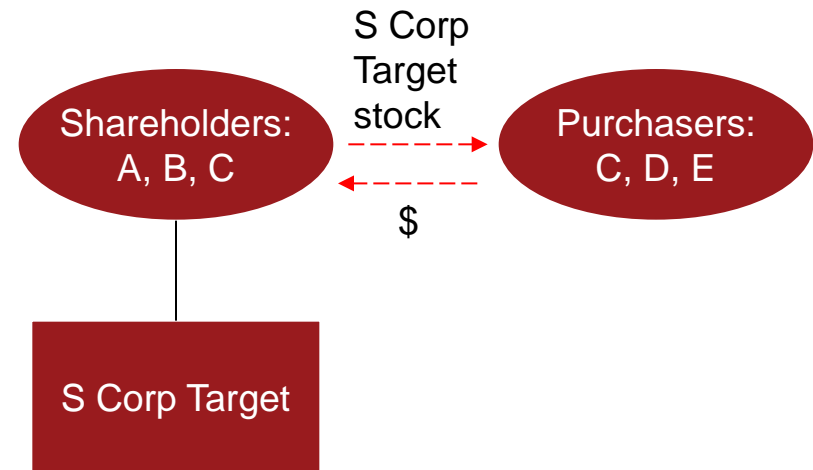
Sale of Stock of S Corp Target

- To make a §336(e) election, all S Corp Target Shareholders (including those that do not sell stock) and S Corp Target itself must enter into a binding written agreement.
- If Shareholders make a §336(e) election—
 - S Corp Target is deemed to sell all its assets to an unrelated person (New S Corp Target) for ADADP.
 - New Target is deemed to purchase S Corp Target's assets from an unrelated person for AGUB.
 - S Corp Target is deemed to distribute the consideration received for the stock to its shareholders (§331 liquidation).
 - A new election to treat New Target as an S corporation must be made (if New Target is eligible).



Multiple Sales by S Corp Target Shareholders

- S Corp Target has two shareholders, A and B. Each owns 50 shares.
 - 12/01/13: A sells 50 shares to C.
 - 03/01/14: C sells 50 shares to D.
 - 06/01/14: B sells 50 shares to E.
- Questions: If the Shareholders wish to make a §336(e) election—
 - Does C have to sign a written, agreement to make the election?
 - How should A report its sale of stock on its 2013 return?
 - Is C's sale on 03/01/14 taken into account in determining whether a QSD has occurred?
 - What is the Disposition Date?
 - Do A and C report S Corp Target's income for the period after they sell their stock until the Disposition Date?
 - Does C report the gain or loss on the deemed asset sale, and is C receiving a §331 liquidating distribution from Target?

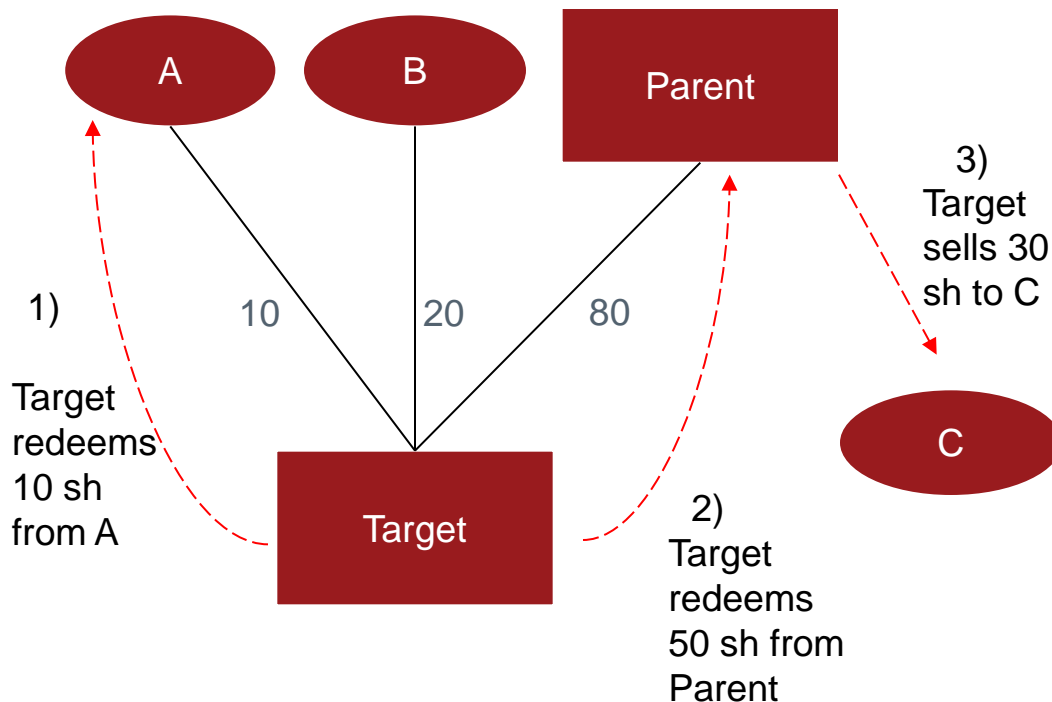


Taking Into Account Redemptions for QSD Purposes—I

Facts

- Individuals A, B and C and Parent are unrelated.
- 1) 01/01/14: Target redeems 10 shares from A for cash.
- 2) 08/01/15: Target redeems 50 shares from Parent for cash
- 3) 08/02/15: Parent sells 30 shares to C for cash.
- After the transactions, Target stock is owned as follows:

Parent	0 sh
A	0 sh
B	20 sh
C	30 sh
Target (Treasury)	50 sh



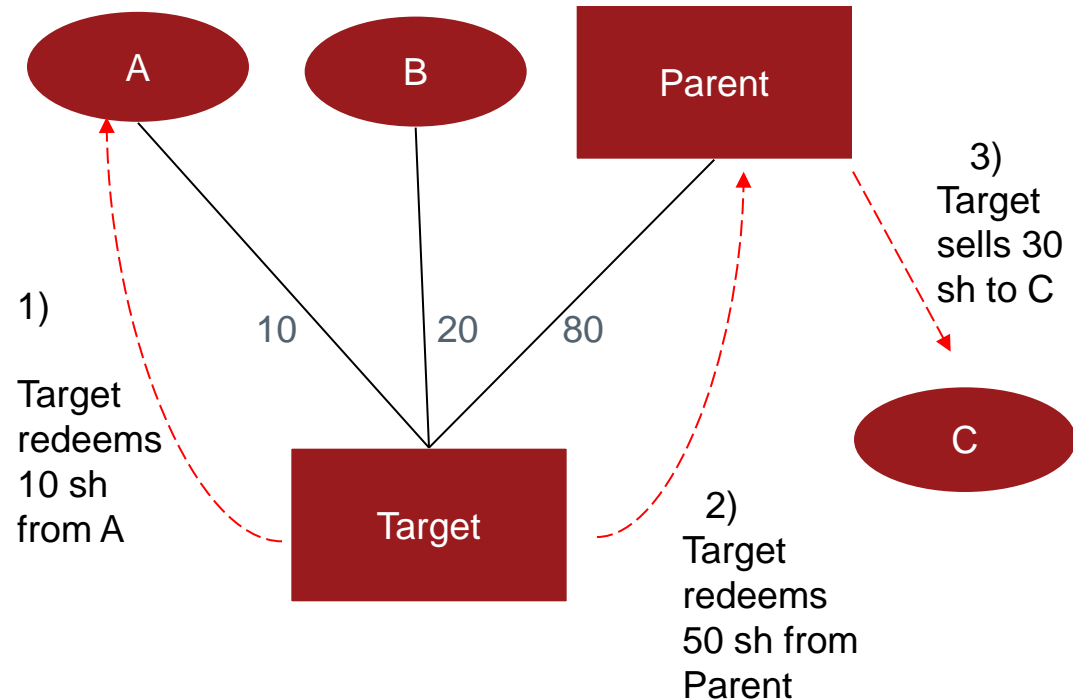
Questions

- Is there a QSD by Parent to Target and C as Purchasers?
- If yes, is the stock redeemed from A Nonrecently Disposed Stock?

Taking Into Account Redemptions for QSD Purposes—2

■ Is there a QSD by Parent to Target and C as Purchasers?

- In a QSP, stock remaining after a redemption from a non-Related Person determines if the $\geq 80\%$ test is met.
- Sale to C would not be a QSP, even if C were a corporation (30 sh / 50 sh = 60%)
- Policy under §336(e) could be different.
- Disposition, as defined, could include redemption.
- Technical problems:
 - Reference in §336(e)(1) to “stock in another corporation”.
 - AGUB is determined by reference to Purchaser’s basis in Target stock.

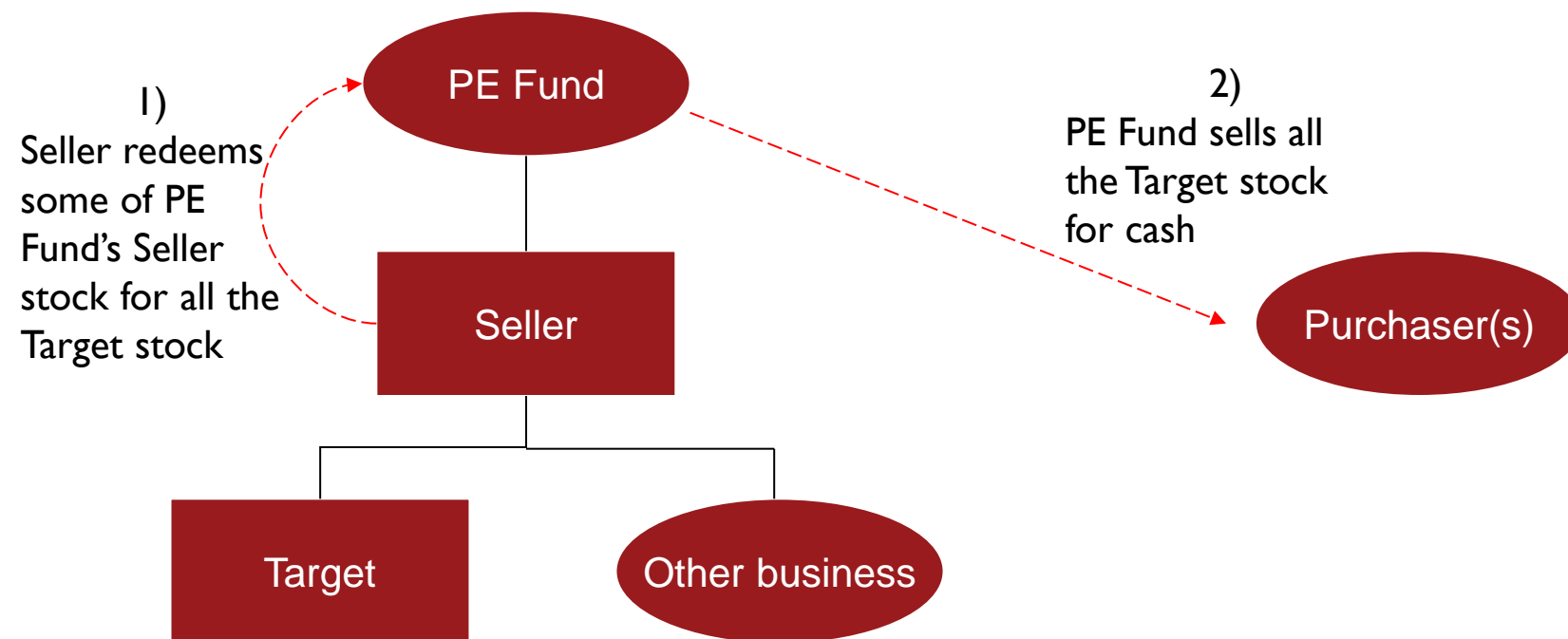


■ If yes, is the stock redeemed from A Nonrecently Disposed Stock?

- Nonrecently Disposed Stock, as defined, could include redeemed stock.
- Applying $\geq 10\%$ test is difficult.
- If redeemed stock is Nonrecently Disposed Stock, actual redemption price is used to determine AGUB.

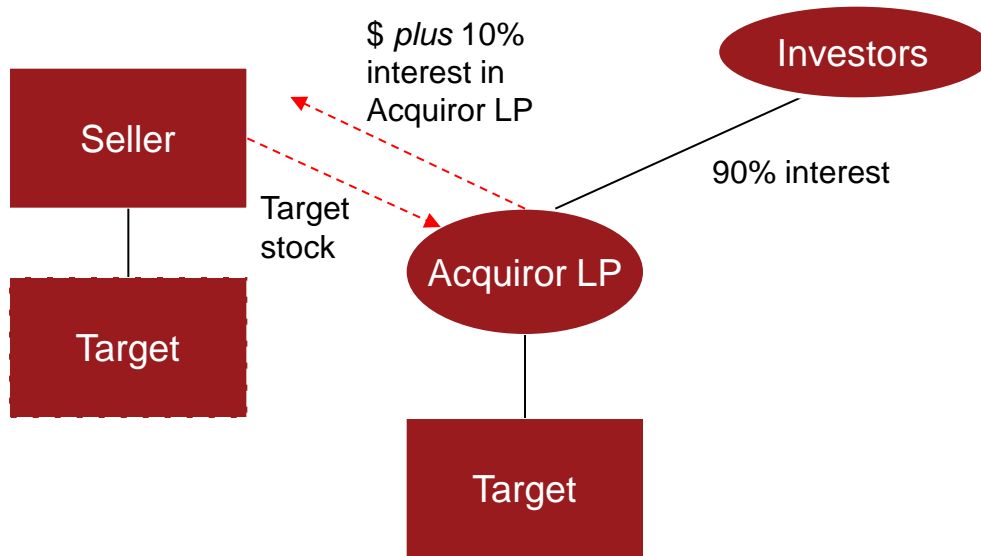
RELATED PERSONS

Related Person Rule: “Immediately After”



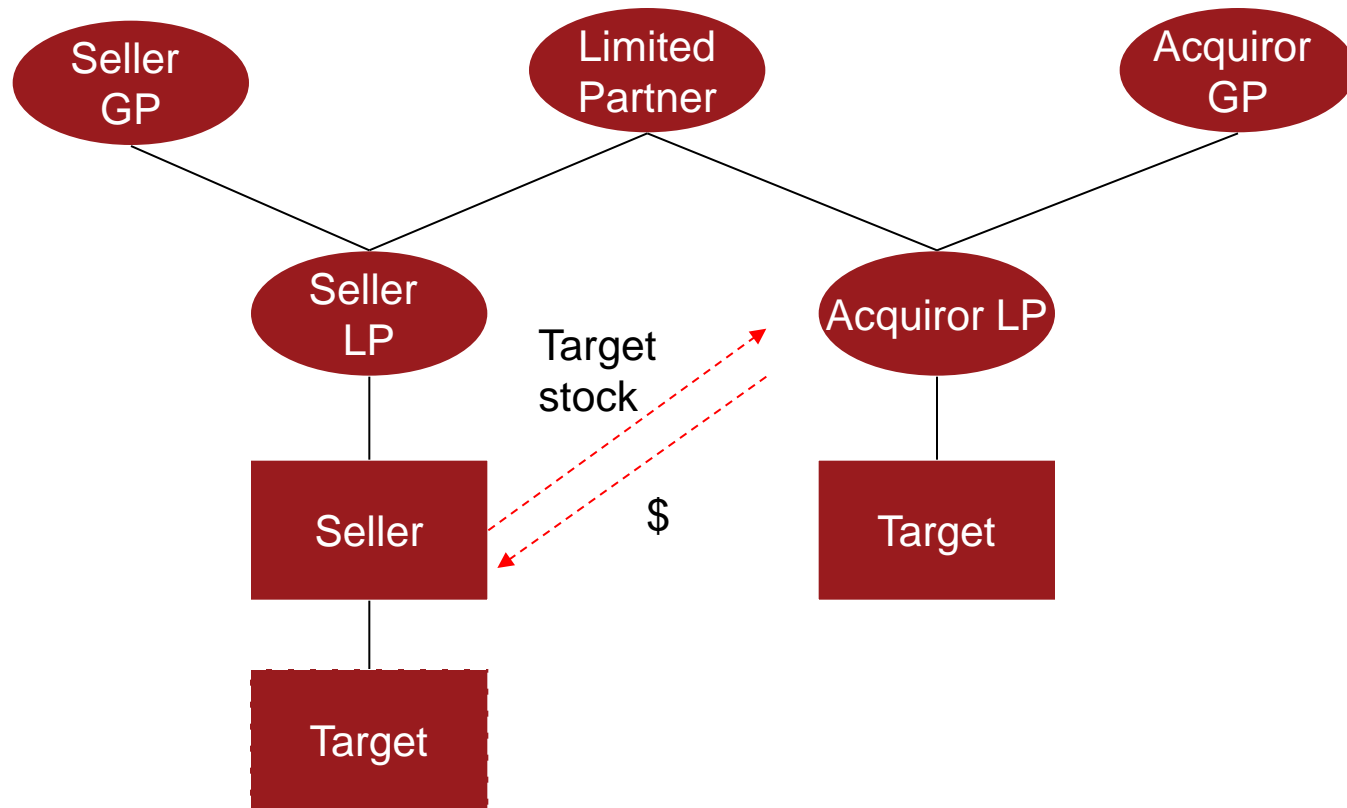
- Section 336(e) election is available for the distribution of Target stock in redemption of PE Fund's Seller stock.
- Compare Reg. §§ 1.338-3(b)(3)(ii)(C) & -3(b)(3)(iv), Example 1 (transfer of Target stock to Newco followed by binding commitment sale of Newco stock to Underwriter constitutes QSP).

