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This special report contains six charts which identify the consequences of various elections under section 338 and the temporary regulations. Chart A details the consequences of an express section 338 election. Chart A-1 describes a section 338(h)(10) election to treat the purchase of target stock as an asset purchase. Chart B details what happens when there is no express section 338 election. Charts B-1, B-2, and B-3 are derived from Chart B and describe what happens when there is no express section 338 election but a protective carryover election is made in three types of acquisitions: an unincorporated company asset acquisition (UCA); an intercompany consolidated asset acquisition (ICA); and an intercompany nonconsolidated asset acquisition (INA).

Introduction

In its July 22, 1985, issue, Tax Notes published a series of charts on section 338 and the temporary regulations, relating to taxable stock acquisitions. These charts were intended to help practitioners navigate section 338 and the temporary regulations, especially as to the numerous elections with which practitioners must be familiar.

In the introduction to the 1985 charts, I pointed out that, since 1982, Congress had enacted these rules and then reworked them twice, and that, with its temporary regulations, Treasury had made yet another fresh start at making these rules workable.

Since that time Treasury has issued extensive additional regulations under section 338. These regulations treat such subjects as allocation of basis among assets of the target company, and the election under section 338(h)(10) to treat the purchase of the target stock as an asset purchase. They also answer a number of the questions raised in the 1985 charts and provide a great deal more analysis on numerous issues. In the introduction to the 1985 charts, I stated: 'Unfortunately, these regulations are complicated, even by modern standards, and practitioners planning

stock acquisitions must keep the entire regulatory structure in mind.' I would not change that characterization at all now.

The charts which follow are revised versions of the 1985 charts, to take the new regulations into account.

Like the 1985 charts, these charts relate to qualified stock purchases with acquisition dates after August 31, 1982. The charts exclude the transitional rules relating to (1) transactions with acquisition dates after August 31, 1980, and before September 1, 1982 (section 1.338-2T), (2) the LIFO recapture rule (section 1.338-3T(a)), and (3) certain acquisitions of financial institutions (section 1.338-3T(b)).

In February the Treasury published extensive new regulations on the international aspects of section 338, in section 1.338-5T. The charts do not deal with these regulations in any significant way. Rather, like the 1985 charts, they assume that all parties are United States persons, and that none of them is (1) a DISC, (2) a corporation described in section 934(b) (relating to Virgin Islands business), (3) a section 1248(e) corporation (a domestic corporation formed or availed of principally to hold foreign corporation stock), or (4) a corporation electing the Puerto Rico and possession tax credit under section 936. Sections 1.338-4T(b)(1), -4T(b)(6). See also sections 1.338-1T(j) and -1T(k).

The charts only touch upon a number of difficult areas. Several of the terms used in section 338 and the charts have complex definitions with unexpected wrinkles. For example, a 'purchase' of stock under section 338 includes some stock redemptions and other transactions not usually thought of as 'purchases,' and excludes some, but not all, stock purchases from related persons. These wrinkles may affect the determination of whether a qualified stock purchase has occurred and, if so, the timing of the acquisition date. As another example, the 'consistency period' may extend beyond the nominal one-year period before and after the acquisition date. For instance, if P makes a qualified stock purchase of T and **[*478]** then, every 11 months thereafter, makes a qualified stock purchase of a T/A, P's consistency period for T could continue indefinitely. Also, the duration of the extended consistency period under section 1.338-4T(g) depends upon subjective factors and is uncertain. As still another example, the elective ADSP formula discussed in section 1.338-4T(h) involves highly complex valuation questions and computations.

Finally, the charts do not even touch upon the procedures for actually filing the various elections under section 338. These election procedures are complex and exacting, because of Treasury concerns that IRS receive adequate information, and that all appropriate parties be bound by the election. Some of these requirements have been quite controversial, especially those relating to which corporations must sign the election. The Service has simplified these procedures to some extent. At the same time, because of the amount of time which has elapsed since the effective date of section 338, the limitations period could run on taxable years of some early acquisitions subject to section 338. Thus, Treasury has had to complicate election procedures further by adding procedures to extend the limitations period in some instances. See section 1.338-1T(m).

Glossary

The charts and the accompanying notes use the following terms:

Acquisition Date. The date on which P completes a Qualified Stock Purchase of T. Section 338(h)(2); section 1.338-1T(b)(2).

