REPORT #674

TAX SECTION

New York State Bar Association

Report on the Role of Section 338
Consistency Rules After Repeal of the
General Utilities Doctrine

November 29, 1990

Table of Contents

cover Letter i

I. Introduction 1

II. Consistency Rules 3

III. Summary of Report's Conclusions and Recommendations 7

IV. Impact of General Utilities Repeal on Need for Consistency Rules 8

A. Relationship Between General Utilities Doctrine and Consistency Rules 9

B. Remaining Areas of Potential Abuse 17

C. Transactional vs. Express Electivity 26

V. Interim Solutions 31

A. Section 1.338-4T(e): Stock Consistency Rules 32

B. Section 1.338-4T(f): Asset Consistency Rules 33

C. Consistency and Acquisition Periods 46

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TAX SECTION

New York State Bar Association

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December 3, 1990

The Honorable Fred T. Goldbreg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue N.W
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Dear Commissioner Goldberg:

I enclose a Report on the role of the section 338 Consistency Rules After Repeal of the General Utilities Doctrine. The authors of the Report are Neil z. Auerbach, Jeffery H. Koppele, Michael Nissan and Mary Katharine wold.

In the interest of simplifying Subchapter C, our Report recommends repeal of the consistency rules contained in sections 338(e) and (f) of the internal Revenue Code. We believe that, for a number of reasons, the consistency rules have become unnecessary following the repeal of the General Utilities doctrine.

We recognize that statutory repeal of the consistency rules may take time. Therefore, our Report recommends several interim measures to shorten as simplify the temporary regulations implementing sections 338 (e) and (f), which the tax bar considers unduly burdensome and complex. Our recommendations include: (1) replacing the protective and affirmative action carryover elections with an automatic carryover basis rule for tainted asset acquisitions, unless a special rule for non-substantial stock or asset purchases applies or the transaction occurs within a consolidated group; (2) replacing the de minimis stock and asset acquisition rules with rules that would permit a purchaser to obtain assets at a cost basis

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where either the assets acquired are not substantial in relation to the stock acquired, or the stock acquired is not substantial in relation to the assets acquired; and (3) eliminating the so-called UCA, INA and ICA rules contained in section 1.338-4T (f) (6).

We would be pleased to discuss the Report and its recommendations with your staff at their convenience.

Very truly yours,

Arthur A. Feder
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Enclosure

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NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Report on the Role of Section 338 Consistency Rules After Repeal of the *General Utilities* Doctrine

November 29, 1990

I. Introduction

This report[1] sets forth the recommendations of the Committee on Corporations for the repeal of sections 338(e) and (f)[2] and interim changes to the temporary regulations thereunder (referred to herein as the "consistency rules") as a step in the process of simplifying Subchapter C of the Internal Revenue Code through the elimination of rules that have become unnecessary following the repeal of the General Uitilities[3] doctrine. It is the fifth in a series of reports of this Committee relating to section 338.[4]

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1 This report was prepared by a subcommittee of the Committee on Corporations consisting of Neil Z. Auerbach, Jeffrey H. Koppele, Michael Nissan and Mary Katherine Wold. Helpful comments were also received from Arthur A. Feder, Gordon D. Henderson, Stanley I. Rubenfeld, Michael L. Schler and David L. Wasser.

2 All "section" and "§" references are to the Internal Revenue Code of 1986, as amended, or to regulations promulgated thereunder, unless otherwise indicated.

3 See General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). The so-called General Utilities doctrine was incorporated in several places in Subchapter C, including sections 311, 333 (repealed), 336 and former section 337.

4 The earlier reports of the Committee relating to section 338 were dated April 15, 1983 (the "1983 Bar Report"), February 10, 1984, February 15, 1984 (the "1984 Bar Report") and November 25, 1985 (the "1985 Bar Report"). The 1983 Bar Report was reprinted in 37 Tax Lawyer 155 (1983); the 1985 Bar Report was reprinted in 30 Tax Notes 137 (1986). Pages cited herein are to the reprinted versions of those Reports.

The issuance of this report coincides with a growing awareness in Congress and the Internal Revenue Service (the "Service")[5] of the need to reexamine the Internal Revenue Code for ways to reduce the level of complexity that has overwhelmed the tax bar and the taxpaying public in the wake of eight major tax acts over a span of nine years. Much of the complexity has been engendered by a growth of what commentators have called "hyperlexis"[6] — the unrestrained impulse to hurl statutes and indecipherable regulatory roadblocks in the path of every attempt by taxpayers to take advantage of "loopholes"- in the quest to save taxes. This report offers a remedy for hyperlexis in one area of Subchapter C by proposing the repeal of the consistency rules, which are commonly recognized as some of the more complex provisions in Subchapter C, but which have become unnecessary following the repeal of the General Utilities doctrine.