Related Person Rule: Rollover



- Possible impact on rollover transactions involving non-corporate acquirers.
- Acquiror LP is a Related Person to Seller because, under §318(a) (other than by reason of §318(a)(4)), immediately after the transfer, stock owned by Seller is attributed to Acquiror LP and vice versa.
- Stock owned by Seller is treated as owned by a partnership in which Seller is a partner (*i.e.*, Acquiror LP), if Seller owns $\geq 5\%$ interest in the partnership.
- Section 336(e) election not available.
- If, instead of receiving 10% interest in Acquiror LP, Seller retains 10% of Target stock, §336(e) election is available.

Related Person Rule: Partnership Attribution



If Limited Partner owns a $\geq 5\%$ interest in both Seller LP and Acquiror LP, Seller LP and Acquiror LP are Related Persons, and the sale is not a Disposition.

CONSISTENCY RULES

Consistency Rules under §338—I

- The consistency rules that would be applicable to QSPs, in §§338(e) and (f), would apply to a broad range of transactions, with potentially devastating impact.
- Due to *General Utilities* repeal after enactment of §338, Treasury and IRS concluded that regulations should narrow application of the consistency rules and make and their effects less onerous.
- The preamble to the §336(e) regulations (TD 9619) describes the consistency rules that apply to QSPs under the regulations:

In general, section 1.338-8 provides that if (1) a purchasing corporation (or an affiliate) acquires an asset meeting certain requirements from target (or a subsidiary of target) in a sale during the target consistency period, (2) gain from the sale is reflected in the basis of target stock as of the target acquisition date, and (3) the purchasing corporation acquires stock of target in a qualified stock purchase (but does not make a section 338 election), then the purchasing corporation is required to take a carryover basis in the acquired asset.

Consistency Rules under §338—2

- The §338 consistency rules are intended to apply only in potentially abusive situations, e.g.—
 - Gain on sale of a Target asset increases basis of Target stock under the consolidated return regulations, and that stock is sold to the same Purchaser (or a Related Person to the Purchaser).
 - Target distributes proceeds of an asset sale to its nonconsolidated Parent subject to the 100% dividends-received deduction.
 - A Target Sub that is a controlled foreign corporation sells an asset at a gain that is subpart F or PFIC income that increases the basis of the Target stock.

Consistency Rules under §336(e)

- The “principles” of the consistency rules apply to QSDs as to QSPs, but these principles apply—
 - To all types of Purchasers in a QSD, not only to corporations.
 - Only if a Purchaser (or a Related Person) acquires both—
 - An asset with cost basis from Target or a Target Sub during the 12-Month Disposition Period, and
 - $\geq 5\%$, by value, of the Target stock in the QSD.
- If no §336(e) election is made in the QSD, the affected Purchaser takes carryover basis in the acquired asset.
- Because of their application to any Purchaser that acquires $\geq 5\%$ of the Target stock, and its Related Persons, the consistency rules are more likely to apply to a QSD than to a QSP, and determining whether the consistency rules apply is more difficult in a QSD than in a QSP.

TAXABLE STOCK DISTRIBUTIONS— GENERAL

QSD Mechanics: §336(e) Election for Taxable Stock Distribution

- Target is deemed to sell all its assets to an unrelated person for ADADP.
 - Gains are recognized in full.
 - To implement the policy of §311(b), any net loss is disallowed in proportion to the amount of stock distributed vs. sold (retained stock excluded).
 - New Target is deemed to purchase the assets from an unrelated person for AGUB.
- Target is deemed to distribute to Seller the consideration deemed received for its assets.
 - Generally a liquidation subject to §332 and §337.
 - If so, Target's E&P (adjusted to reflect the deemed asset sale) and other tax attributes are transferred to Parent.
- Seller is deemed to purchase the New Target stock from an unrelated person for fair market value. No gain or loss is recognized on this deemed sale to any taxpayer.
- No gain or loss is recognized to Seller on distribution of New Target stock.
- Distributee shareholders are taxed under §301 or §302, as applicable, and take fair market value basis in the stock, as in any other taxable distribution of property.

Protective §336(e) Election

- A protective §336(e) election should be considered in connection with any intended tax-free stock distribution (spin-off or split-off).
 - Such an election mitigates the tax cost of the distribution becoming taxable under §355(d) or §355(e).
 - The tax sharing agreement could allocate the benefits of any basis step-up to the party that bears the tax cost of the taxable deemed asset sale.
 - The mitigation is less effective if Target or any Target Sub realizes net loss on a separate basis.
 - Steps to reduce or eliminate net losses in Target Subs should be considered.
 - If a net loss is large enough, a protective election could be counter-productive.
- IRS officials have stated that IRS may be willing to issue an advance ruling that such a protective election is effective.
 - Will the general no-rule for §355 distributions (Rev. Proc. 2013-32) affect IRS's willingness to rule on this issue?
 - Will a “significant” issue regarding the election be required?

Disallowed Loss: General

- Some or all of the net loss realized in Target's deemed asset sale is disallowed.
- The proportion of net loss disallowed is determined by the "disallowed loss fraction":
 - **Numerator:** Value on the Disposition Date of all Target stock distributed during the 12-Month Disposition Period (including stock distributed outside the QSD).
 - **Denominator:** Sum of—
 - Value on Disposition Date of Target stock sold during 12-Month Disposition Period as part of QSD.
 - Numerator.
- Proportion of net loss attributable to any Target stock sold during 12-Month Disposition Period as part of QSD is allowed.
- Disallowed losses are allocated among assets deemed sold at a loss in proportion to losses realized.
- Disallowed losses are permanently disallowed and do not result in any increase in basis of Target assets.

Disallowed Loss: Changes from Proposed Regulations

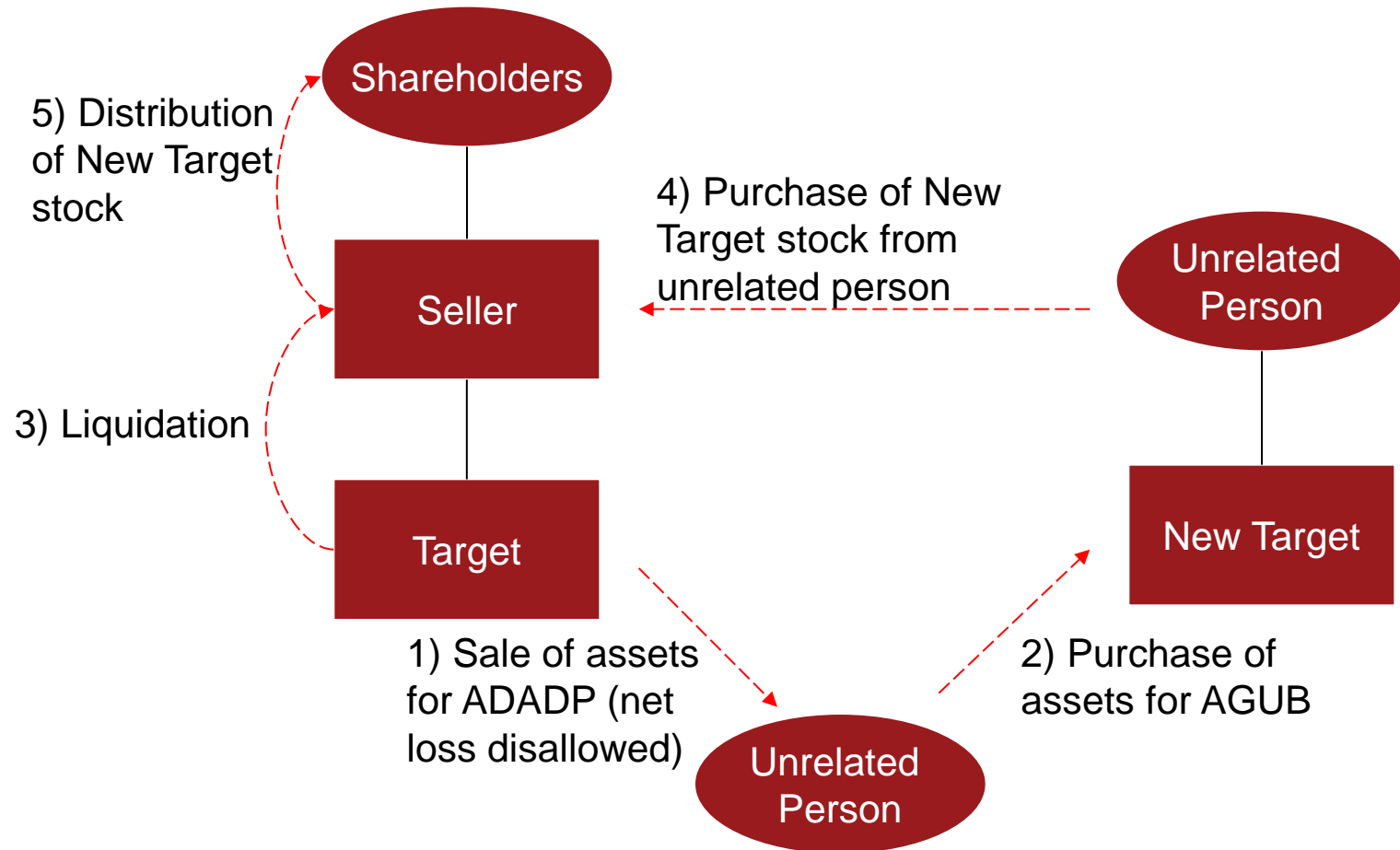
The final regulations modify the proposed regulations regarding loss disallowance:

- Target's losses realized in the deemed asset sale are allowed to the extent of Target's "gains realized."
 - How does disallowance of net losses apply to a QSD that involves both stock sales under the installment method and stock distributions?
- Loss disallowance applies to all distributions of Target stock during the 12-Month Disposition Period, including—
 - Stock distributions after the Disposition Date.
 - Stock distributions that are not part of the QSD, e.g., a distribution to a Related Person.

Disallowed Losses: Target Sub

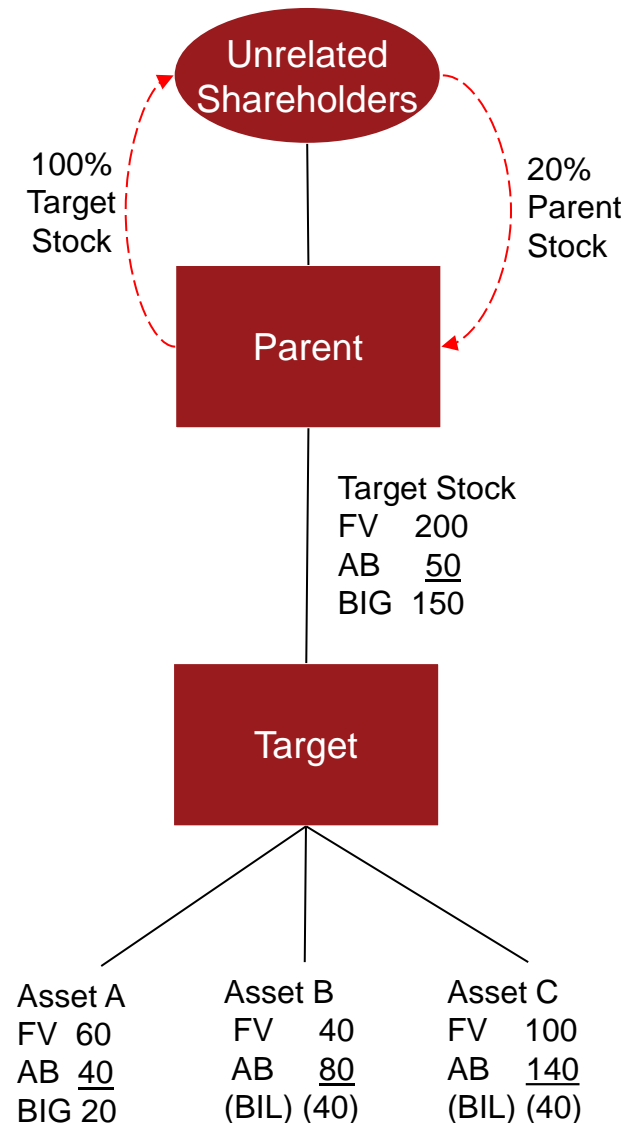
- If Target has a Target Sub, and Target stock is distributed in a QSD, with §336(e) elections for both Target and Target Sub, the deemed disposition of the Target Sub stock is a deemed distribution of that stock.
- Loss disallowance, including netting losses against gains, is determined separately for Target (excluding stock of Target Subs for which §336(e) is elected) and for each Target Sub.
- Separate-entity netting reduces the benefit of loss netting.
 - It may be difficult to determine the value of assets held by each Target Sub.
 - Computation of ADADP can complicate the process even further. See Reg. §1.336-2(b)(1)(i)(B)(3) Example 2.
 - Difficulty is similar to that of determining location of goodwill within a corporate group, as required under Prop. Reg. §1.355-3(b)(2)(iii) (§355 active trade or business).
 - Can the impact of separate-entity loss netting be reduced with intercompany combinations and the like?