ADSP. Aggregate deemed sale price of T assets resulting from an Express Section 338 Election on a Deemed Section 338 Election, used in computing T's recapture. Section 1.338-4T(h)(2)(i).

Consistency Period. Generally, the period beginning one year before the first purchase of Recently Purchased T Stock and ending one year after the Acquisition Date. Section 338(h)(4); section 1.338- 4T(b)(5). This period may be extended, however. Sections 1.338-4T(e) Q&A 3, and -4T(g).

C/R. Consolidated return.

D/D. District Director.

Deemed Section 338 Election. Section 338 election (but not an Express Section 338 Election), under authority of sections 338(e), (f), or (i) or the temporary regulations. Section 1.338-4T(b)(9).

Express Section 338 Election. Section 338 election by P for T under sections 338(a) and (g), made by filing a statement of election for T. Section 1.338-4T(b)(8).

H-10 T/A. A 'section 338(h)(10) target affiliate' within the meaning of section 1.338(h)(10)-1T(b)(4), i.e., generally, a member of the same C/R group (other than the parent) of any T which is the subject of a section 338(h)(10) election.

ICA Acquisition. Intercompany consolidated asset acquisition -- generally, a post-acquisition-date transfer by T or by any T/A to P or to a member of P's affiliated group, if this group files consolidated returns. Section 1.338-4T(f)(6)(iv) Q&A 3.

INA Acquisition. Intercompany nonconsolidated asset acquisition -- generally a post-acquisition-date asset transfer by T or by any T/A to P or to a member of P's affiliated group, if this group does not file consolidated returns. Section 1.338-4T(f)(6)(iv) Q&A 2.

MADSP. Modified aggregate deemed sale price of T assets, used in determining gain or loss to T under section 338(h)(10), if this method is elected. Section 1.338(h)(10)-1T(f).

Nonrecently Purchased T Stock. T stock which is owned by P on the Acquisition Date but is not Recently Purchased T Stock. Section 338(b)(6)(B).

P. Corporation acquiring T stock in a Qualified Stock Purchase. Section 338(d)(1). Stock and asset purchases by members of P's affiliated group (section 338(h)(5)) may be aggregated. Section 338(h)(8).

Qualified Stock Purchase. Acquisition by purchase (section 338(h)(3); section 1.338-4T(c)) during the '12-month acquisition period' (section 338(h)(1)) by P or its affiliated group (section 338(h)(8)) of T stock having at least 80 percent of T's voting power, plus 80 percent of the number of any shares of T's nonvoting stock other than nonvoting preferred. Section 338(d)(3).

Recently Purchased T Stock. T stock which is owned by P on the Acquisition Date and was acquired by purchase during the preceding one year. Section 338(b)(6)(A).

S. Seller of T stock, not necessarily a corporation.

T. Target corporation, whose stock P acquires in a Qualified Stock Purchase. Section 338(d)(2). T may be either an 'original target' (section 1.338-4T(b)(4)) or an 'affected target' (section 1.338- 4T(b)(3)). If an Express Section 338 Election or a Deemed Section 338 Election is in effect as to T, then 'old T' is considered to have sold all of its assets to 'new T.' Section 1.338-1T(b)(7).

T/A. Target affiliate of T -- a corporation which is a member of T's affiliated group (section 338(h)(5)) at any time during the one year before the acquisition date. Section 338(h)(6).

UCA Acquisition. Unincluded company asset acquisition -- generally, a pre-acquisition-date asset transfer by T or by any T/A to P or to a member of P's affiliated group. Section 1.338-4T(f)(6)(iv) Q&A 1.

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Chart A Omitted

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Chart A-1 Omitted

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Chart B Omitted

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Chart B-1 Omitted

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Chart B-2 Omitted

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Chart B-3 Omitted

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NOTES

/1/ For purposes of computing asset basis, P's grossed-up basis of Recently Purchased T Stock equals P's actual basis in such stock, multiplied by 100 percent less the percentage of P's Nonrecently Purchased T Stock, and divided by the percentage of T stock attributable to P's Recently Purchased T Stock. The same computation is made for subsidiaries of T. Section 338(b) (4). Sections 1.338-4T(j)(2) Q&A 1, 1.338(b)-1T(d).