[5] See, e.g., Address by Commissioner Fred T. Goldberg, Jr. before the American Institute of Certified Public Accountants ("AICPA") Tax Division (December 8, 1989); Address by Commissioner Fred T. Goldberg, Jr., AICPA/American Bar Association Invitational Conference on Reduction of Income Tax Complexity (January 11-12, 1990); Address by Commissioner Fred T. Goldberg, Jr., Eleventh Annual Colorado Springs Tax Institute (August 20, 1990).

[6] See, e.g., Henderson, Controlling Hyperlexis -- The Most Important "Law and . . .", 43 Tax Lawyer 177 (1989); Manning, Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385, 36 Tax Lawyer 9 (1982).

Section II of this report describes the consistency rules of sections 338(e) and (f). Section III of this report summarizes the Committee's conclusions and recommendations as to the need for and means of effectuating the repeal of the consistency rules. Section IV discusses the relationship between the General Utilities doctrine and the consistency rules and examines whether retention of the consistency rules is justified following the repeal of the General Utilities doctrine in the Tax Reform Act of 1986.[7] Section V suggests interim measures that can be implemented at the regulatory level before the consistency rules are repealed to simplify compliance with section 338.

II. Consistency Rules

The consistency rules are divided into two parts: section 338(e), which contains the asset consistency rules, and section 338(f), which contains the stock consistency rules. Section 338(i)(l) grants Treasury further authority to promulgate regulations to implement the consistency rules.

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[7] P.L. 99-514, § 100 Stat. 2085 (1986) (referred to herein as "TRA '86").

The stock and asset consistency rules can be explained, respectively, with Examples 1 and 2 below:[8]

> Example 1. P makes a qualified stock purchase of T on January 1, 1990. On November 1, 1990, P makes a qualified stock purchase of Tl. P makes a section 338 election on August 1, 1990 for its qualified stock purchase of T.
>
> Example 2. Assume the same facts as in Example 1, except that P does not make a section 338 election for its purchase of T, and on November 1, 1990 purchases an asset from Tl rather than the stock of Tl. P's asset purchase is not covered by any of the exceptions to the asset consistency rules in section 338(e)(2).

In Example 1, under the stock consistency rules of section 338(f), the section 338 election made for the qualified stock purchase of T applies as well to P's qualified stock purchase of Tl.

In Example 2, P's asset purchase is a "tainted asset acquisition,"[9] which triggers the application of the asset

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[8] Throughout this report, the corporations used in examples are identified as S, T, Tl and P, the same symbols used in § 1.338-4T(b)(1). S is a domestic corporation that owns all of the stock of T prior to the qualified stock purchase. T is a domestic corporation the stock of which is purchased by P in a qualified stock purchase. Tl is a domestic corporation that is a target affiliate of T.

[9] A "tainted asset acquisition" occurs with respect to T (or a target affiliate) if an express election is not made with respect to a qualified stock purchase and if, during the consistency period of T (or of an affected target), a P group member acquires an asset of T or its target affiliate (or of an affected target or its target affiliate) in an acquisition that is described in section 338(e)(1) and that is not subject to an exception (other than the carryover basis election exception) to section 338(e)(1).However, P can purge itself of a tainted asset acquisition by prompt disposition of the tainted asset. See § 1.338-4T(f)(5)(vii).

consistency rules of section 338(e). Section 1.338-4T(f)(l)(ii) (Q&A 1) provides that, upon P's tainted asset acquisition, P will be deemed to have made a section 338 election with respect to its qualified stock purchase of T only if the District Director examining P's return determines that (i) neither a section 338 election nor a protective carryover election[10] is made by P with respect to T, and (ii) a deemed section 338 election[11] for T, in lieu of the affirmative action carryover election for T, is

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[10] If P makes a protective carryover election in conjunction with a qualified stock purchase of T, a tainted asset acquisition will not cause a deemed section 338 election for T. Rather, subject to a number of exceptions set forth in the temporary regulations, the P group will take a carryover basis in any asset acquired in a tainted asset acquisition. See § 1.338-4T(f)(6)(ii) (Q&A 1).

[11] An affirmative action carryover election is a carryover basis election that is caused by the taxpayer's failure to make either a section 338 election or a protective carryover election within the time required therefor. Section l.338-4T(f)(6)(ii) (Q&A 3) sets forth the following requirements for an affirmative action carryover election:(1) a P group member made the tainted asset acquisition; (2) neither a section 338 election nor a protective carryover election is made by P with respect to T; and (3) the time to make a protective carryover election for T has expired.

appropriate to carry out the purposes of the consistency rules.