QSD Mechanics: §336(e) Election for Taxable Distribution of Target Stock



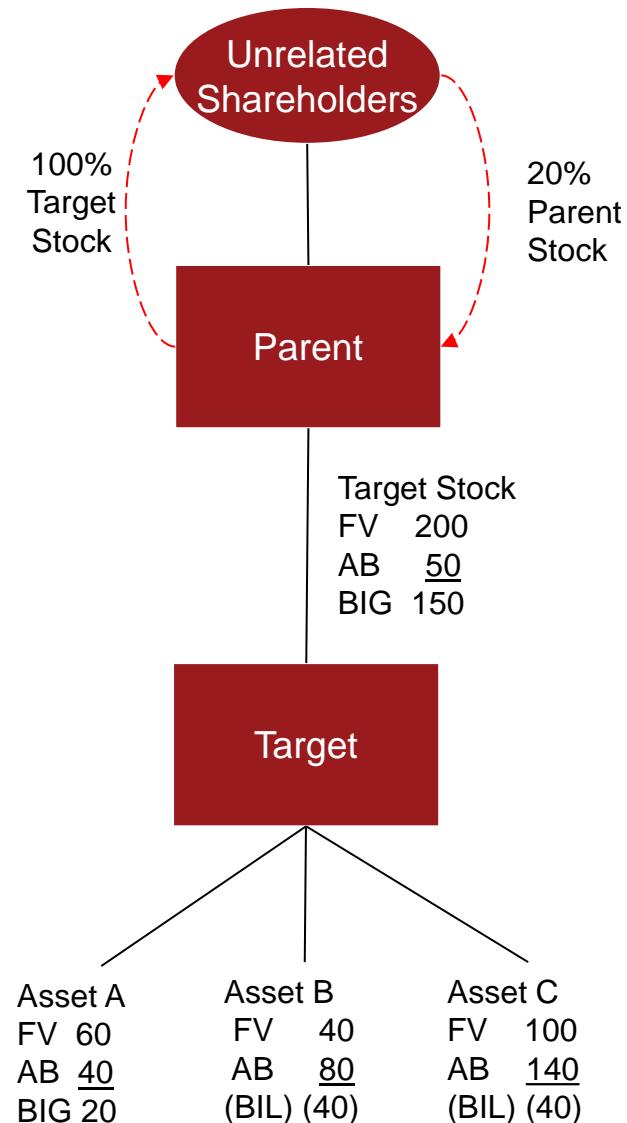
Distribution to Unrelated Shareholders—I

- Transactions
 - In a tender offer, Parent distributes all the Target stock to Unrelated Shareholders in exchange for 20% of the Parent stock, at a premium.
 - The exchange is intended to qualify under §355, but it does not do so.
 - Parent makes a protective §336(e) election.
- Target is deemed to sell all its assets to an unrelated person for ADADP (assume \$200).
 - Target realizes \$60 net loss.
 - Because all the Target stock is distributed (not sold), all the net loss is disallowed.
 - Disallowed loss is allocated 50% (\$30) each to Asset B and Asset C.
 - Target recognizes \$20 gain on Asset A, \$10 loss on Asset B and \$10 loss on Asset C.
- Target is deemed to purchase the assets from an unrelated person for AGUB (assume \$200).
- Are ADADP and AGUB determined by the value of the distributed Target stock or of the redeemed Parent stock?
 - If the Target stock, does *Pope & Talbot, Inc. v. Commissioner*, 162 F.3d 1236 (9th Cir. 1999) control (§311 gain determined by value of distributed property to distributing corporation, not traded price)?
- Target is deemed to liquidate, and its tax attributes are transferred to Parent.



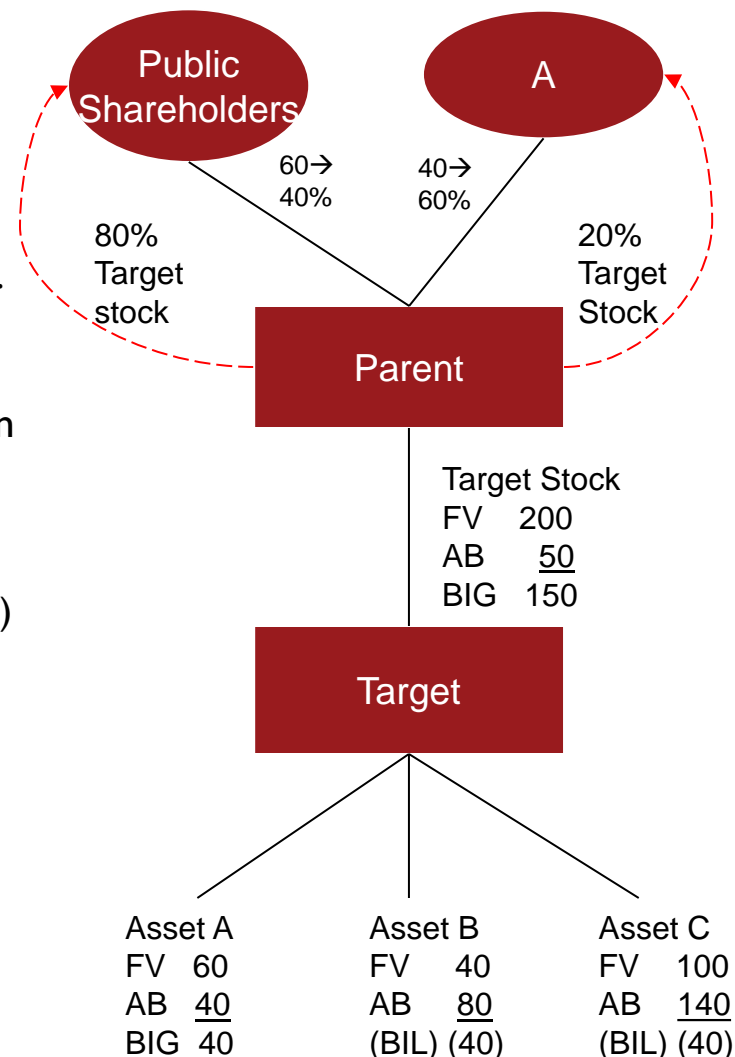
Distribution to Unrelated Shareholders—2

- Parent distributes the Target stock to Unrelated shareholders, pro rata.
 - No gain is recognized to Parent.
 - Shareholders receive the Target stock as a taxable §301 distribution.
- Target's deemed sale-to-self does not cause the distribution to fail any §355 requirement, including the 5-year active trade or business test.
- Question: If Target is a Newco, is Target treated as the deemed seller of its assets, or is Seller treated as the asset seller under assignment-of-income and step-transaction principles?
- Reg. §1.338-1(a)(2) provides that other rules of law apply to determine the tax consequences of a §338 election as if the parties had actually engaged in the deemed transactions.



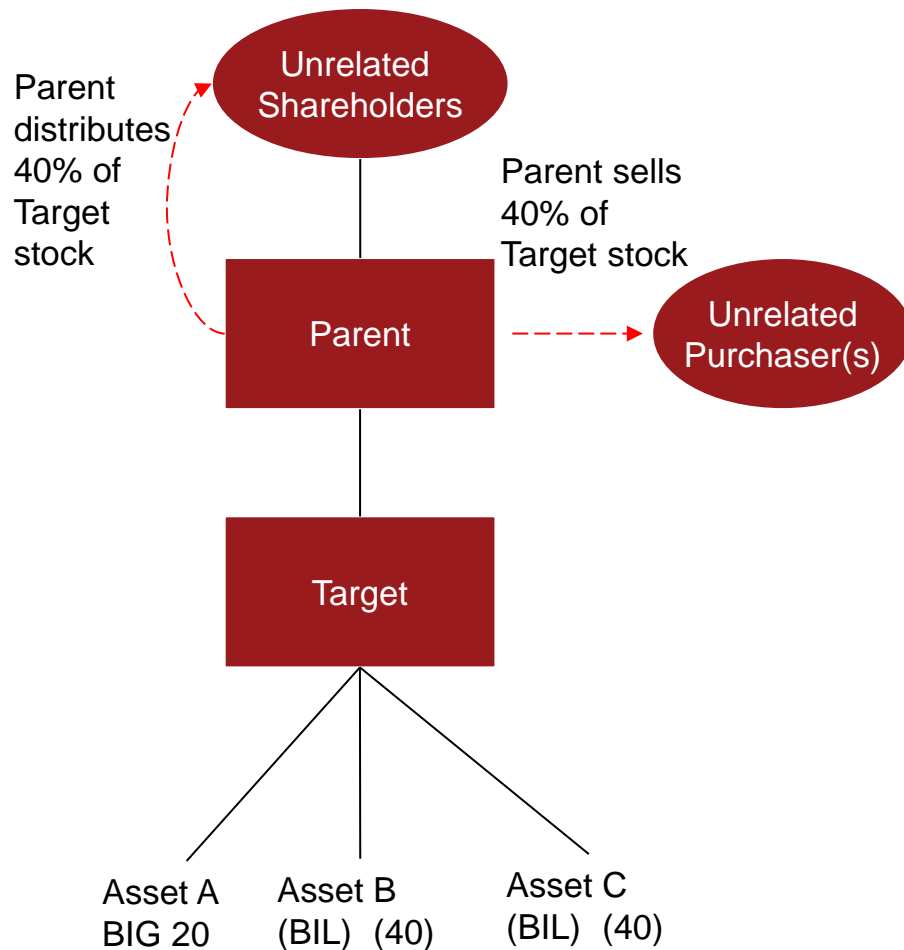
Distribution to Unrelated and Related Shareholders

- Transactions:
 - In a tender offer, Parent distributes 80% of the Target stock to Public Shareholders and 20% to A in exchange for Parent stock.
 - The exchange is intended to qualify under §355, but it does not do so.
 - Parent makes a protective §336(e) election.
 - As a result of the exchange—
 - A's ownership of Parent stock increases from 40% to 60%.
 - Public's ownership of Parent stock declines from 60% to 40%.
 - Target is acquired as part of a §355(e) "plan."
- The distribution to Public Shareholders is a QSD.
- Target is deemed to sell all its assets to an unrelated person for ADADP (assume \$200).
 - Target realizes \$60 net loss.
 - Because all the Target stock is distributed (not sold), all the net loss is disallowed.
 - Disallowed loss is allocated 50% (\$30) to Asset B and 50% (\$30) to Asset C.
 - Target recognizes \$20 gain on Asset A, \$10 loss on Asset B, and \$10 loss on Asset C.
- A is a Related Person.
 - The Target stock distributed to A is not part of the QSD.
 - This stock is included as distributed stock in the computation of disallowed loss.
 - The value of this stock is not taken into account in determining ADADP and AGUB.



40% Sale, 40% Distribution, 20% Retention

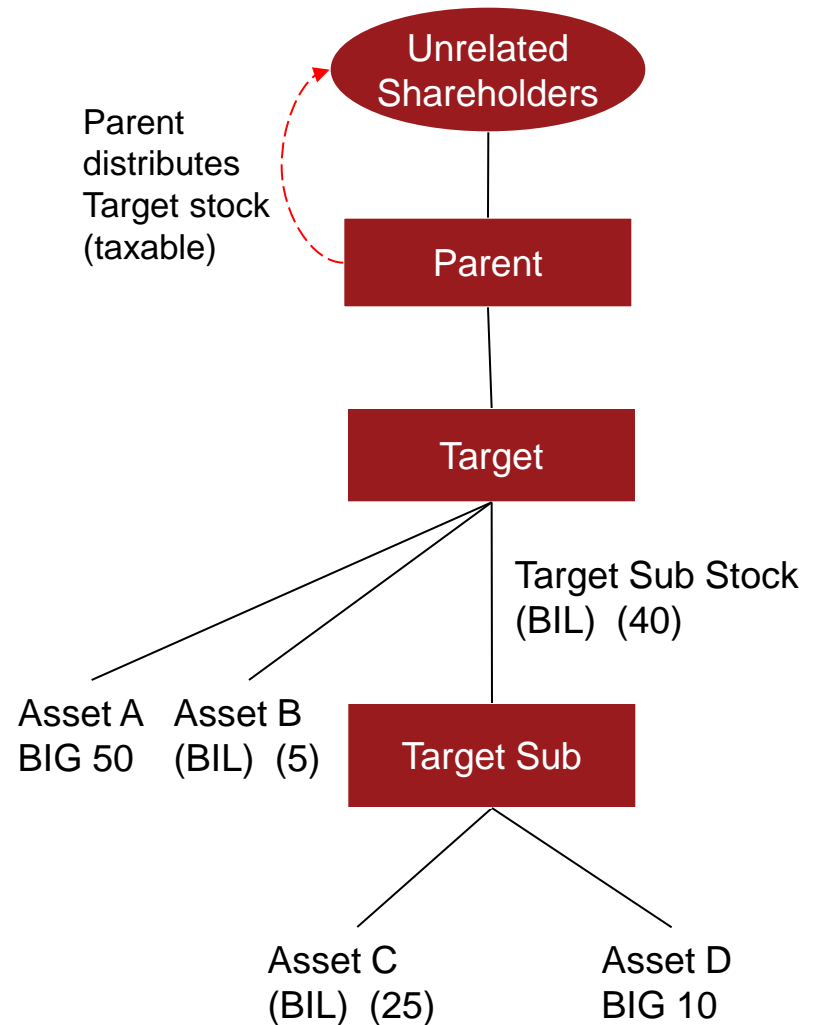
- Target is deemed to sell all its assets to New Target for ADADP (\$200, or $(\$80 + \$80) / 0.8$).
- Target realizes \$60 net loss. Because half of the Target stock disposed of in the QSD (40 / 80 shares) is distributed (as opposed to sold), half of the net loss (\$30) is disallowed. The disallowed loss is allocated 50% (\$15) to Asset B and 50% (\$15) to Asset C. Target recognizes \$20 gain on Asset A, \$25 loss on Asset B, and \$25 loss on Asset C.
- New Target is deemed to purchase Target's assets from an unrelated person for AGUB (\$200).
- Target is deemed to distribute to Parent the consideration deemed received for the assets (§332 liquidation).
- Parent is deemed to purchase 40% of the New Target stock from an unrelated person and then distribute that stock.
- Parent is deemed to purchase 20% of the New Target stock on the day after the Disposition Date.



Taxable Distribution of Target with Target Sub—I

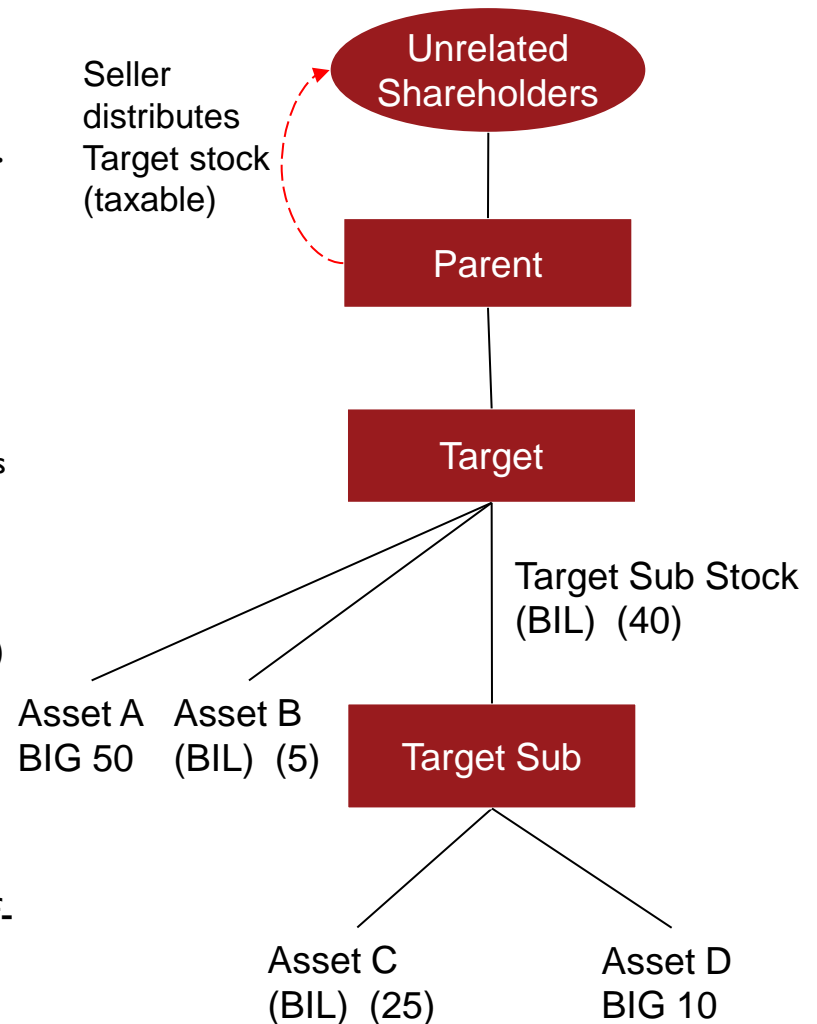
Section 336(e) elections are made for Target and for Target Sub.

- Target Sub deemed sale and liquidation
 - Target Sub is deemed to sell Asset C and Asset D to an unrelated person for ADADP. Target Sub realizes \$15 net loss.
 - Because all the Target stock is distributed, all the Target Sub stock is also deemed distributed.
 - All of Target Sub's net loss is allocated to Asset C and disallowed. Target Sub recognizes \$10 loss on Asset C and \$10 gain on Asset D.
 - Target Sub is deemed to liquidate into Target before Target's liquidation into Parent.
- Target deemed sale and liquidation
 - Target is deemed to sell Asset A and Asset B to an unrelated person for ADADP.
 - Target recognizes \$50 gain on Asset A and \$5 loss on Asset B.
 - Deemed sale of the Target Sub stock is disregarded.
 - Target is deemed to liquidate into Parent after Target Sub's deemed asset sale and liquidation into Target.