/2/ Generally, this basis is historic basis. Section 1.338(b)- 1T(e). P may elect, however, to step up the basis of its Nonrecently Purchased T Stock to reflect any increased price it would have paid if it had purchased this stock at the same time as the Recently Purchased T Stock. If P makes this election, it must recognize gain and pay tax on this increase. No loss may be recognized, however. The regulations do not state whether this tax is added to P's adjusted grossed-up basis. It is apparently not considered a T liability under the ADSP formula. Section 338(b) (3). Section 1.338-4T(j)(2) Q&A 2-6.

/3/ Liabilities include tax resulting from the section 338 election itself, unless a section 338(h)(10) election is also made. Section 1.338(b)-1T(f)(1). See Chart A-1. See also note 2.

/4/ The only such items are 'adjustment events,' as defined in section 1.338(b)-1T(b)(ii), or adjustments later made by the D/D. Section 1.338(b)-1T(g)(1). This provision limits the imagination of taxpayers seeking to increase the basis step up.

/5/ See section 1.338(b)-2T. Subject to transition rules, discussed below, basis is allocated using two special rules:

First, basis is allocated to assets in four classes. Class I assets are cash and certain deposits. Class II assets are certificates of deposit, marketable securities, and foreign currency. Class IV assets are goodwill and going concern value. Class III assets are everything else. Basis is allocated among assets in each class to the extent of, and in proportion to, their respective fair market values, before going to the next class. Thus, if P underpays for T, the financial assets of new T will receive a disproportionate share of basis. Note, however, that accounts receivable are Class III assets.

Second, no Class I, II, or III asset may have an allocation of basis in excess of its fair market value. Thus, if P overpays for T, the full overpayment will go directly to Class IV.

Also worthy of note is that, unlike the regulations under old section 334(b)(2), the section 338 regulations do not specially allocate to an asset basis which results from a T debt secured by that asset.

A special rule exists, however, if P has Nonrecently Purchased Stock at a basis which is very low in relation to the basis of Recently Purchased Stock, and if no gain election (as described in note 2) is made. In this situation, Class I assets are still valued at their full amount. Class IV assets then are valued at the excess of a 'hypothetical purchase price' (intended to be the full value of T, extrapolated from the purchase price paid by P for the Recently Purchased Stock) over the sum of the

amount of Class I assets and the fair market value of Class II and III assets. The remaining basis is then allocated among all Class II and III assets, intermingled, in proportion with their fair market values. Sections 1.338(b)-2T(c)(3) and -2T(d) Example (2). This rule is apparently intended to ensure that goodwill gets its full allocation where basis is low in relation to value.

In response to concerns about the retroactive effect of the basis allocation rules, Treasury recently published a transition rule. T.D. 8092 (June 27, 1986). See also Announcement 86-51, 1986-16 I.R.B. 55. Under this rule, if the Acquisition Date is from September 1, 1982, through January 29, 1986 (or if the acquisition is pursuant to a contract binding at all times after January 29, 1986), an irrevocable transitional allocation election is available. If this election is made, basis is allocated pursuant to the rules applicable to lump sum asset purchases. But the IRS will carefully scrutinize elections which allocate amounts to assets in excess of their fair market value. Section 1.338(b)-4T(e).

/6/ See section 1.338(b)-3T. Basis may be increased for payments of contingent amounts for stock (e.g., earnouts) or contingent T liabilities becoming fixed. Basis may be decreased for decreases in purchase price of T stock or for decreases in the amount of T liabilities.

If basis is increased or decreased, the allocation of basis among assets is recomputed as well. If an asset has been disposed of, depreciated, or depleted, T may recognize gain or loss under an Arrowsmith-type analysis. Generally, basis adjustments are shared among all assets, but contingent payments may be allocated specially to patents or similar assets. The amount so allocable is limited, however, to the fair market value of the assets when the contingent payment is made. Sections 1.338(b)-3T(g) and -3T(j) Examples (6), (7).

/7/ The surrogate tax is the tax resulting from the partial disallowance of section 337, which occurs if P does not own all the stock of T on the Acquisition Date. Section 338(c)(1).

/8/ Even though T is a subsidiary in a C/R, no section 338(h)(10) election may be made as to T if, during the consistency period as to T, P makes a Qualified Stock Purchase of the stock of the common parent of the C/R. Sections 1.338(h)(10)-1T(b)(2), -1T(b)(3), and -1T(b)(6) Example (2).