The temporary Treasury regulations implementing section 338(e) are the principal source of complexity in the consistency rules. The most complex provisions are those implementing section 338(e)(2)(D), which deal principally with exceptions to the application of the various elections, including the carryover basis and affirmative action carryover elections described in section 1.338-4T(f)(6).The exceptions serve to limit the circumstances under which an asset acquisition will give rise to double taxation of gain as a result of the carryover basis given to the asset acquired[12]. Asset acquisitions are divided into three categories, each of which contains a different set of rules.[13] Asset acquisition categories are determined by

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[12] These elections are discussed in greater detail in Part V.B. of the Report.

[13] The three categories are:(1) unincluded company asset ("UCA") acquisitions, (2) intercompany non-consolidated asset ("INA") acquisitions, and (3) intercompany consolidated asset ("ICA") acquisitions. See § 1.338-4T (f) (6) (iv) (Q&A 1, 2 and 3)

the corporate relationship existing between P and the asset seller at the time of the asset acquisition, and by reference to whether or not P and the asset seller file a consolidated return during the year the asset sale occurs.

III. Summary of Report's Conclusions and Recommendations

This report examines the impact of the repeal of the *General Utilities* doctrine by TRA '86 on the utility of the consistency rules. It concludes that the consistency rules no longer serve their originally intended purpose, which was to prevent taxpayers from engaging in transactions designed selectively to obtain tax benefits then available without the associated tax cost otherwise imposed by the limitations on the *General Utilities* doctrine, particularly those limitations on the doctrine enacted when section 338 was introduced in 1982. This report concludes that because of the repeal of the *General Utilities* doctrine, there are no longer any meaningful tax policy objectives served by the consistency rules that justify their retention, given their complexity, the administrative burden of enforcing them and the compliance burden imposed on taxpayers. The only rationale we could identify supporting such retention is the arbitrary bias against selectivity. We strongly believe that, because full gain recognition is the cost of basis step-up under current law, the integrity of the' corporate tax system already has been preserved.

On the basis of the foregoing, this report recommends the repeal of sections 338(e) and (f), and further recommends, as an interim measure, regulatory changes to reduce the scope and complexity of the consistency rules.

IV. Impact of General Utilities Repeal on Need for Consistency Rules

The Committee reports accompanying the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA")[14] contain a very brief explanation of the purpose of the consistency rules. The Senate Finance Committee Report states:

> Present law also provides unwarranted tax motivations for structuring a corporate acquisition as in part a purchase of assets and in part a purchase of stock or as a purchase of several corporations historically operated as a unit in order to provide selectivity of tax treatment. These motivations include the ability to achieve a stepped-up basis for some assets while avoiding recapture tax and other unfavorable tax attributes with respect to other assets[15]

Taxpayers were able to obtain the tax-free basis step-up referred to in the Senate Finance Committee Report before the repeal of the *General Utilities* doctrine. The repeal of the *General Utilities* doctrine invites a more

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[14] Pub. L. No. 97-248,96 Stat. 324 (1982).
[15] S. Rep. No. 494, 97th Cong., 2d Sess. 192 (1982) (emphasis added).

critical examination of the continuing purpose, if any, served by the consistency rules. This part of the report examines the relationship between the General Utilities doctrine and the consistency rules and examines the need to preserve the consistency rules in light of the repeal of the General Utilities doctrine.

A. Relationship Between General Utilities Doctrine and Consistency Rules

Section 338, as originally enacted, utilized one of the pillars of the General Utilities doctrine — former section 337 — to implement its conversion of a stock sale into an asset sale. A corporation with respect to which a section 338 election was made was deemed to sell its assets in a former section 337 transaction to a newly-formed corporation.

The incorporation of former section 33 7 into the section 338 deemed asset sale fiction offered a strong inducement for stock purchasers to avail themselves of the section 338 election. Former section 337(a) generally allowed a corporation to sell its assets without recognition of gain during a 12-month period beginning on the date on which it adopted a plan of complete liquidation, provided that the assets of the corporation were distributed at the end of the 12-month period. This nonrecognition rule did not apply to certain types of property, including inventory,

recapture property (to the extent subject to recapture) and most installment sales. Thus, unless gain on recapture assets and other excluded assets was too high, a corporation acquiring the stock of T often could obtain a step-up in the basis of T's assets without substantial tax cost.