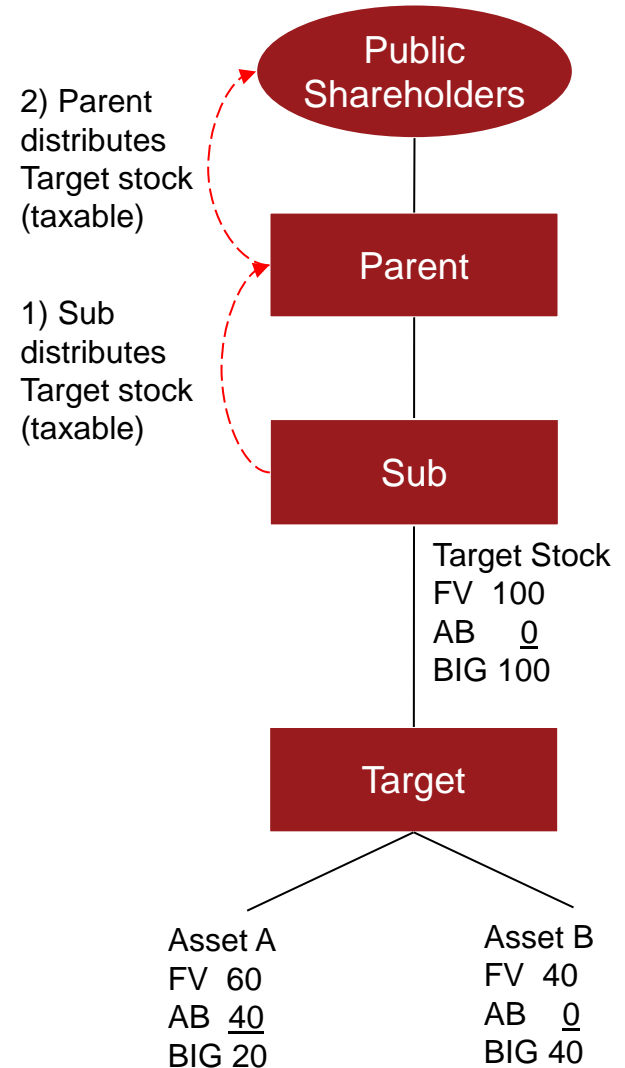
Taxable Distribution of Target with Target Sub—2

- Target as a whole has economic built-in gain, regardless of whether Target Sub stock or Target Sub assets, or neither, is taken into account.
- Nevertheless, if §336(e) elections are made for both Target and Target Sub, \$15 of the loss on Asset C will be disallowed, and the basis of Asset C will be reduced by \$15.
- If Target transfers Asset A to Target Sub under §351, the disallowed loss is reduced from \$15 to \$5.
- If a §336(e) election is made for Target but not for Target Sub—
 - No loss is disallowed.
 - Target Sub retains its full basis in Asset C and Asset D.
 - The consistency rules do not limit New Target’s basis in Asset A to carryover basis, because gain on the deemed sale of Target’s assets does not increase the basis of the Target Sub stock or allow a dividend from Target Sub subject to a 100% dividends-received deduction.
- If Target Sub is liquidated or converted to a disregarded entity, or if Target is merged downstream into Target Sub, the net loss is absorbed into Target’s built-in gain. If §336(e) elections are made for Target and Target Sub, no loss is disallowed.
- Would a §351 transfer, a liquidation or a downstream merger like the above be disregarded or recast under anti-abuse principles? See Reg. §1.338-1(c).
- Would a downstream merger fail to meet the continuity-of-business-enterprise requirement for a tax-free reorganization?



Intragroup Taxable Distribution

- 1) Sub's distribution of Target to Parent is not a QSD, because Parent is a Related Person to Sub.
 - Sub recognizes \$100 gain on distribution of Target stock, deferred under Reg. §1.1502-13 (but accelerated by Step 2).
 - Parent takes \$100 cost basis in the Target stock.
- 2) Parent's distribution of Target stock to Public Shareholders is a QSD, because no Public Shareholder is a Related Person to Seller.
 - If Parent makes a §336(e) election, Target is deemed to sell all its assets to New Target for ADADP.
 - Target recognizes \$60 gain on the deemed asset sale.
 - Target's \$60 gain increases Parent's basis in the Target stock from \$100 to \$160.
 - New Target is deemed to purchase the assets from an unrelated person for AGUB.
 - Target is deemed to distribute the consideration deemed received for the assets to Parent (§332/337 liquidation). Gain on Step 1 is triggered.
 - Parent may elect to apply Reg. §1.1502-13(f)(5)(ii)(C), which treats Target's liquidation as a §331 liquidation (solely to cause Parent to recognize loss on the Target stock). If this election is made, Parent recognizes \$60 loss in the deemed liquidation.
 - \$100 net gain to Parent (\$100 gain on Target stock in Step (1), \$60 gain on deemed asset sale and \$60 loss on deemed taxable liquidation in Step 2). Parent's net gain equals its BIG on the Target stock, not on Target's assets.
 - Parent is deemed to purchase the New Target stock from an unrelated person.
 - Parent is deemed to distribute the New Target stock, with no gain or loss.
 - Target's tax attributes are transferred to Seller.
 - New Target takes AGUB basis in its assets.
 - Public Shareholders receive a \$100 §301 distribution and take \$100 basis in the New Target stock.



STOCK DISTRIBUTIONS SUBJECT TO §355(d) OR §355(e)

Sale-to-Self Mechanics

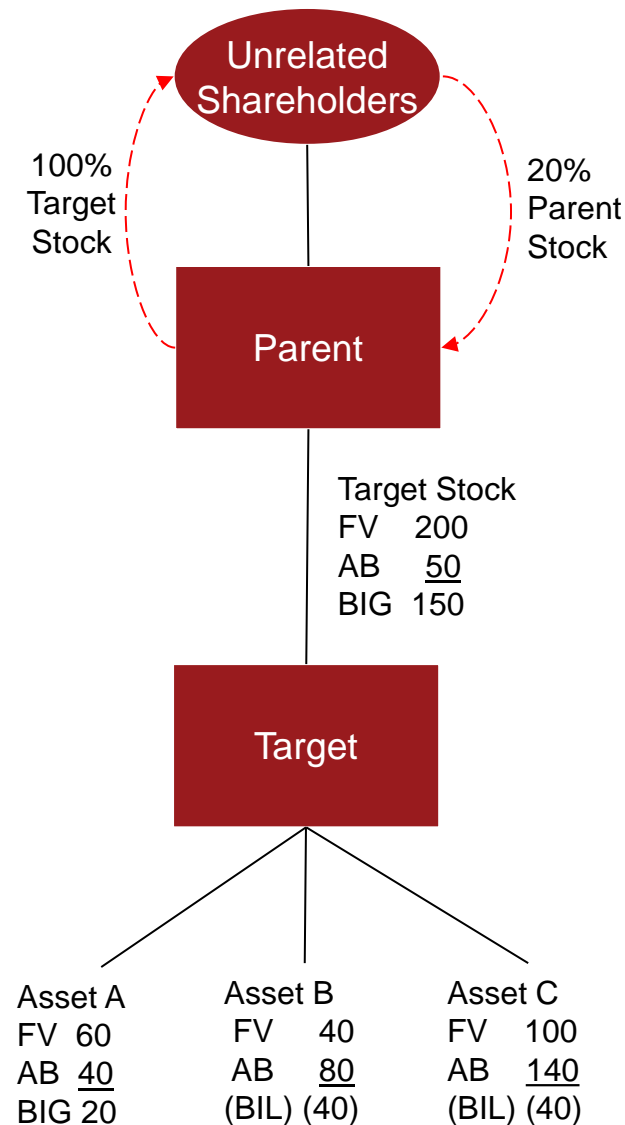
- Target is deemed to sell all its assets to an unrelated person for ADADP.
 - Gains are recognized in full.
 - To implement the policy of §311(b), any net loss is disallowed in proportion to the amount of stock distributed compared with any amount of stock sold as part of the QSD. The rules regarding disallowed losses are the same as those applicable to fully taxable stock distributions. See “Taxable Stock Distributions,” above.
- Target is deemed to re-acquire its assets from an unrelated person for AGUB (sale to self).
- Target is *not* deemed to liquidate.
- Seller distributes the Target stock.
 - Seller recognizes no gain or loss on the distribution.
 - Target’s tax attributes remain intact with Target.
 - Target’s earnings and profits account is adjusted to reflect gain or loss on the deemed asset sale.
- The distributee shareholders receive the Target stock tax-free under §355 and allocate their basis in their Seller stock between the Seller stock and Target stock, under §358.

Collateral Matters

- **Excess Loss Account.** IRS officials have indicated that any excess loss account (“ELA”) in the stock of Target or Target Sub is triggered, whether or not the ELA was created in connection with the distribution. Reg. §1.336-2(b)(2)(iii) (“No gain or loss is recognized by seller on the distribution.”); Reg. §1.1502-19(b)(1)(i) (“if M is treated under this section as disposing of a share of S's stock, M takes into account its excess loss account in the share as income or gain from the disposition.”)
- **Sections 197(f)(9) and 1091.**
 - For purposes of §197(f)(9) (intangibles amortization anti-churning rule) and §1091 (wash sale), Target in its capacity as deemed seller “shall be treated as a separate and distinct taxpayer from, and unrelated to,” Target in its capacity as deemed buyer in the deemed sale-to-self. Reg. §1.197-2(h)(8).
 - What if Seller spins Target pro rata, and one of Seller’s shareholders owns 30% of Seller’s stock (more than the 20% relatedness threshold under §197(f)(9))? IRS officials have stated that the intention was not to exempt sale-to-self transactions from anti-churning where anti-churning otherwise would apply.
 - See Slide 113, describing proposed repeal of §197(f)(9).

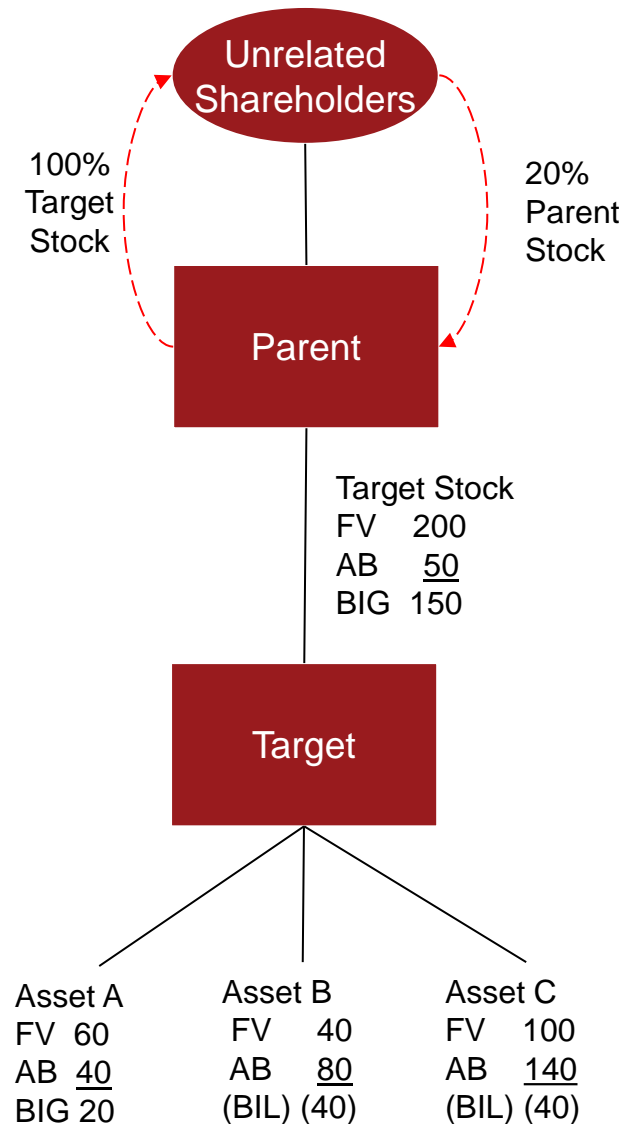
Distribution to Unrelated Shareholders—I

- Transactions
 - In a tender offer, Parent distributes all the Target stock to Unrelated Shareholders in exchange for 20% of the Parent stock, at a premium
 - Parent makes a protective §336(e) election.
 - Target is acquired as part of a §355(e) “plan.”
- Target is deemed to sell all its assets to an unrelated person for ADADP (assume \$200).
 - Target realizes \$60 net loss.
 - Because all the Target stock is distributed (not sold), all the net loss is disallowed.
 - Disallowed loss is allocated 50% (\$30) each to Asset B and Asset C. Target recognizes \$20 gain on Asset A, \$10 loss on Asset B and \$10 loss on Asset C.
- Target is deemed to purchase the assets from an unrelated person for AGUB (assume \$200).
- Are ADADP and AGUB determined by the value of the distributed Target stock or of the Parent stock redeemed?
- If the value of the Target stock is determinative, does *Pope & Talbot, Inc. v. Commissioner*, 162 F.3d 1236 (9th Cir. 1999) (\$311 gain determined by value of distributed property to distributing corporation, not traded price) control?
- Target is not deemed to liquidate, and it retains its tax attributes.



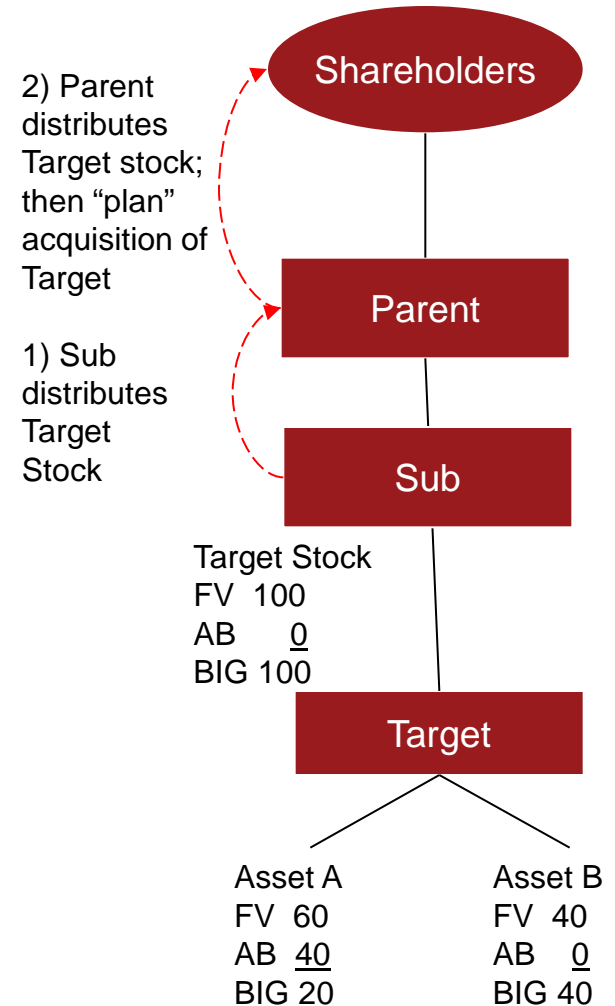
Distribution to Unrelated Shareholders—2

- Parent distributes the Target stock.
 - No gain is recognized to Parent.
 - Shareholders receive the Target stock tax-free under §355.
 - Shareholders' basis in Target stock is determined under §358.
- Target's deemed sale-to-self does not cause the distribution to fail any §355 requirement, including the 5-year active trade or business test.
- E&P of Parent and of Target are determined under Reg. §§1.312-10 and 1.1502-33(e). E&P is adjusted to reflect the deemed asset sale before allocation in Reg. §1.312-10.