/9/ This election must be made jointly by P and S, and it is irrevocable. Sections 1.338(h)(10)-1T(d)(1), -1T(d)(2), and -1T(d)(6)(D). If this election is made, the S group may not revoke its election to file C/R. Section 1.338(h)(10)-1T(d)(8).

/10/ For some Qualified Stock Purchases pursuant to binding contracts entered into after September 2, 1982, and before January 13, 1983, the deemed sale of assets may be reported in S's C/R, not in a separate deemed sale return. Section 1.338-1T(1).

/11/ If adjustments are made later in the cost of T stock or the amount of T liabilities (see notes 6, 12), this allocation is not affected, except as applied to the deemed sale price of intangible assets such as patents. Section 1.338(b)-3T(h)(1)(iii).

/12/ For purposes of determining recapture, ADSP is allocated among all the T assets in the same proportions used in determining their basis. Sections 1.338-4T(h)(2), -

4T(e)(5). See note 5.

The amounts of income, gain, and tax resulting from application of the elective ADSP formula are adjusted if P's purchase price for the T stock or the amount of T's liabilities increase or decrease. See section 1.338(b)-3T(h)(2). This tax is payable in the year of the adjustment. The tax is a tax of new T, but only carryovers from old T are available to offset any increased income or gain. Similarly, income of old T from before the acquisition may offset new T losses resulting from these adjustments.

/13/ For purposes of computing T's recapture, P's 'grossed-up basis of recently purchased stock' equals P's basis of T stock purchased by P within the 12-month acquisition period (section 338(h)(1)), divided by the percentage such stock bears to all the outstanding stock of T. Section 1.338-4T(h)(3) Q&A 2(ii). These amounts may be adjusted if P's purchase price for the T stock is increased or decreased later. See note 12.

/14/ Section 337 may apply, however. See note 15. Nonrecognition of loss under section 311(d) should not apply, because of the deemed sale of assets out of the S group to new T.

/15/ The requirements of sections 338(h)(12) and 337(c)(3) must be satisfied. Section 1.338(h)(10)-1T(j)(1). That is, T must adopt a plan of complete liquidation during the 12 months before the Acquisition Date, and within 12 months after that plan is adopted, all corporations up the chain from T must liquidate, with the liquidation of the parent being subject to section 331. Thus, the parties must anticipate the section 338(h)(10) election before the acquisition, in order to take advantage of section 337.

/16/ See section 1.338(h)(10)-1T(j)(3).

/17/ See section 1.338(h)(10)-1T(f). MADSP is equal to the sum of (1) P's basis in its Recently Purchased T Stock, divided by its percentage of ownership of T attributable to that stock, (2) T's liabilities, and (3) 'other relevant items' (see note 1). MADSP thus differs from ADSP in that T's liabilities for this purpose do not include the tax liability resulting from the deemed asset sale.

If the MADSP method is elected, the MADSP amount is allocated among the T assets. If the Acquisition Date is before July 1, 1986 (or if the acquisition is pursuant to binding contract on that date), the allocations are made in proportion with the assets' fair market values. Otherwise, the allocation rules of section 1.338(b)-2T apply. See note 5.

The fair market value method or the MADSP method is elected by the S group, without regard to the P group. There is a [***486**] consistency rule applicable to a fair market value or MADSP election, and such election may be revoked at any time, provided no year affected by the election is closed.

/18/ Subject to limitations on carryovers, including section 382(a) and the SRLY and CRCO rules, and other limitations such as those imposed by section 269, and the rules on built-in deductions.

/19/ If P has not made an Express Section 338 Election for T, and after the Acquisition Date but within T's consistency period, P makes a Qualified Stock

Purchase of T/A, P may not make an Express Section 338 Election as to T/A. Section 338(f)(2); section 1.338-4T(e) Q&A 1.

/20/ The de minimis exception applies to transfers of assets with total value of up to the lesser of \$ 50,000 or five percent of the sum of P's grossed-up basis in T stock and T's liabilities. Section 1.338-4T(f)(7).

/21/ The 'other exceptions' (and the basis of the transferred asset in each situation) are:

(1) Sales in the ordinary course of the seller's business (cost basis). Section 338(e)(2)(A); section 1.338-4T(f)(3).