The draftsmen of section 338 perceived a potential abuse if taxpayers could circumvent the limits on section 337 nonrecognition in a section 338 context by "cherry-picking," i.e., acquiring assets with a high recapture tax cost without a basis step-up, and acquiring assets without a high recapture tax cost in a section 338 acquisition. In testimony before the Senate Finance Committee on S. 2687,[16] Mr. David Glickman, then Deputy Assistant Secretary for Tax. Policy, described pre-TEFRA law as follows:

> Corporation T may have certain high value, low basis assets which a purchaser (corporation P) desires to acquire with a fair market value basis for cost recovery purposes. T may have other assets, also desired by P, but whose tax detriments (e.g., recapture) outweigh the value of a fair market value basis. If P acquires all of T's assets, all would receive a fair market value basis and T (assuming adoption of a section 337 plan of liquidation), would recognize recapture items on all assets. Similarly, if P purchased all of the T stock, P would receive either a fair market value basis for all assets (with attendant

[16] S. 2687, 97th Cong., 2d Sess., 128 Cong. Rec. S7589 (1982).

recapture) if a section 334(b)(2) liquidation were undertaken, or would preserve T's historic basis for those assets (with no gain recognition) if T were not liquidated. Under existing law, however, by dispersing assets among subsidiaries, by causing a partial liquidation after an acquisition, or by any number of other techniques, P and T can achieve both results — stepped up basis on some assets (generally at the cost only of recapture on those assets^, which recapture may be deferred or avoided if a consolidated return is filed) and carryover basis on other assets (without triggering their tax detriments)[17].

The techniques referred to in Mr. Glickman's testimony are illustrated in Examples 3 and 4:

> Example 3. P wishes to acquire the stock of two corporations, T and Tl. T owns commercial real estate, which has been depreciated on a straight-line basis. Tl owns a manufacturing facility, on which substantial depreciation deductions have been taken. P wishes to step up the basis of T's assets, which lack recapture tax potential, but does not wish to incur the necessary recapture taxes to obtain a step-up in the basis of Tl's assets.

Under pre-TEFRA law, P could purchase the stock of T and Tl, liquidate T under former section 334(b)(2) but keep Tl in

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[17] Tax Treatment of Corporate Mergers and Acquisitions, and of Certain Distributions of Appreciated Property, and Job Training Credit Proposal, 1982: Hearings on S. 2687 Before the Committee on Finance, United States Senate, 97th Cong., 2d Sess. 74, 83-84 (1982) (hereinafter referred to as "S. 2687 Hearings") (statement of Mr. Glickman, Deputy Assistant for Tax Policy, Department of the Treasury) (hereinafter referred to as "Glickman Testimony")

existence. Alternatively, P could purchase T's assets without tax cost to T pursuant to section 337, and purchase the stock of Tl.

> Example 4. T operates two businesses, Major and Minor, valued at 800 and 200, respectively. Major's assets consist of inventory with a basis of 300 and fair market value of 400, and a manufacturing plant with an adjusted basis of 100, original cost of 150, and fair market value of 400. Minor's only asset is an item of equipment with an adjusted basis of 0, and a cost and fair market value of 200.

Under pre-TEFRA law, P could purchase T for 1000 and promptly cause T to distribute the Major assets in partial liquidation of T under section 346(a)[18]. P would acquire the manufacturing plant with a stepped-up basis of 400. T would recognize 50 of recapture income on the distribution of the plant to P. However, if P filed a consolidated tax return for the year of distribution that included T, the 50 of income would have been deferred intercompany gain, which T would recognize as P took depreciation deductions on the plant. T would escape taxation entirely on the 250 excess of the fair market value of the plant over its original basis

[18] For a more detailed discussion of this technique, see Ginsburg, Taxing Corporate Acquisitions, 38 Tax L. Rev. 177, 223-28 (1983).

and on the 100 appreciation in the fair market value of the inventory.[19]

The Treasury Department viewed selectivity as undermining the integrity of the exceptions to the General Utilities doctrine. Mr. Glickman, in his testimony before the Senate Finance Committee on S. 2687, stated:

> The question really is, should a corporation be able to tax-plan in that format and just pick and choose? Corporations would, in essence, start managing their affairs in such a fashion, or have managed their affairs in such a fashion, to put themselves in a posture so that the acquiring corporation can pick and choose and determine where they want to pay the tax and where they do not.
>
> The provision in the bill would, in essence, require an all-or-nothing approach. By that I mean is that it would say that if you buy all of the assets of a corporation, even though some of them are in corporate solution, in that type of situation you would be forced to take a step-up in basis for all the assets, and also pay tax on the recaptured income or credit with respect to those assets. If you did not want a step-up in any of the assets, you would not have to pay the recapture tax on any of them.[20]

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[19] Partial liquidation under section 346(a) was often preferable to liquidation under section 334(b)(2) because any recapture income on the partial liquidation of T would be deferred pursuant to the consolidated return regulations. See Ginsburg, 38 Tax L. Rev. at 227

[20] Glickman Testimony, at 92-93.