Intragroup Distribution

- 1) Sub's distribution of Target stock to Parent is not a QSD, because Parent is a Related Person to Sub.
 - Section 355(f) treats Sub's distribution as a taxable distribution.
 - Sub recognizes \$100 gain on distribution of Target stock, deferred under Reg. §1.1502-13 (but accelerated by Step 2).
 - Parent takes \$100 cost basis in Target stock.
- 2) Parent's distribution of Target stock to Shareholders is a QSD.
 - Target is deemed to sell its assets to an unrelated person for ADADP (\$100).
 - Target recognizes \$60 gain.
 - This gain increases Parent's basis in the Target stock from \$100 to \$160.
 - Target is deemed to purchase its assets from an unrelated person for AGUB (\$100) (sale-to-self).
 - Target is not deemed to liquidate, and it retains its own tax attributes.
 - If an election is made to apply Reg. §1.1502-13(f)(5)(ii)(C), then, solely for purposes of that regulation, Target is deemed to liquidate into Parent under §331. Parent recognizes \$60 loss.
 - Net result: \$100 gain to Parent group = Sub's BIG in the Target stock.
 - Parent is deemed to distribute the Target stock at no gain or loss.



MAKING A §336(e) ELECTION

Making the §336(e) Election—General

- Reg. §1.336-2(h) provides the general rules, including specific requirements depending on whether Seller and Target are members of the same consolidated group, whether Target is an S Corp Target or a Target Sub.
- Election generally requires:
 - Binding written agreement to make the election.
 - Attaching election statement to relevant returns of Seller and/or Target.
- Target and New Target must report information concerning the deemed sale of Target's assets on Form 8883 "Asset Allocation Statement under Section 338" (making appropriate adjustments to report the results of the §336(e) election).
- Two Forms 8883 are filed by Target in the case of a Disposition subject to §355(d) or §335(e).
- The election is irrevocable.

Making the §336(e) Election—Consolidated and Affiliated Target

- Consolidated Seller and Target
 - Seller and Target enter into a written, binding agreement on or before the due date of the group's consolidated return for the year that includes the Disposition Date to make the §336(e) election.
 - The common parent retains a copy of the agreement.
 - The common parent attaches a §336(e) statement to the group's return for the year that includes the Disposition Date.
 - The common parent provides a copy of the election statement to the target on or before the due date of the group's return.
- Affiliated, Non-Consolidated Seller and Target
 - Seller and Target enter into a written, binding agreement on or before the due date of the earlier of Seller's or Target's return for the taxable year that includes the Disposition Date.
 - Seller and Target each retains a copy of the agreement.
 - Seller and Target each attaches a §336(e) election statement to its return for the taxable year that includes the Disposition Date.

Making the §336(e) Election— S Corp Target, Target Sub

- S Corp Target
 - All the S Corp Target Shareholders (including those who do not Dispose of their stock) and S Corp Target enter into a written, binding agreement on or before the due date of S Corp Target's return for the taxable year that includes the Disposition Date.
 - S Corp Target retains a copy of the agreement.
 - S Corp Target attaches a §336(e) election statement to its return for the taxable year that includes the Disposition Date.
- Target Sub
 - Must meet written, binding agreement requirement, but can be included in Target's agreement; or can be a separate agreement.
 - Separate §336(e) election statement is required for each Target Sub.

ADADP, AGUB AND GAIN RECOGNITION ELECTION

Aggregate Deemed Asset Disposition Price (ADADP)

- **ADADP** is the price at which Target is deemed to sell its assets and equals:
 - Grossed-up amount realized on Dispositions of Recently Disposed Stock.
 - Plus: Target's liabilities.
 - Less: Target's Disposition costs.
- Target determines its gains and losses by allocating ADADP among its assets under the residual method of Reg. §1.338-6.
- Formula does not necessarily reflect Target stock or asset value on the Disposition Date, if value changes during the 12-Month Disposition Period.

Recently Disposed Target Stock

- **Recently Disposed Stock** is any Target stock that—
 - Is not held by Seller, a member of Seller's consolidated group, or an S Corporation Shareholder immediately after the close of the Disposition Date, and
 - Was disposed of by Seller, a member of Seller's consolidated group, or an S Corporation Shareholder during the 12-Month Disposition Period.
- Stock sold or distributed to a Related person to Seller is not treated as “Disposed of” in the QSD and is not Recently Disposed Stock.

Grossed Up Amount Realized for Recently Disposed Stock

- **Grossed Up Amount Realized for Recently Disposed Stock** equals:
 - Sum of:
 - Total amounts realized on all sales of Recently Disposed Stock.
 - Fair market value of Recently Disposed Stock that is distributed in the QSD. (FMV is determined on the date of each distribution.)
 - Divided by the percentage of Target stock (by value, determined on the Disposition Date) attributable to the Recently Disposed Stock.
 - Less: Costs incurred by Seller(s) in connection with the sale or exchange of Recently Disposed Stock that reduce the amount realized on the sale or exchange (e.g., brokerage commissions).

Adjusted Grossed Up Basis (AGUB)—General

- **Adjusted Grossed Up Basis (AGUB)** is New Target's basis in the deemed purchased assets, *i.e.*, the amount for which Target is deemed to purchase its assets in the deemed purchase.
- AGUB generally is determined based on the amount paid by Purchaser(s) for the Target stock (or the value of Target stock distributed to Seller shareholders).
- AGUB under §336(e) is essentially the same as AGUB under §338(h)(10). But the complexities of AGUB are more likely to arise under §336(e), because of multiple Purchasers in §336(e) Dispositions.
- In most cases, AGUB is the same as ADADP (apart from differences in the parties' transaction costs), but the two amounts may differ where a prior Target shareholder acquires additional Target stock in the QSD.

Adjusted Grossed Up Basis (AGUB)— Computation

- AGUB equals the sum of:
 - Grossed-Up Basis in Recently Disposed Stock.
 - Purchasers' aggregate basis in Nonrecently Disposed Stock
 - New Target's liabilities (in a distribution subject to §355(d) or §355(e), Target's liabilities).
 - Acquisition costs.
- AGUB is allocated among the assets under the residual method of Reg. §1.338-6.

Grossed Up Basis of Recently Disposed Stock

Grossed Up Basis of Recently Disposed Stock = $AB/C - D$:

- A = Purchasers' aggregate basis in Recently Disposed Stock (reduced by capitalized costs described in D) as of the beginning of the day after the Disposition Date.
- B = 100 minus the percentage of Target stock (by value, determined on the Disposition Date) attributable to Nonrecently Disposed Stock.
- C = Percentage of Target stock (determined as in B) attributable to Recently Disposed Stock.
- D = Capitalized acquisition costs that Purchasers incurred in connection with acquisitions of Recently Disposed Stock.

Nonrecently Disposed Stock—General

- **Nonrecently Disposed Stock** is Target stock that is:
 - Not Recently Disposed Stock and
 - Held on the Disposition Date by a Purchaser, *i.e.*, someone that purchased Target stock as part of the QSD, or a Related Person, but only if such Purchaser and/or Related Persons holds $\geq 10\%$ of the Target stock (by either vote or value).
- Other minority Target stock is not Nonrecently Disposed Stock.
- Other Target stock retained by Seller is not Nonrecently Disposed Stock.
- $\geq 10\%$ limitation prevents overly burdensome information gathering from Purchasers, but obtaining necessary information, even from possible $\geq 10\%$ holders and their Related Persons may be burdensome and requires contractual provisions to prevent surprise and ensure compliance.
- If Target is an S Corp Target, there can be multiple Sellers, as well as multiple Purchasers. Can stock held by someone who sells some stock and purchases other stock during the 12-Month Disposition Period be Nonrecently Disposed Stock?

Nonrecently Disposed Stock—<80% Target Shareholder

- A purchaser of Target stock that holds Nonrecently Disposed Stock and holds <80% of the Target stock on the Disposition Date may, but is not required to, make a **Gain Recognition Election**.
- Results of Gain Recognition Election:
 - Taxable gain to Purchaser on appreciation in Nonrecently Disposed Stock (but no loss on any depreciation, even if loss on one block nets against gain on another block).
 - AGUB is increased by the amount of the gain.
- Results of no Gain Recognition Election:
 - No taxable gain to Purchaser.
 - AGUB reflects that Purchaser's historic basis in Nonrecently Disposed Stock and as a result is <ADADP.
- Gain recognition to Purchaser may be avoided via “longhand” asset sale.

Nonrecently Disposed Stock — $\geq 80\%$ Target Shareholder

- A Purchaser with Nonrecently Disposed Stock that holds $\geq 80\%$ of the Target stock (by vote or value) is deemed to make a Gain Recognition Election. Reg. §1.336-4(c)(2).
- Result: Taxable gain to Purchaser on the appreciation in its Nonrecently Disposed Stock (but no loss on any depreciation, even if loss on one block nets against gain on another block).
- Can gain recognition to Purchaser be avoided?
 - Can the Purchaser's ownership of $>80\%$ of the Target stock be postponed until after the Disposition Date or after the end of the 12-month Disposition Period (if there are other Purchasers)?
 - Can the transaction be accomplished via “longhand” asset sale?

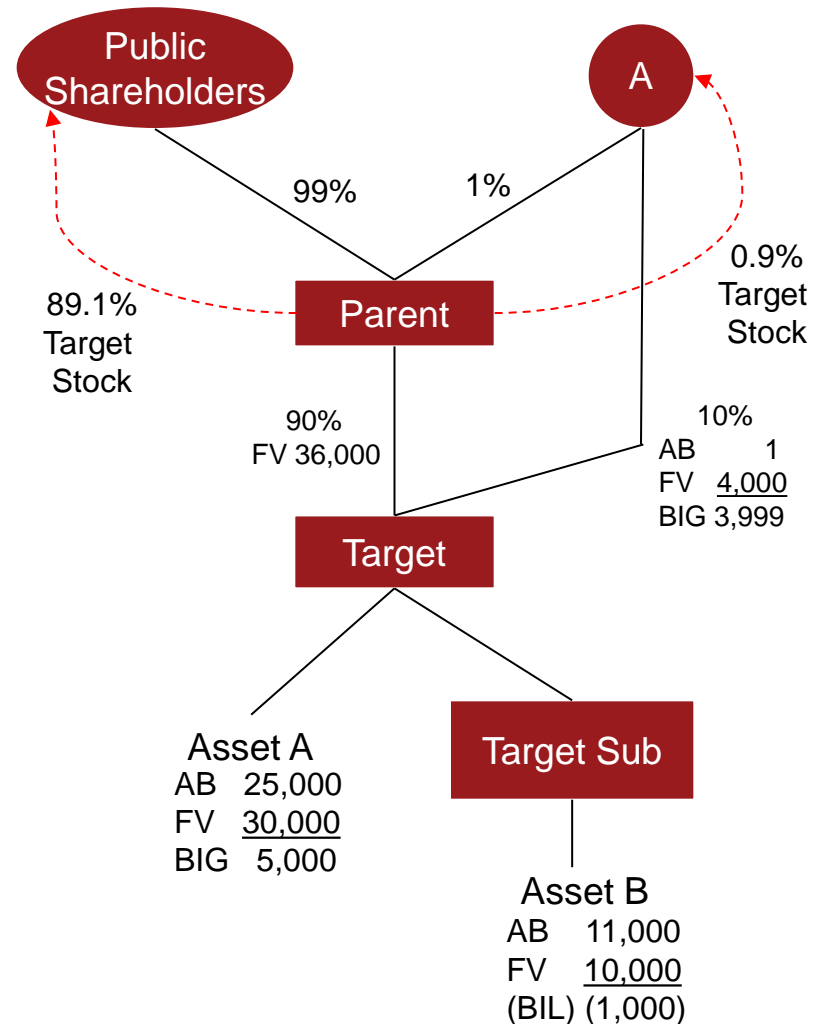
Gain Recognition Election

If a holder of Target stock makes (or is deemed to make) a Gain Recognition Election, Nonrecently Disposed Stock is treated as sold on the Disposition Date.

- The holder recognizes gain but not loss (even loss netted against gain) on a deemed sale of that stock.
- The deemed sale price = “basis amount” = AB/C :
 - A = Holder’s basis in Recently Disposed Stock at the beginning of the day after the Disposition Date.
 - B = Percentage of Target stock that is that holder’s Nonrecently Disposed Stock.
 - C = Percentage of Target stock that is that holder’s Recently Disposed Stock.
- Idea is to approximate the value of the Target stock per share, as determined by each holder’s actual cost of its Recently Disposed Stock.
- Each holder’s basis is determined separately, but all the holders’ basis amounts may be relevant in computing AGUB.

ADADP, AGUB and Gain Recognition

- Transactions
 - Parent distributes its 90% of the Target stock to its Shareholders, *pro rata*, i.e., 89.1% to Public and 0.9% to A.
 - After the distribution, Public owns 89.1%, and A owns 10.9%, of the Target stock.
 - Protective §336(e) elections are made for Target and Target Sub, and A does not make a gain recognition election.
 - Target is acquired as part of a §355(e) “plan.”
- Target Sub
 - ADADP = \$10,000
 - Asset Basis = \$11,000
 - Loss disallowed. \$0 gain or loss recognized.
 - Target Sub AGUB = \$10,000
- Target
 - ADADP (excluding Target Sub) = $\$27,000 / 0.9 = \$30,000$
 - Asset Basis = \$25,000
 - Gain recognized = \$5,000
 - Target AGUB = \$36,000
- Total
 - ADADP = \$40,000
 - Gain recognized = \$5,000
 - AGUB = $\$36,000 + \$1 = \$36,001$
- If Target and Target Sub had sold their assets for ADADP, net gain recognition would have been \$4,000, and asset basis would have totaled \$40,000.
- If A makes gain recognition election—
 - A gain recognition on Parent stock = \$3,999
 - Total AGUB = $\$36,001 + \$3,999 = \$40,000$



INTERNATIONAL ASPECTS

Domestic Target and Foreign Target Sub: QSP

- For a disposition of Target stock to qualify as a QSD—
 - Both Seller and Target must be domestic.
 - Any or all of the Purchasers may be foreign.
- If a domestic Target has a foreign subsidiary, and Seller disposes of the Target stock in a QSD with a §336(e) election, there is a deemed Disposition of the stock of the foreign Target Sub.
- The deemed Disposition cannot be a QSD, because Target Sub is foreign.
- The Disposition can be a QSP.
 - The QSP cannot be subject to a §338(h)(10) election, again because Target Sub is foreign.
 - This QSP can be subject to a §338(g) election (deemed taxable sale of Target Sub stock followed by deemed sale of Target assets).
 - If the QSP is subject to a §338(g) election, the QSP is treated as a sale of the Target Sub stock (not Target Sub's assets) in determining source and character of gain, for foreign tax credit purposes.

Target Foreign Branch: §§901(m) and 338(h)(16)

- Section 901(m) denies foreign tax credit for tax attributable to “covered asset acquisitions,” e.g., QSPs with §338 elections that are treated as acquisitions of assets for U.S. tax purposes but acquisition of stock for foreign tax purposes.
- Reg. §1.336-2(g)(3)(iii) applies §901(m) to QSDs with §336(e) elections.
- Legislation has been proposed to extend application of §338(h)(16) to conform to §901(m). General Explanations of the Administration’s Fiscal Year 2014 Revenue Proposals (Apr. 2013), 60.

Target Foreign Branch: Taxable Year End and Foreign Tax Allocation

- Target's U.S. taxable year ends on the Disposition Date if a §336(e) election is made for the Disposition.
- If Target has a foreign branch, and if its taxable year in a foreign country does not end on the Disposition Date, its foreign income tax is allocated between Target and New Target “under the principles of §1.1502-76.” TD 9619. This is the same rule as Reg. §1.338-9(d) applicable to §338 elections.
- If Target has an interest in a partnership or disregarded entity, and if foreign income tax is imposed on that entity, the tax is allocated between Target and New Target in accordance with Reg. §1.901-2(f)(4).
- TD 9619 states:
 - The IRS and Treasury Department intend to issue future guidance that will make similar modifications to §1.338-9(d).