(2) Wholly carryover basis transfers, including cash dividends (but not partially carryover basis or substituted basis transfers) (carryover basis). Section 338(e)(2)(B); section 1.338-4T(f)(4).

(3) Transfers before September 1, 1982 (cost or other normal basis). Section 338(e)(2)(C).

(4) Dividend distributions of property whose basis in the distributing corporation's hands is equal to or greater than fair market value (fair market value basis). Section 338(e)(2)(D); section 1.338-4T(f)(4) Q&A 3(ii).

(5) Transfers of property whose basis in the hands of the transferee is equal to or less than its basis in the hands of the transferor (cost basis). Section 338(e)(2)(D); section 1.338-4T(f)(5) Q&A (i).

(6) Issuances or transfers of stock of a T/A (but not other stock -- apparently excludes, e.g., stock of less-than-80 percent- owned corporations and sometimes stock distributed in divisive type-D reorganizations) (cost or other normal basis). Section 338(e)(2)(D); section 1.338-4T(f)(5) Q&A (ii).

(7) Issuances or transfers of debt instruments, warrants, and similar instruments issued by T or a T/A (cost or other normal basis). Section 338(e)(2)(D); section 1.338-4T(f)(5) Q&A (iii).

(8) Covenants not to compete (cost or other normal basis). Section 338(e)(2)(D); section 1.338-4T(f)(5) Q&A (iv).

(9) Leases and licenses, but not sales of property or of underlying leasehold interests or licenses (cost or other normal basis). Section 338(e)(2)(D); section 1.338-4T(f)(5) Q&A (v).

(10) Transfers of property which was acquired by T (not by a T/A) after acquisition date (cost or other normal basis). Section 338(e)(2)(D); section 1.338-4T(f)(5) Q&A (vi).

(11) Transfers of property disposed of to an unrelated person, not T or a T/A, within 90 days after (i) the Acquisition Date, or (ii) the date the property was acquired, whichever is later (or, if later, March 15, 1986) (cost or other normal basis). This exception also applies if the P group member holding the property ceases to be a P group member and ceases to be related to any member of the P group within the

required time period. But the exception does not apply if the member ceases to exist in a section 381(a) transaction (e.g., a merger or a section 332 liquidation), and the acquiring corporation in this transaction is a P group member. Section 338(e)(2)(D); section 1.338-4T(f)(5) Q&A (vii).

(12) Acquisitions of property if basis is stepped up solely because of section 367(a) (cost or other normal basis). Section 1.338-5T(e)(1).

(13) Acquisitions of foreign currency in the ordinary course of the transferor's trade or business (cost or other normal basis). Section 1.338-5T(e)(2).

/22/ An affirmative action carryover election occurs as a result of every Qualified Stock Purchase with a tainted asset acquisition, unless there is in effect either an Express Section 338 Election or a protective carryover election. Section 1.338-4T(f)(6)(i)(A), - 4T(f)(6)(ii) Q&A 3. D/D may override the affirmative action carryover election and put into effect a Deemed Section 338 Election, if he 'determines that such a deemed election is appropriate to carry out the purposes of the consistency rules of section 338(e), (f) or (i).' Section 1.338-4T(f)(6)(ii) Q&A 3(iii) Example (1). See also section 1.338-4T(f)(6)(ii) Q&A 1.

/23/ By definition, every tainted asset acquisition is categorized as a UCA Acquisition, an INA Acquisition, or an ICA Acquisition, if a protective carryover election is in effect.

/24/ A 'dropdown' is a transfer of the tainted asset to T or any other member of the P affiliated group, during a specified time period, (i) in a section 351 exchange, (ii) as paid-in surplus, or (iii) as a contribution to capital. Section 1.338-4T(f)(6)(iv) Q&A 1(i)(B).

/25/ If the deferred intercompany transactions rules do not apply, the transaction will be governed by the INA Acquisition rules. See Chart B-2. Investment tax credit recapture also may occur. Section 1.338-4T(f)(6)(iv) Q&A 3(vi).

/26/ Foreign tax credits may offset this tax within a special limitation: the section 904(a) limitation, computed as though the foreign offset prohibition gain were the only foreign-source income. Section 1.338-5T(d)(2).