The objective of the "all or nothing" approach of the consistency rules was to put an end to selectivity. The new operative principle, stated succinctly by Mr. Glickman, was that "[i]f P desires to make an acquisition from (or of) T, P should take the bad with the good with respect to the property acquired."[21]

At the time of TEFRA's passage, it was thought that anti-selectivity measures would be unnecessary if the General Utilities doctrine were repealed. In advocating the consistency rules as the solution to selectivity in his testimony before the Senate Finance Committee, Mr. Glickman acknowledged that "this is not to say that other solutions [to the problems arising from selectivity] may not also be viable. A complete repeal of the General Utilities doctrine, which provides generally that corporations recognize no gain or loss on certain sales and distributions, is also an approach worthy of consideration."[22]

One of the most forceful proponents of General Utilities repeal as an alternative to the consistency rules was Professor Martin D. Ginsburg, former Chairman of the New York State Bar Association Tax Section. In his testimony before the Senate Finance Committee, he commented as follows:

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[21] Glickman Testimony, at 84.

[22] Glickman Testimony, at 85.

> The Section 338 all-or-nothing rule is designed . . . to be a second best answer . . . . The problem is the historic General Utilities doctrine. . . . If Congress were to repeal the entire General Utilities doctrine . . ., we would have in hand the right answer to the problem. Section 337, the operative provision that is vouched in under proposed Section 338, then would require that H corporation, as the price for stepping up the basis of its [asset], must pay tax on the entire appreciation in the value of that property and not merely on its depreciation. . . .
>
> If Congress were minded to deal directly with the General Utilities problem in this fashion . . ., proposed section 338 would not contain an all-or-nothing rule because there would be no reason to supply an inadequate answer in addition to a right answer.[23]

Professor Ginsburg acknowledged that the consistency rules were a deterrent against selectivity, but challenged Congress to deal directly with the source of the problem –- the General Utilities doctrine. In TEFRA, Congress was content merely to enact further limitations on the scope of the General Utilities doctrine.[24] In 1986, however,

[23] S. 2687 Hearings, at 125, 148 (statement of Martin D. Ginsburg, professor of law, Georgetown University Law Center).

[24] Prior to the Tax Reform Act of 1986, section 311(d)(2) provided certain exceptions to the rule of corporate recognition of gain on distribution of appreciated assets. TEFRA repealed one of the more important exceptions, under which a corporation did not recognize gain on certain distributions of stock or obligations of a subsidiary corporation. This exception provided the statutory basis for the Mobil-Esmark and similar transactions. TEFRA also repealed the rule of nonrecognition of gain on a distribution of appreciated assets in "partial liquidation" of the distributing corporation. For a description of these transactions, see Ginsburg, Taxing Corporate Acquisitions, 38 Tax L. Rev. 177, 218-228 (1983). Corporate shareholders are no longer entitled to partial liquidation treatment, and corporations distributing appreciated property in a partial liquidation now generally must recognize gain on the distribution

Congress took the step urged by Professor Ginsburg in 1982 and repealed the General Utilities doctrine[25] but left the "inadequate answer" — the consistency rules — intact.

In light of the legislative history of TEFRA, it would appear that, with the demise of the General Utilities doctrine, sections 338(e) and (f) have become deadwood and should be repealed. However, before accepting that conclusion, it is necessary to determine whether the consistency rules protect against any other meaningful abuses of the corporate income tax system that would justify their retention. If not, Congress should act quickly to repeal the consistency rules, which are extremely complex and pose an

[25] The enactment of current section 311(b) in 1986 completed repeal of the General Utilities doctrine by requiring generally that a distributing corporation recognize gain as though it had sold the distributed property to the distributee at its fair market value.

enormous burden for taxpayers and, presumably, the Service.[26]

Part B below examines whether other potential corporate income tax abuses exist that would justify retention of the consistency rules.

B. Remaining Areas of Potential Abuse

With the demise of General Utilities, every step-up or step-down in b asis resulting from a stock or asset

[26] For example, with limited exceptions, each corporation included in the P group at any time during the portion of T's consistency period ending on the day a protective carryover election statement is filed must join in making the election. See § 1.338-4T(f)(6)(ii) (Answer l(ii)). For a large multinational corporation, this may require hundreds of signatures. Furthermore, a taxpayer making a protective carryover election must file the election statement with the District Director for each internal revenue district in which a corporation required to join in making the protective carryover election has its principal office or principal place of business (although generally this would not be a problem for a consolidated group). See § 1.338-4T(f)(6)(ii) (Answer l(i)). An indication of the difficulty taxpayers experience in complying with the consistency rules is the flurry of private letter rulings concerning inadvertent failures to file or errors in filing a section 338 election. See, e.g., PLR 8913016 (December 28, 1988); PLR 8832038 (May 17, 1988); PLR 8750025 (September 11, 1987). In addition to the burden on taxpayers, government employees likely will be required to spend hundreds of man-hours finalizing the consistency regulations and countless hours enforcing such regulations (e.g., examining lengthy protective carryover elections to ensure their compliance with strict regulatory specifications). The investment of such considerable administrative effort would seem to require adequate justification.

transfer should be accompanied by gain or loss recognition. Conversely, a transfer of stock or assets that escapes gain recognition should be accompanied by carryover basis to the transferee for the stock or assets acquired. Given the foregoing, we believe that taxpayer selectivity does not accomplish any objectionable purpose.