Target Sub CFC: Consistency Rules

- If a Target Sub is a controlled foreign corporation and sells an asset to Purchasers at a gain that is subpart F or PFIC income—
 - Target's basis in the Target Sub stock is increased, under §961.
 - Seller's basis in the Target stock is increased, if Seller and Target are members of a consolidated group.
- Thus, if Seller sells the Target stock to Purchasers with no §336(e) election, the basis of the Target Sub asset sold may be reduced to a carryover basis.
- The affected assets are those sold to Purchasers who acquire >5% or more of the Target stock in the QSD.
- The §961 increase in Target's basis in the Target Sub stock is also reduced.

OPEN ISSUES

Open Issues Regarding Disposition— Liquidation of Parent

Complete Liquidation of Parent. Can a distribution of Target stock in a complete liquidation of Parent be a Disposition of the Target stock and a QSD, provided $\geq 80\%$ of the Target stock is distributed to non-Controlled Persons?

- Should be a Disposition if the liquidation is not subject to §§332 and 337 (nontaxable distribution to a Controlled Person).
- How to determine whether a distribution of Target stock is to a Controlled Person where Seller disappears? Use hypothetical stock ownership if the distribution had been under §311, and Seller had remained in existence?
- If a distribution of Target stock in complete liquidation of Parent is a Disposition of the Target stock and a QSD, does loss disallowance apply?
 - If a loss on the stock would have been allowed within the limitations of §336(d), there is no reason to disallow losses on the deemed asset sale if a §336(e) election is made.
 - If a loss on the stock would be disallowed by §336(d), the reason for loss disallowance in a distribution under §311 (or §355(d) or §355(e)) should apply to require loss disallowance.

Open Issues Regarding Disposition— Stock Redemption by Target

Is a redemption of Target stock a Disposition?

- Can a redemption be a sale by one corporation of the stock “another corporation,” referred to in §336(e)(1)?
- How is AGUB determined, since Target has no basis in its own stock?
- What is the right policy answer, considering the treatment of stock redemptions under §338 (outstanding stock determined after redemptions from non-Related Persons)?
- See Slides 28-29.

Open Issues Regarding Disposition—Related Person

- **Related Person in Disposition of S Corp Target Stock.**

A sale or distribution of Target stock to a Related Person is not a Disposition. In a sale of S Corp Target stock, there can be more than one Seller. To be a Related Person, must Purchaser be a Related person to its particular Seller, or is it enough to be related to any Seller?

Example 1. A and B are unrelated, and each owns 50% of the stock of S Corp Target. C is related to A but not to B, and D is related to B but not to A. A sells his stock to C, and B sells his stock to D. Or, A sells his stock to D, and B sells his stock to C. Does it matter who sells to whom? Should it matter?

Example 2. A and B are unrelated. A owns 1%, and B owns 99%, of the stock of S Corp Target. C is related to A but not to B. Does C's Related Person status with respect to A prevent the sale of B's stock to C from being a Disposition and a QSD?

Open Issues Regarding Section 338 Model Under Other Provisions

- **Anti-churning rule.** Target is not considered a related person to itself under §197(f)(9) or §1091 in a sale-to-self transaction.
 - Does Reg. §1.197-2(h)(8) apply so that “New Target” is not considered a Related Person under §197(f)(9)?
 - Does §197(f)(9) still apply if Purchaser is >20% related to Seller?
 - See Slide 113, describing proposal to repeal §197(f)(9).
- **CERT (§172(h)(3)(B)(ii)).** “Major stock acquisition” does not include a QSP to which a §338 election applies. Does a similar rule apply to a stock Disposition subject to a §336(e) election?
- **Excess Loss Account.** Is an ELA in the stock of Target or Target Subs triggered?
 - Stock sale?
 - Fully taxable stock distribution?
 - Stock distribution subject to §355(d) or §355(e)?

Open Step Transaction Issues

- **Newco Target.** If Parent forms Target as a Newco to effect the QSD, which corporation is taxed on the deemed sale—Parent or Target?
- **Minimizing Loss Disallowance.** Intra-Group transactions may be engaged in to minimize loss disallowance in a distribution of Target stock, where there are Target Subs with net losses.
 - Does a cross-chain or downstream merger or other purported reorganization fail the continuity-of-business-enterprise requirement for tax-free treatment due to deemed asset sales? Cf. Reg. §1.336-2(b)(2)(v), providing that the deemed sale-to-self does not cause any §355 requirement (including 5-year active trade or business requirement) not to be satisfied.
 - Does a transfer of a built-in gain asset to a net loss Target Sub not qualify under §351, due to the deemed asset sale?
 - Do these types of transactions fall afoul of anti-abuse principles like those expressed in Reg. §1.338-1(c) (implementing the residual method of allocating deemed asset sale and purchase price)?

Open Issues in Creeping Disposition of S Corp Target

- An S Corp Target Shareholder who purchases Target stock during the Pre-Deemed Sale Period may have to—
 - Consent to a §336(e) election for the election to be valid.
 - Report gain or loss from the deemed sale and any income or loss from the date of purchase through the Disposition Date (both potentially offset by adjustments to stock basis and the deemed liquidation of the S Corp Target).
- An S Corp Target Shareholder could be both a Seller and a Purchaser of S Corp Target stock during the 12-Month Disposition Period, and both tranches of stock could be included in the QSD. The same Seller could also retain other shares of the stock. If so, is the stock retained by that shareholder Nonrecently Disposed Stock?

Open Issues in Creeping Acquisitions— Pre-Deemed Sale Period

- **Straddling Year End.** If the Pre-Deemed Sale Period straddles a taxable year end of Target or Seller, the tax consequences of the first part of a QSD in the first year are uncertain.
 - How does Seller report the sale or distribution of Target stock on its return for the first year?
 - If Target is a member of a consolidated group or an S Corp Target, how is Target's income or loss reported?
 - How can this reporting be changed once the 336(e) election is made with the Seller's return for the 2d year?
 - How is Seller's E&P affected and adjusted to determine the shareholders' treatment of a distribution of Target stock during the first year?
- **Plan of Liquidation.** What is the timing of adoption of the plan of liquidation necessary to §332/§337 treatment? Reg. §1.338(h)(10)-1(e) Example 2 suggests that the plan is adopted on the Disposition Date.

Open Issues in Creeping Acquisitions— Pre-Deemed Sale Period—Consolidated Group

If Target is a consolidated group member, and if >20% of its stock is sold to a non-group member during the Pre-Deemed Sale Period; the rest of the Target stock is sold on the Disposition Date; and a §336(e) election is made (presumably valid even though the group owns <80% of the Target stock on the Disposition Date)—

- When does Target leave the group?
- Does the group report the gain or loss on the deemed sale and any Target income or loss from the date of the >20% stock sale through the Disposition Date?
- See Reg. §1.336-2(k) Example 6 (§332 applies to the deemed liquidation).
- Same issue if Purchaser is a consolidated group.

Example. A Corp. and B Corp. each is the parent of a consolidated group. A owns 80%, and B owns 20%, of the Target stock. On 01/01/14, A sells 60% of stock to B, and on 07/01/14, A sells the remaining 20% of the stock to B. A makes a §336(e) election. The Disposition Date is 07/01/14. During the Pre-Deemed Sale Period (01/01 – 07/01/14), is Target a member of A's group or B's group?

TAX AND TRANSACTION PLANNING

Tax Planning in Stock Sales and Purchases

- If Seller sells §1504(a)(4) Target stock or sells Target stock to a Related Person, the sale is not a “Disposition.”
 - Seller recognizes gain or loss on the sale of this stock, even if it sells the rest of the Target stock subject to a §336(e) election.
 - Is this double tax appropriate?
- Should every §338(h)(10) election include a protective §336(e) election for Target and Target Subs?
- Before structuring stock disposition as a QSD with a §336(e) election, consider whether other structures are available (*i.e.*, “longhand” asset sale, forward cash merger, conversion to disregarded entity and sale of equity of that entity, stock sale with §338(h)(10) election) and relative advantages and disadvantages. See, e.g., Slide 21, comparing §336(e) election with a “busted” §351 exchange qualifying for §338(h)(10) election.

Tax Planning in Stock Distributions

If a §336(e) election is made for a stock distribution (protective or not), consider that the net loss to Target and each Target Sub is disallowed on an entity-by-entity basis.

- Consider not making the election for Target Subs with net inside losses. The basis in the stock of those Target Subs is included in determining net gain or loss attributable to their shareholder corporations.
- Consider combinations of net gains and net losses in Target and Target Subs.
 - Liquidations and check-the-box elections should be respected unless subject to anti-abuse rule as under §338.
 - Cross-chain and downstream mergers and other reorganizations may fail continuity-of-business-enterprise requirement for tax-free treatment due to deemed asset sales.
 - Transfer of built-in gain asset to net loss Target Sub may not qualify under §351, also due to deemed asset sale.
 - Re purported §351 transfer of built-in loss assets out of net loss Target or Target Sub to net gain target Sub:
 - Could §362(e) (reducing basis of built-in loss assets transferred in §351 exchange, capital contribution or as paid-in surplus, or stock received in transaction) have an impact? See Reg. §1.362-4(c)(1) (§362(e)(2) does not apply if basis in stock received in transaction does not reflect built-in loss, i.e., stock is spun off under §355).
 - Is loss triggered to transferor and possibly deferred under §267(f)?

Drafting a Stock Purchase Agreement

- Acquisition agreement needs to provide for reporting gain or loss, payment of tax on deemed asset sale and benefit of any loss carrybacks or carryovers.
- Seller and Target may agree to file election but then revoke the agreement, so long as they do it before the election is filed.
 - The election itself is irrevocable.
 - Agreement should include procedures for revocation of agreement to elect section 336(e) if circumstances change.
- Buyer of <80% of the Target stock from Seller, with Seller holding the remainder, could be buying liability for its share of the tax on the deemed asset sale, if a later stock sale is made with a §336(e) election.
 - Buyer would benefit from its share of the basis step-up.
 - Nevertheless, agreement should provide procedures for deciding to make or not make the election
- How can Purchaser ensure that an election is actually made in accordance with the agreement between Seller and Target (or another agreement between Seller and Purchaser)?
- Purchaser needs to document whether the consistency rule might apply: Purchaser needs to have information about any asset purchases from Target or Target Subs by itself and its Related Persons, if a §336(e) or §338(h)(10) election is not made. If there were no such purchases, that fact should be memorialized.
- Seller and Purchaser should consider whether to reach agreement on allocation of ADADP and AGUB for deemed asset sale. By not reaching such an agreement, they can avoid being bound vis-à-vis IRS. See Slide 97 (*Peco Foods, Inc. v. Commissioner*).

Drafting a Tax Sharing Agreement for Stock Distribution

- Similar considerations to those listed in Slide 91.
- In an intended tax-free spin-off with protective §336(e) election, tax sharing agreement needs to allocate tax on the deemed asset sale and tax benefit of inside basis step-up. Usually, tax on deemed sale and basis benefit should be allocated to the same party.

OTHER RECENT DEVELOPMENTS

COURTS

Daishowa-Marubeni International Ltd. v. Her Majesty the Queen, **2013 Sup. Ct. Canada 29 (2013)**

Assumed Liability or “Embedded” Future Cost?

- Seller owned licenses to harvest timber (“forest tenures”) on tracts in Alberta. Under provincial law, the areas in which timber was harvested had to be reforested.
- Seller sold the forest tenures, and, as a legal condition to the sale, Acquiror assumed the obligation to reforest land that Seller had harvested. Seller was relieved of the liability.
- Court held that Seller was not required to include the assumption of the obligation in its amount realized, because the obligation was not a separate liability. The Court stated: “The obligations – much like needed repairs to property – are a future cost embedded in the forest tenure that serves to depress the tenure’s value at the time of the sale.”
- This analysis removes the future events from Seller’s tax computations. As the Court pointed out, including the reforestation obligation in sale price would have introduced asymmetry: Seller’s amount realized would include the assumed obligation, but Acquiror’s basis in the property would not.
- Such an asymmetry exists under U.S. tax law but as a timing matter:
 - Seller includes Acquiror’s assumption of contingent liabilities in its amount realized on a sale (generally at closing) but usually is entitled to an offsetting deduction, although the timing of the deduction is uncertain.
 - Acquiror includes the assumed liability in its asset basis but only upon accrual and economic performance—usually payment.

Welle v. Commissioner, 140 T.C. No. 19 (2013)

Services Provided by Corporation to Shareholder at Cost Not a Constructive Distribution

- Sole shareholder of construction company built a home for himself. The company's crew framed the house, and he ordered supplies in the company's name.
- The shareholder reimbursed the company for labor and overhead costs but did not pay any margin usually charged.
- Court held that the corporation did not divert actual value available to it by failing to apply its customary profit margin. The shareholder therefore did not receive a constructive dividend.
- This case presents an issue analogous to *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998).
 - The success of a corporation's ice cream distribution business was largely attributable to its shareholder's personal contacts with supermarket chain managers.
 - In connection with a sale of intangible assets of the business, the court held that the relationships were assets of the shareholder, not the corporation.

Peco Foods, Inc. v. Commissioner,
112 AFTR 2d 2013-5137 (11th Cir. 2013)
Agreed Purchase Price Allocation Binding on Acquiror

- Agreement for sale of poultry processing facilities allocated purchase price among assets, including real property, for accounting and tax purposes.
- Buyer initially depreciated non-residential real property on its tax return using straight-line method and 39-year recovery period.
- The following year, buyer commissioned a segregated cost analysis of the facilities. Based on the analysis, buyer divided the real property assets into subcomponents to take advantage of accelerated depreciation methods and shorter recovery periods applicable to certain subcomponent asset categories.
- 11th Circuit affirmed Tax Court decision to disallow reallocation of the purchase price. Written agreement allocating purchase price to specific assets is binding on both the seller and buyer for tax purposes. §1060(a).

Majestic Star Casino, LLC v. Barden Development Corp., **716 F.3d 736 (3d Cir. 2013)**

S Corporation Election Not “Property” in Bankruptcy

- S corporation had subsidiary, classified as a QSub
- QSub filed for bankruptcy.
- Later, S corporation’s sole shareholder revoked S election.
 - Result was automatic termination of subsidiary’s QSub status.
 - Subsidiary became responsible for paying income tax on its income.
- Subsidiary’s creditors challenged the loss of its QSub status, arguing that the status was property of the bankruptcy estate.
- Court held that QSub status (as well as S corporation status) is not a “legal or equitable interest in property” that could be brought into a bankruptcy estate.
- Even if the QSub status were found to be property, the court reasoned, it would be property of the parent corporation rather than the subsidiary.

***In Re: BankUnited Financial Corp.*, 112 AFTR 2d 2013-5729 (11th Cir. 2013)
Tax Refund Attributable to Consolidated Subsidiary Not Property of
Parent's Bankruptcy Estate**

Facts

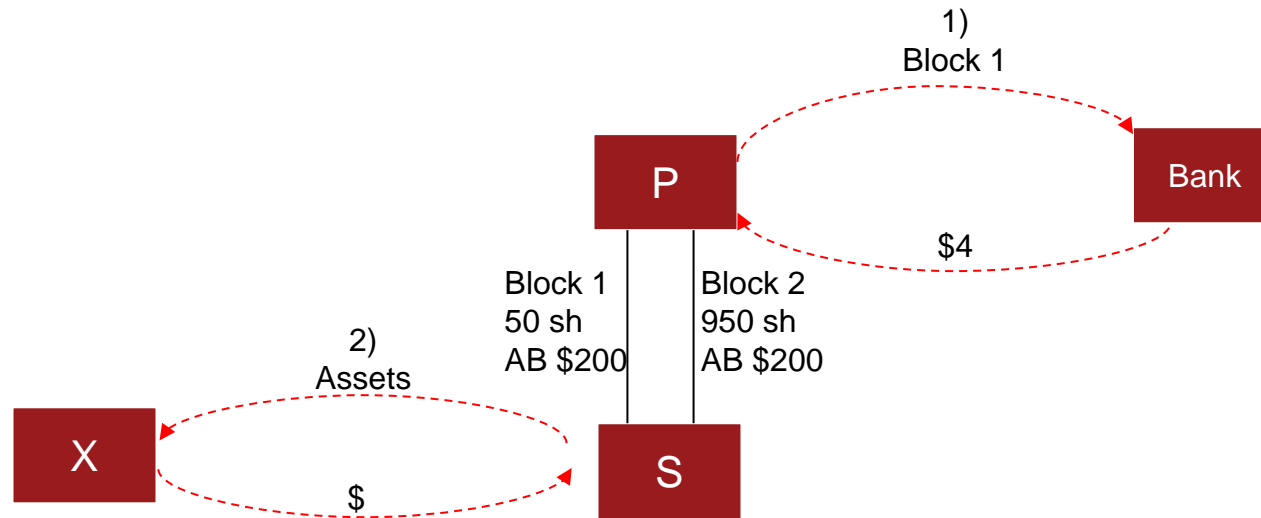
- Parent and Bank were members of a consolidated group with a tax sharing agreement (TSA).
- OTS closed Bank, and FDIC became receiver.
- Parent declared bankruptcy.
- Parent received from IRS refunds of tax attributable to Bank (apparently loss carrybacks) and held proceeds as property of bankruptcy estate.