The next section of the report considers whether taxpayers could obtain any meaningful advantage from selectivity if the consistency rules were repealed. As the following discussion illustrates, we believe that, in certain circumstances, limited advantages do exist, but such advantages hardly justify retention of a system as complex and far-reaching as the consistency rules.

1. Deferred Intercompany Transactions.

If, upon making a qualified stock purchase of T, P wishes to obtain an asset of T at a stepped-up basis without making a section 338 election, it must make a protective carryover election. If the election is made, the intercompany consolidated asset acquisition rules of section 1.338-4T(f)(6)(iv) (Q&A 3)[27] do not force P to take

[27] Because taxpayers engaging in ICA acquisitions selectively can step up the basis of assets transferred within the affiliated group if a protective carryover election is made, the appropriate comparison is between an intercompany acquisition in the absence of section 338 consistency rules and an intercompany acquisition in which a protective carryover election is made.

a carryover basis in an asset acquired by T after T has joined the P group. However, this regulation overrides the normal restoration rules of section 1.1502-13 in certain key respects. Most importantly, whereas the normal restoration rules of section 1.1502-13 generally restore deferred gain on depreciable property as the related depreciation deduction is taken, the ICA rules disregard the gain and deny the related deductions. The apparent intent of these rules is to prevent T from obtaining a benefit from the basis step-up, particularly from the utilization of SRLY loss carryovers to shelter gain recognized by T on the intercompany transfer.-This concern is made explicit in some of the examples in the regulations.[28]

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[28] In Example 1 of § 1.338-4T(f)(6)(iv) (Q&A 3), a corporation, T, recognizes gain on the sale of an amortizable asset to P, a member of T's affiliated group. P's acquisition of the asset is a deferred intercompany transaction under § 1.1502-13, and T's gain is a deferred intercompany gain. Accordingly, under the usual intercompany transaction rules of §§ 1.1502-13(c) and (d), T's deferred gain would be restored to income over time as P claimed amortization deductions. However, § 1.338-4T(f)(6)(iv) (Q&A 3(ii)) prevents T from taking into account this gain in determining its separate taxable income, thereby limiting T's ability to use SRLY loss carryovers to offset its gain on the intercompany transaction, and prevents the effective shift of the SRLY loss to P.

Absent the consistency rules, T could accelerate income to absorb SRLY losses by causing T to distribute or sell appreciated property to other P group members. It is difficult, however, to comprehend the policy justification for restricting the utilization of SRLY losses in the consistency rules. There are no specific restrictions on utilizing SRLY losses to reduce the amount of deferred intercompany gains outside of the section 338 context even though the problem -- if it really exists -- extends well beyond the one-year forward reach of the consistency period, If this is a problem, the proper place to address it is in the consolidated return regulations.[29]

2. Investment Adjustment Rules

Repeal of the consistency rules may encourage transactions that utilize the consolidated return investment

[29] If it is considered appropriate to modify the consolidated return regulations in this regard, it should be considered whether the more liberal approach with respect to built-in gains taken by section 382(h) conflicts with the restrictive approach of the ICA acquisition rules.

adjustment rules[30] to permit P to step up the basis of certain Tassets at the same tax cost to the S-T group as on a sale by S of the T stock.[31] To achieve this result

[30] §§ 1.1502-32, 1.1502-32T

[31] The following example illustrates this point:

T owns Asset A, with a basis of 0 and a value of 100, and Asset B, with a basis and value of 0. S purchases all of the T stock for 100 and S and T elect to file consolidated returns. Asset B subsequently appreciates in value to 100, increasing the value of T to 200.

Upon sale of the stock of T, S would recognize 100 of gain, and T, upon its acquisition by P, would hold two assets with a zero basis. Absent the consistency rules, however, P first could purchase either Asset A or Asset B for its fair market value of 100 and then P could purchase T for its market value of 100 and then P could purchase T for its fair market value of 200 (T would then hold 100 of cash and the asset not sold). S's basis in T to 200. Thus, S would have no further gain on the sale of the T stock.

As a result of the initial asset sale, P would receive Asset A at a stepped-up basis, but the S-T group would recognized on a sale of the stock. P would Acquire T for 200 with 100 of built-in gain as S alone would have recognized on a sale of the T stock. P would acquire a T for 200 with 100 of built-in gain in T (T's basis in its assets is 100 – the cash held by T). This is an appropriate result for P since gain on Asset B. Gain on the subsequent sale of Asset B will be taxed to T, and the 100 loss on the subsequent sale of T will be disallowed pursuant to § 1.337 (d)-2T and prop. Reg. § 1.1502-20. Thus, corporate-level tax on the 100 appreciation in Asset B will be recognized upon until its eventual The foregoing example is not an illustration of the classic "son of mirror" transaction, which undermined the repeal of the General Utilities doctrine by allowing sale of the stock of subsidiaries at a loss to offset recognized built-in gains, resulting in the avoidance of corporate-level tax on sale of the built-in gain assets. Here the investment adjustment rules merely protect against the S-T group having to recognize two levels of corporate tax: first on the sale of Asset A, and next on the sale of T. The only potential issue with respect to the integrity of the General Utilities repeal is whether a positive investment adjustment to the stock of T should be allowed on the sale of Asset A, a built-in gain asset, or only on the sale of Asset B. In order to distinguish between the sale of Assets A and B, a tracing rule or presumption would have to be employed; § 1.1502-20T disavowed tracing and presumption mechanisms, while Prop. Reg. § 1.1502-20 uses presumptions to a very limited extent. See Prop. Reg. § 1.1502-20(c).

without creating a disallowed loss on S's sale of T,[32] T would have to own certain assets with post-acquisition appreciation. If, upon sale of certain of its assets to P, T recognized gain not in excess of the aggregate amount of post-acquisition appreciation in T's assets, T's stock basis would increase by the amount of such gain (but not above T's fair market value), reducing by a corresponding amount S's gain on a subsequent sale of T's stock

[32] The regulations implementing Notice 87-14, 1987-1 c.B. 445 generally adopt a loss disallowance approach in Curir####e "son of mirror" problem. See generally T.D. 8319, Fed. Reg. 49,029 (1990) (preamble to §§ 1###7 (d)-l and 1.337(d)-2T, and Prop. Reg. §§ 1.1502-20); T.D. 8294, 1990-1 C.B. 66 (preamble to §§ 1.337(d)-lT and 1.1502-20T (withdrawn by T.D. 8319).

The preamble to section 1.1502-20T[33] expressly sanctions this result, although the relevant discussion does not identify the purchaser of the T asset. Furthermore, this result is consistent with the approach taken by Notice 87-14[34] to resolving the "son of mirror" problem. Both Notice 87-14 and the regulations issued pursuant thereto preserve the essence of the consolidated return investment adjustment rules, which is "to reflect changes in a group's investment in the stock of a subsidiary, so that income or loss previously included in a group's consolidated taxable income is not reflected a second time on the sale of a subsidiary's stock."[35] Where T's assets reflect post-acquisition appreciation as well as built-in gain, the investment gain eliminated on the sale of T's stock is a duplication of gain that remains preserved in the low basis in the assets that were not sold to P.

From the foregoing, it does not appear that repeal of the consistency rules would lead to abuse of the consolidated return investment adjustment rules. Therefore,

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[33] See T.D. 8294, 1990 1 C.B. 66, 70-71 (Example 5 and discussion). Although § 1.1502-20T was withdrawn by T.D. 8319, the approach to this issue taken by Prop. Reg. § 1.1502-20 did not change

[34] 1987-1 C.B. 445.

[35] Id

the only objection to repeal of the consistency rules raised by the operation of the investment adjustment rules stems from the arbitrary bias against selectivity, and, as stated previously, in a world where basis step-up is coupled with full gain recognition, we believe that selectivity in and of itself is not objectionable. Moreover, any regulatory modification of the investment adjustment rules, if considered necessary, should be addressed in regulations under section 337(d) or 1502 rather than in the consistency rules.

3. Utilization of Expiring-Carryovers.

Repeal of the consistency rules may enable taxpayers to utilize expiring carryovers. For example, suppose that S wishes to cause T to accelerate income so as to take advantage of T's expiring NOL carryovers prior to its disposition of the T stock. To accomplish this objective, T may sell an appreciated asset to P before the sale of T stock. The use of T's NOL carryover to absorb the gain recognized on the sale of the appreciated asset before the

sale of T's stock is not limited by section 382.[36]

There does appear to be some attainable benefit from the repeal of the consistency rules that would be available to taxpayers in such a situation. However, we do not believe that the availability of such a benefit arising in such

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[36] The following example illustrates one such opportunity involving the utilization of expiring net operating losses. S owns all the stock of T, which has a basis in S's hands of 700 and a fair market value of 1,000. S and T file a consolidated return. T owns two assets: Asset X, an operating asset with a basis of zero and a fair market value of 100, and Asset Y, with a basis of 500 and a fair market value of 900. T has a 100 SRLY NOL that will expire in 1990.