Holding

- TSA was intended to require Parent to pay the tax refund over to Bank and not to make Bank a creditor of Parent.
- When Parent received tax refund, it did so “as if in escrow” and was required to forward the proceeds promptly to Bank.

Duquesne Light Holdings, Inc. v. Commissioner, T.C. Memo. 2013-216

Consolidated Return Double Deduction



- P and S are members of P's consolidated group.
- 1) In 2001, P sells Block 1 of (50 of its 1,000 shares of S stock) to Bank for \$4 (\$196 loss). S continues as a P group member.
- 2) In 2002-2003, S sells all its assets to X at a loss.
- Court disallows loss on asset sale, to the extent the same economic loss was reflected in the loss on the sale of Block 1. *Charles Iffeld Co. v. Hernandez*, 292 U.S. 62 (1934);
 - Court applies the same analysis used in a contingent liability tax shelter case (*Thrifty Oil Co. v. Commissioner*, 139 T.C. 198 (2012)).
 - Court does not address the validity of the disproportionately large basis in Block 1 to evaluate the loss on the sale of Block 1.

Tax Court Petitions in *Google Inc. v. Commissioner* and *Time Warner Inc. v. Commissioner* Grant and Exercise of Warrant—I

Facts

- In 2002 AOL chose Google to be its exclusive search provider. As part of the arrangement, Google granted to AOL a warrant to buy Google stock for \$21.6 million.
- In 2004, shortly before Google's IPO, AOL exercised the warrant.
- In 2004-2005, after the IPO sold the stock for \$1.13 billion.

Issue and Litigation

- Was the taxable event—taxable income to AOL and deduction to Google—the grant of the warrant (AOL's position) or its exercise (Google's position)?
- Google and Time Warner (AOL's successor) each has filed a petition in U.S. Tax Court—Time Warner in May and Google in June 2013.
- Outcome seems to turn on application of §83:
 - Did Google grant the warrant in connection with performance of services by AOL?
 - Could the value of the warrant be determined with reasonable accuracy at the time it was granted?

Tax Court Petitions in *Google Inc. v. Commissioner* and *Time Warner Inc. v. Commissioner* Grant and Exercise of Warrant—2

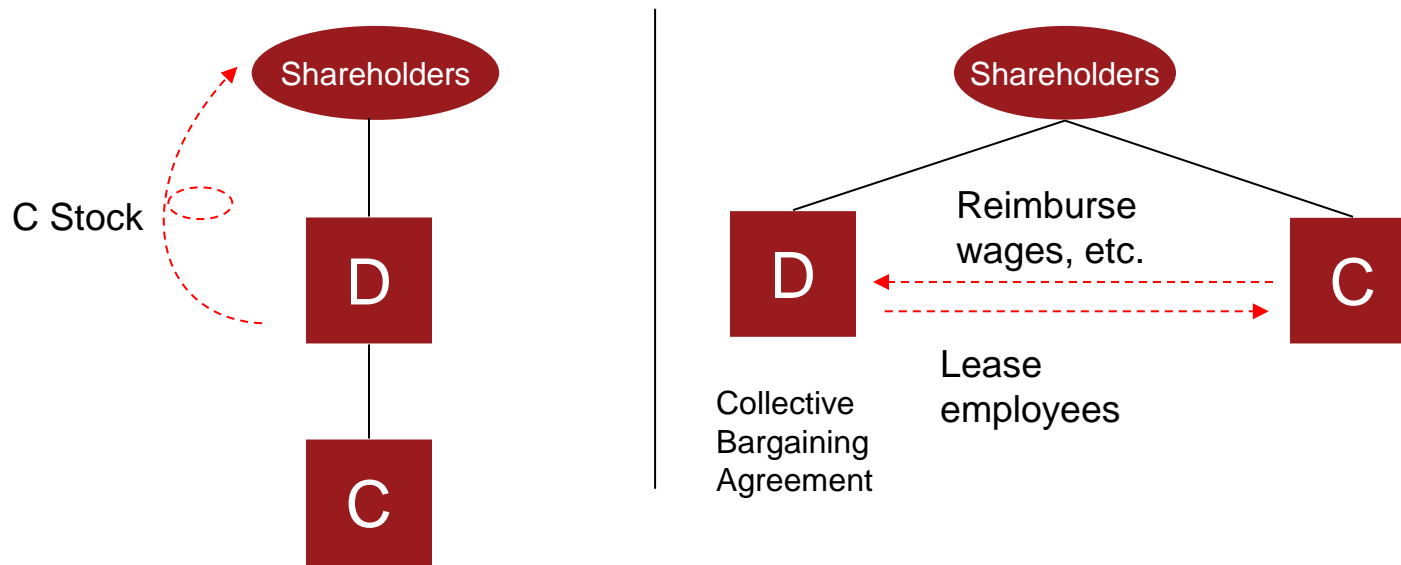
Possible Significance of the Google and Time Warner Cases

- Character and timing (and thus amount) of tax items in acquisitions and other transactions often depends on whether payments are made for property or services.
- Payments in equity and options to acquire equity are especially susceptible to this issue.
- Examples include the following:
 - Rev. Rul. 2007-49 (tax-free acquisition coupled with employment agreement).
 - Cases dealing with Ernst & Young's disposition of Cap Gemini its consulting business—*Culp, Berry, Bergbauer, Fletcher, United Fort, Nackel* and *Hartman*.
 - Authorities involving grants of stock options in connection with financing transactions and sales of inventory—*Custom Chrome, Computervision Int'l, Centel Communications, Monarch Cement* and TAMs 200043013 and 9737001.
- The Google and Time Warner cases may provide guidance to untangle the property and services elements of such transactions.

INTERNAL REVENUE SERVICE

LAFB 20100301F (May 15, 2009)

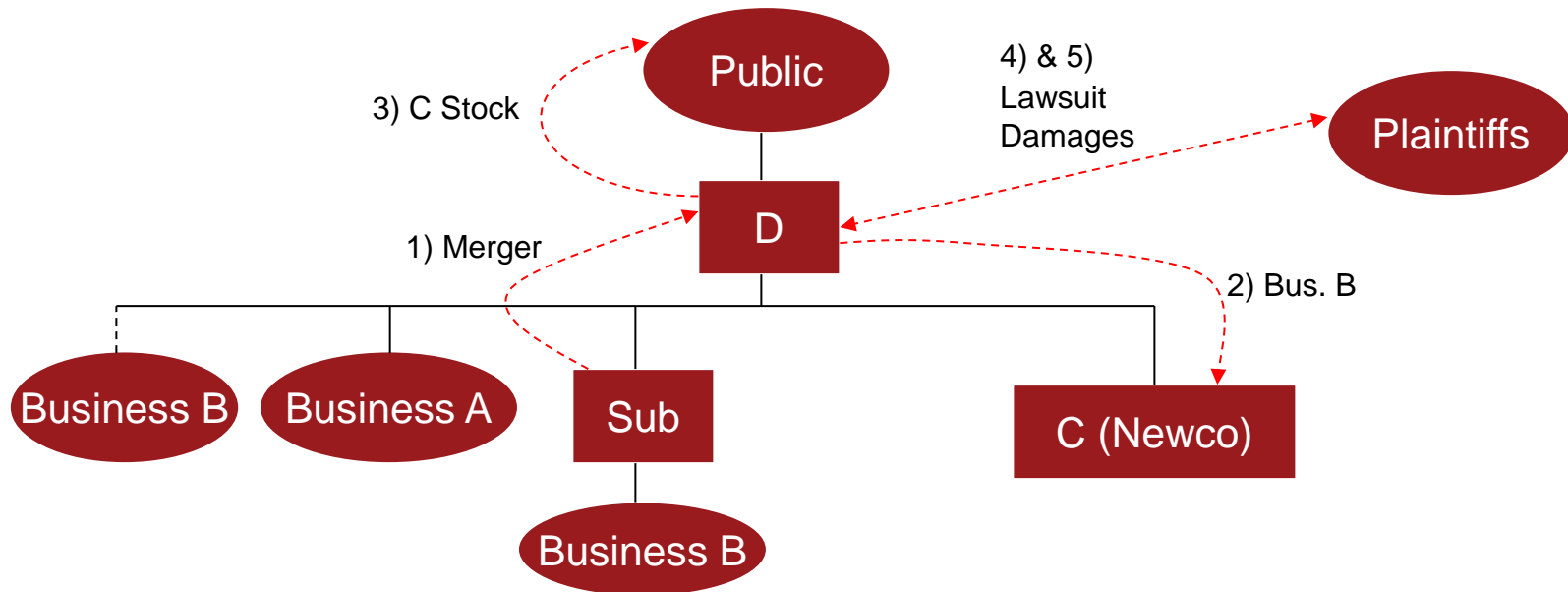
Characterization of Continuing Payments



- D spins off C. D is subject to a collective bargaining agreement. D retains employees and leases them to C. D pays wages, benefits, taxes, etc., and C reimburses D. Under tax sharing agreement, D deducts the payments and reports the reimbursements as income.
- Ruling: The reimbursements are taxable income to D:
 - *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), does not apply because employee lease is tied to obtaining union approval for spin-off, not to spin-off itself.
 - D is held to the terms of its tax sharing agreement. *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967).

CCA 201023056 (Sept. 22, 2009)

Spin-Off and Contingent Liability



- 1) Sub merges into D and transfers Business B to D.
- 2) D forms C and transfers Business B to C.
- 3) D distributes the C stock to Public, *pro rata*.
- 4) Plaintiffs file Lawsuit against D relating to Business B.
- 5) Lawsuit is settled for payment of damages to Plaintiffs. Liability for damages is shared between D and C under separation agreement.
 - C may deduct its share of the Lawsuit liability when paid. Rev. Rul. 80-198; Rev. Rul. 95-74.
 - C may not compute its tax liability under claim-of-right rules (§1341) by reference to prior years' tax liability, because C did not receive Business B in a §381(a) transaction.
 - Suppose Sub had merged directly into C?

GLAM 2012-010 (Nov. 15, 2012)

Consolidated Return Next Day Rule

- P acquires the T stock (no §338 election), and T joins the P consolidated group.
- T incurs the following costs:
 - Cash payments to employees to cancel nonqualified stock options and stock appreciation rights exercisable upon a change in control.
 - Fees payable to financial advisory and investment banking firms for consulting services to T, contingent on closing of the acquisition.
 - Retirement of T bonds at a premium after the acquisition has closed.
- Reg. §1.1502-76(b)(1)(ii):
 - A corporation that joins or leaves a consolidated group is deemed to do so at the end of the day.
 - Next day rule: Certain items incurred on day of change are deemed to occur on the next day.

GLAM 2012-010 (Nov. 15, 2012)

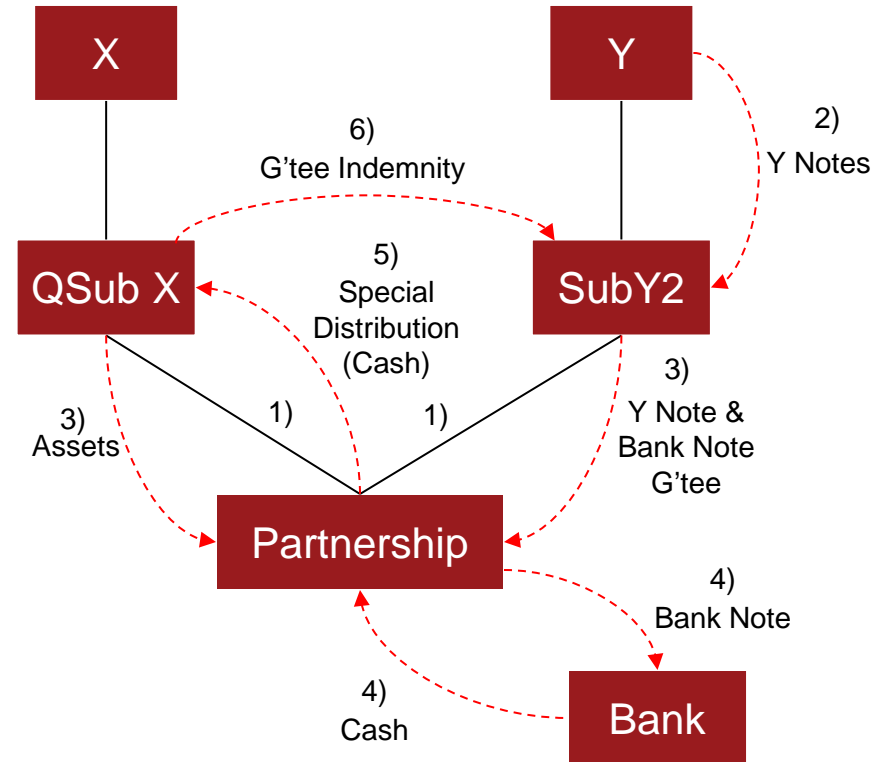
Consolidated Return Next Day Rule—2

- IRS concludes that the next day rule does not permit expenses associated with the stock options and stock appreciation rights, or the fees contingent on closing to be allocated to the period after the acquisition.
 - Conclusion is based on the view that these are items from transactions that precede the acquisition.
- IRS concludes that application of the next day rule may be appropriate to retirement of T's bonds at a premium.
 - Conclusion is based on the view that T made the decision to redeem the bonds after closing.
- Next-day rule does not apply to asset acquisitions or to stock acquisitions with elections under §338(h)(10) or §336(e), because no corporation joins or leaves a group.
- Query: May the parties determine issues like these by agreement?

ILM 201324013 (Mar. 14, 2013)

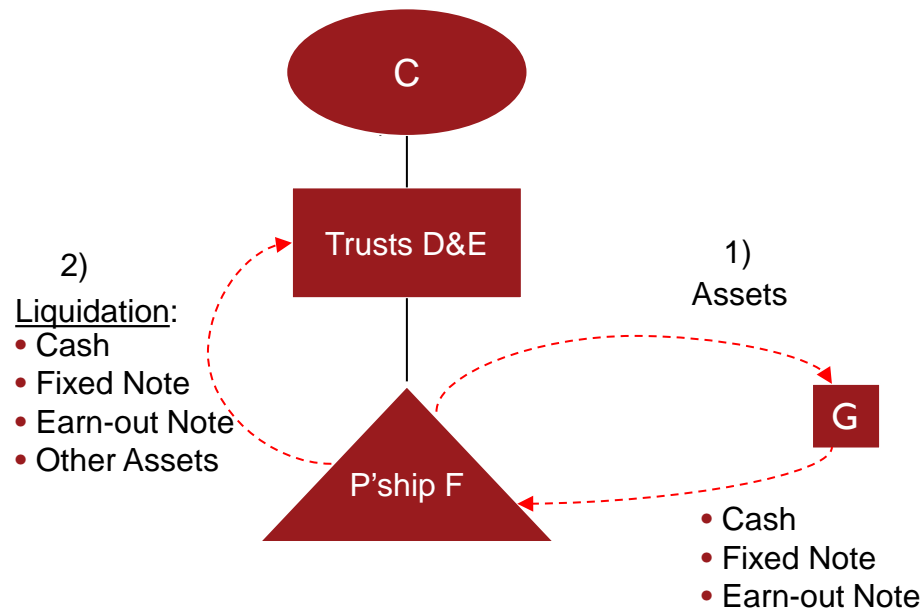
Leveraged Partnership Treated as Asset Sale

- Believed to involve transfer of Newsday Media Group by Tribune Co. to Cablevision Systems Corp. in 2008.
- Transactions:
 - 1) QSubX and Sub Y2 form Partnership
 - 2) Y contributes Y Notes to SubY2.
 - 3) QSub X contributes Assets, and Sub Y2 contributes Y Notes to Partnership for Partnership interests.
 - 4) Partnership borrows cash from Bank with guarantee of Bank Note from SubY2.
 - 5) Partnership makes Special Distribution of cash to QSubX.
 - 6) QSubX indemnifies SubY2 for its guarantee obligation on Bank Note.
- QSubX treats Special Distribution as tax-free, because indemnity causes Bank Note debt to be added to its Partnership interest basis (Reg. §1.752-2).
- IRS concludes:
 - QSubX Indemnity is disregarded (Reg. §1.752-2(j)).
 - No safeguards such as net worth maintenance.
 - The Y Notes rendered the Indemnity effectively unenforceable.
 - Bank Notes and Y Notes were back-to-back loans.
 - QSubX transfer of Assets and Special Distribution by Partnership make up a disguised sale of Assets, taxable to QSubX (§707(a)(2)(B)).
- As alternative arguments, IRS relied on the partnership anti-abuse rule in Reg. §1.701-2(b) and the judicial substance-over-form doctrine.
- See *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010) (same result with substantial understatement penalty).
- See Slide 121, regarding status of pending revisions to Reg. §1.752-2.



ILM 20132803 I (Apr. 3, 2013)

Bad Debt or Loss Deduction from Earn-Out—I

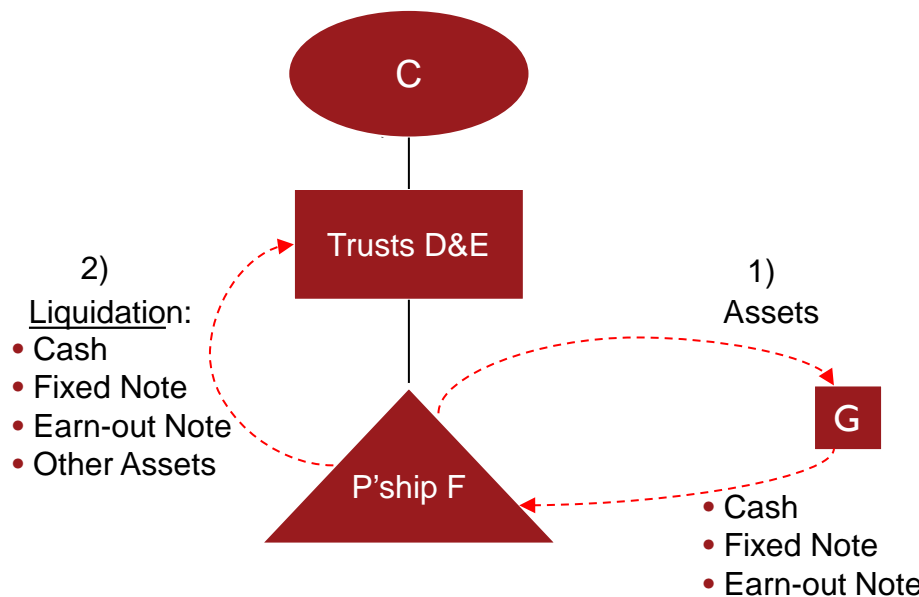


Facts

- 1) In Year 1, P'ship F sold assets to G for—
 - Cash
 - Note with fixed principal.
 - Earn-out note based on assets' performance in Years 1-4, with maximum payments.
- P'ship F elected out of installment method and reported amount of cash and maximum face amounts of notes as amount realized.
- 2) P'ship F liquidated and distributed sale proceeds to Trusts D and E.
 - In Year 4 (after Year 1 had closed), G defaulted on the fixed note.
 - No payments were made on the earn-out note, because none of the performance targets was met.

ILM 201328031 (Apr. 3, 2013)

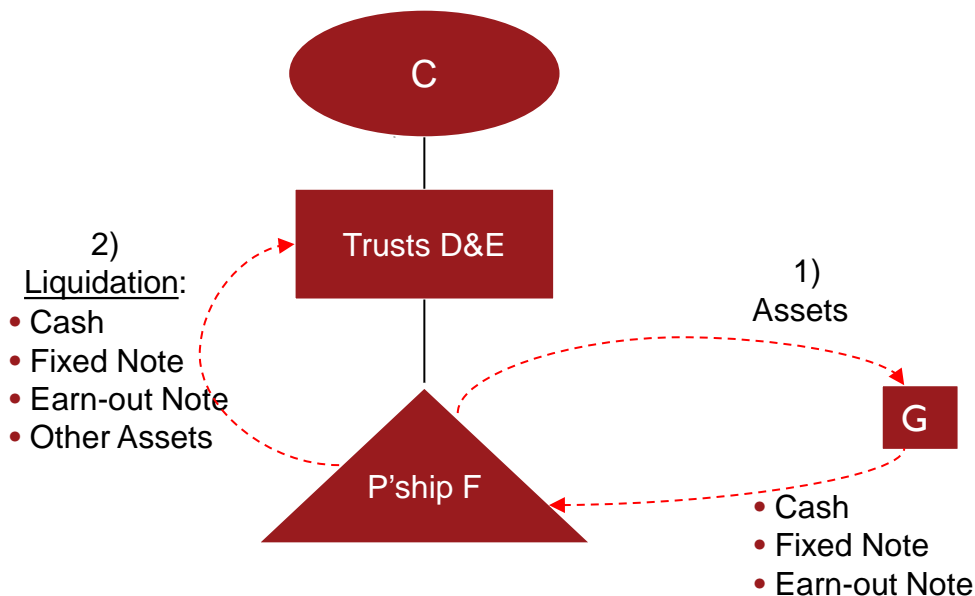
Bad Debt or Loss Deduction from Earn-Out—2



Principal IRS Conclusions

- No tax reduction under §1341 in Year 4 is allowed, because P'ship F had unrestricted rights to the notes. Overvaluation of the notes does not cause §1341 to apply.
- The Partners, Trusts D and E, are allowed ordinary §166 bad debt deductions for fixed note.
- The earn-out note could be either a debt or a contract right.
 - If a debt, ordinary §166 bad debt deduction is allowed.
 - If a contract right—
 - ...the character of the loss would still be an ordinary loss under section 165 and the *Arrowsmith* doctrine. The parties expressly conditioned the ultimate purchase price on the profitability of the purchaser and built the contingency into the sales agreement. Therefore the loss on the contingent debt should relate back to the initial sale, which was reported as ordinary income.
 - Why was the sale “reported as ordinary income”?
 - The contract right could have been treated as proceeds of a closed transaction. If so, nonpayment should be an ordinary loss without *Arrowsmith* relation back. If sale had been reported as producing capital gain, *Arrowsmith* relation back would have produced capital loss.

Bad Debt or Loss Deduction from Earn-Out—3



Installment Sale Issues Not Addressed

- If the installment method had been used, and if a Partner's basis in its interest in P'ship F was greater than P'ship F's basis in the assets sold, it appears that the Partner's basis in the notes would have been stepped up tax-free when P'ship F liquidated and distributed the notes. Reg. § 1.453-9(c)(2).
- If the installment method had been used, and (as occurred) P'ship F reported maximum face amount of the notes as amount realized on the sale—
 - Partners would have paid deferral charges under § 453A.
 - IRS position is that no refund of deferral charge is due. TAM 9853002. (Is this position consistent with the analysis in the ILM?)

LEGISLATION PROPOSED IN 2014 ADMINISTRATION BUDGET

Repeal of Anti-Churning Rule

- The “anti-churning rule” in §197(f)(9) prohibits amortization of otherwise-nonamortizable intangibles that are sold between related parties.
- See Slides 18, 54 and 83, describing the significance of §197(f)(9) in stock dispositions subject to §336(e) elections.
- The standard for relatedness is a $\geq 20\%$ ownership overlap, unlike the $\geq 50\%$ standard in §338 and the §336(e) regulations.
- The Administration has proposed repealing §197(f)(9). General Explanations of the Administration’s Fiscal Year 2014 Revenue Proposals (Apr. 2013), 232.
- The legislation would leave in place §197(f)(2), the step-in-the-shoes rule applicable to tax-free transfers of intangibles and to transfers of intangibles between members of consolidated groups.

Intermediary Transactions

- In Notice 2008-20, following Notice 2001-16, IRS describes an “intermediary transaction” and identifies it as a “listed transaction.”
- In an intermediary transaction,--
 - Target holds assets with built-in gain.
 - Intermediary is formed with losses or other attributes to shelter Target’s gains.
 - Seller sells the Target stock to Intermediary for borrowed cash.
 - Target sells its assets to Purchaser.
 - Sale proceeds are used to repay Intermediary’s debt. Any remaining proceeds may be transferred abroad or otherwise placed beyond collection.
- Where intermediary transactions were invalidated, courts have held that Seller did not have transferee liability for Target’s tax on its gain. *E.g., Starnes v. Commissioner*, T.C. Memo. 2011-61, *aff’d* 680 F.3d 417 (4th Cir. 2012).
- Proposed legislation would impose transferee liability on shareholders that sell $\geq 50\%$ of the Target stock within 12 months in an intermediary transaction, to be defined in regulations. Transferee liability would not apply to publicly-held Targets or sales to public companies. General Explanations of the Administration’s Fiscal Year 2014 Revenue Proposals (Apr. 2013), 184.

Proposal to Extend §338(h)(16)

- Under §338(h)(16), a QSP subject to a §338(g) election is treated as a sale of the Target stock (not Target's assets) in determining source and character of gain, for foreign tax credit purposes.
- Section 901(m) denies foreign tax credit for foreign tax attributable to “covered asset acquisitions,” including QSPs with §338 elections and QSDs with §336(e) elections, in each case treated as acquisitions of assets for U.S. tax purposes but stock for foreign tax purposes.
- The Administration has proposed legislation to extend §338(h)(16) to apply to all covered asset acquisitions, not just QSPs subject to a §338(g) elections. General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (Apr. 2013), 60.

NON-DEVELOPMENTS

“May Company” Proposed Regulations

- In Notice 89-37, issued March 9, 1989, IRS stated that regulations would be adopted to prevent a Seller corporation from disposing of appreciated property tax-free through a partnership:
 - Purchaser buys stock of Seller and transfer it to Partnership.
 - Seller transfers appreciated property to Partnership.
 - Seller liquidates its interest in Partnership for its stock.
- In December 1992, regulations were proposed to tax Seller’s gain on such transactions and transactions involving stock of Seller affiliates (with exceptions for $\leq 5\%$ Partnership interests and for *de minimis* stock held by Partnership).
- The proposed regulations would be effective retroactive to the date of Notice 89-37.
- Adoption of final regulations is listed in the 2013-2014 Treasury-IRS Priority Guidance Plan (Aug. 9, 2013).

Economic Performance by Seller for Assumed Contingent Liabilities

- Under §461(h), a taxpayer may not deduct certain liabilities, or include them in asset basis, until accrual (if the taxpayer is on the accrual method) and “economic performance” (generally, payment).
- In connection with a sale of a trade or business, if Purchaser assumes a liability, arising out of the business, Seller’s inclusion of the assumed liability in its amount realized on the sale satisfies the economic performance requirement. Reg. § 1.461-4(d)(5). Result is that Seller may deduct the assumed liability at the time of closing and so offset the added amount realized.
- Problem is that this rule does not apply to contingent liabilities.
 - It affects only the economic performance requirement. If the contingent liability has not accrued, it still may not be deducted.
 - Treatment of contingent liabilities is “Reserved”. Reg. 1.461-4(j).
- The 2013-2014 Treasury-IRS Priority Guidance Plan (Aug. 9, 2013) does not list this regulation as a subject for further guidance.

Installment Sale Deferral Charge for Contingent Consideration—Background

- Installment method is available to Seller of assets or stock (including Target in a sale subject to an election under §336(e) or §338(h)(10)), where there is contingent consideration. Includes assumption of contingent liabilities.
- Section 453(c)(6), enacted in 1980, provides:

The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this subsection including regulations providing for application of this subsection in the case of contingent payments . . .
- If statutory thresholds are exceeded (\$150K sale price, \$5MM total installment obligations held), Seller must pay deferral charge on tax deferred by installment method. Section 453A.
- Deferral charge is high because 28% tax rate and underpayment interest rate are used to compute it.

Installment Sale Deferral Charge for Contingent Consideration—Possible Methods

- No regulations have been adopted or proposed as to computation of the §453A deferral charge on contingent consideration.
- Relevant guidance:
 - TAM 9853002 (Jan. 4, 1999) (no refund of deferral charge paid on over-estimated contingent purchase price).
 - LAFB 20080101F (Dec. 3, 2007) (“look back” method authorized: Wait until amounts are actually received, and compute deferral charge with added interest)
 - CCA 201121020 (May 27, 2011) (“In the absence of regulations under §453A(c)(6), the Service allows taxpayers to use a reasonable method of calculating the deferred tax and interest on the deferred tax liability with respect to contingent payment installment obligations.”)
- Another possible method is the “closed transaction” method: Compute deferral charge based on estimated value of contingent consideration that would be included in amount realized if Seller elected out of installment method.
- Could no deferral charge be due, because the contingent consideration obligation has no face amount?
- The 2013-2014 Treasury-IRS Priority Guidance Plan (Aug. 9, 2013) lists “Regulations under §453A regarding contingent payment sales.” The 2012-2013 Plan does not refer to this issue.

Leveraged Partnerships

- Update of regulations under §§707 and 752, in light of *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010), has been discussed publicly.
 - One possible change is a limitation on debt allocation to any partner to the partner's net worth, as is the case for disregarded entity partners. Reg. §1.752-2(k).
 - Other possible new rules could require a guaranteeing or indemnifying partner to be subject to restrictions such as net worth maintenance requirements
- See Slide 108, above, describing ILM 201324013 (Mar. 14, 2013).
- The 2013-2014 Treasury-IRS Priority Guidance Plan (Aug. 9, 2013) lists “Regulations under §707 relating to disguised sales of property.” The 2012-2013 Plan contained the same item.

“No Net Value” Proposed Regulations

- In 2005, regulations were proposed that would limit tax-free exchanges, under the reorganization provisions and §§332 and 351, to situations in which the property transferred has net value. 70 Fed. Reg. 11,903 (Mar. 10, 2005).
 - If assets were transferred, and liabilities assumed in or “in connection with” the transaction, and if the amount of the liabilities was greater than the value of the assets, the transaction would be a taxable exchange.
 - Similarly, if, in a purported tax-free reorganization, the amount of Target’s liabilities were greater than the value of its assets, the transaction would be a taxable exchange instead of a reorganization. Thus, *Norman Scott, Inc. v. Commissioner*, 48 T.C. 598 (1967), would be overruled.
 - According to the preamble—
 - A “liability” would include any obligation, *i.e.*, “something that reduces the net worth of the obligor,” such as a contingent liability.
 - Various approaches are being considered to determine the amount of a liability, including special treatment for nonrecourse liabilities.
 - Section 357(d) principles are likely to be used to determine the obligor where more than one person might be responsible.
- Adoption of “no net value” regulations is listed in the 2013-2014 Treasury-IRS Priority Guidance Plan (Aug. 9, 2013).

Rescission

- In Rev. Proc. 2012-3, IRS announced that, pending further “study,” it would no longer rule on “[w]hether a completed transaction can be rescinded for Federal income tax purposes.”
- “Guidance regarding the scope and application of the rescission doctrine” is listed in the updated 2012-2013 Treasury-IRS Priority Guidance Plan (Aug. 9, 2013) as “closed without publication.” It is not listed in the 2013-2014 Plan.