Absent the consistency rules, S could cause T to sell Asset X to P in 1990 and immediately thereafter sell the T stock to P. T would offset its gain on Asset X with the expiring NOL and P would take a stepped-up basis in Asset X. Taking into account the appropriate investment adjustments to its basis in T, S would recognize 300 of gain on the stock sale. While the amount of gain recognized on the sale by S of its T stock would not be changed by the part-asset, part-stock sale approach, P would obtain Asset X at a stepped-up basis at the cost of a NOL that otherwise would have expired. Presumably, P would be willing to compensate S for the benefit of the stepped-up basis.

It is noteworthy that, with a slight change in facts, a section 338(h)(10) election would have been more attractive than the foregoing structure. For example, if S's basis in T were 500 rather than 700, S and T would have recognized 600 of aggregate gain, reduced by the 100 expiring NOL in the part-asset sale, part-stock sale alternative. If S and P had made a section 338(h)(10) election, however, T would have recognized only 500 of gain before reduction by the 100 expiring NOL, and P would have acquired both Assets X and Y at stepped-up bases.

narrow circumstances justifies retaining the consistency rules. As discussed elsewhere in this report, the original purpose for the passage of the consistency rules no longer exists; the "abuse" potential of accelerating income to absorb expiring NOL carryovers available to a very small class of taxpayers does not justify the continued infliction of the consistency rules on the great mass of corporate taxpayers.

C. Transactional vs. Express Electivity

Apart from the initial function of the consistency rules to protect against erosion of the limitations placed on the General Utilities doctrine, consistency rules similar to those found in section 338(e) were assigned the task of protecting the system of express electivity contained in the proposed Subchapter C Revision Act of 1985.[37] The Subchapter C Revision Act proposed repeal of the General Utilities doctrine, yet retained a set of consistency rules for asset transfers (with exceptions for certain nondepreciable and nonamortizable assets).[38] The question

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[37] Staff cf Senate Comm. on Finance, 99th Cong., 1st Sess. Th? Subchapter C Revision Act of 1985 51 (Comm. Print 158c) (hereinafter referred to as the "Subchapter C Revision Act").

[38] The American Law Institute study of Subchapter C Reform upon which the Subchapter C Revision Act is based, contains no equivalent to the asset consistency rules.

we explore is whether the rationale for the consistency rules put forward in the Subchapter C Revision Act is sufficiently persuasive in light of General Utilities repeal.

Section 365(c) of the Subchapter C Revision Act contains a set of consistency rules under which purchasers are permitted to elect cost basis or carryover basis treatment on a corporation-by-corporation basis. Therefore, if an acquiring corporation makes a qualified stock acquisition of both a target and its subsidiary or other affiliate, the acquiring corporation can make a cost basis election for one corporation and a carryover basis election for the other. Section 365(c) provides, however, that assets acquired that were held by a single corporation during the consistency period must be treated consistently, either as part of a cost basis or a carryover basis acquisition.[39]

In the Preliminary Report of the Senate Finance Committee on Subchapter C Reform, released in September 40 1983,[40] the Senate Finance Committee staff attempted to

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[39] For a more complete discussion of the consistency rules contained in the Subchapter C Revision Act, see Faber, The Search for Consistency in Corporate Acquisitions, 13 J. Corp. Tax 187, 223-27 (1986) (hereinafter, "Faber").

[40] Staff of Senate Comm. on Finance, 98th Cong., 1st Sess., The Reform and Simplification of the Income Taxation of Corporations (Comm. Print 1983) (hereinafter, "Senate Finance Committee Staff Report").

justify their inclusion of consistency rules (referred to therein as "anti-selectivity" rules) in the Report's recommendations.

From the rationale articulated by the Senate Finance Committee staff, reproduced in part below[41], it can be seen

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[41] The Senate Finance Committee Staff Report states, in part

d <u>Selectivity: general</u>

Under the proposal, corporations could choose to step up the basis for acquired assets on a corporation-by-corporation basis.

i. <u>Arguments for the proposal</u>. The arguments for the proposal are three: First, the simplification arising out of the repeal of the more sweeping anti-selectivity rules of current section 338 is substantial. Second, stricter anti-selectivity rules are of questionable administrability. Third, a requirement of full recognition whenever gain is recognized collects the full tax required.

ii. <u>Arguments against the proposal</u>. - Critics of the proposal come from both sides. Some critics, like the New York State Bar Association Tax Section, urge that the effort to limit selectivity is unnecessary and undesirable. Once corporate gain is taxed when basis is stepped up, no further tax cost should be imposed (such as consistency in related acquisitions). If churning, valuation or other problems are thought to exist, they should be addressed directly.

Other critics assert that stricter anti-selectivity rules are appropriate. With corporate planning, the corporation-by-corporation rule of the proposal becomes an asset-by-asset rule, except to the extent such transactions are limited by the 24 month anti-avoidance rule. Moreover, the proposal unnecessarily emphasizes corporate formalities.

The staff recommends the corporation-by-corporation rule only because it was unable to develop a better solution. A stricter anti-selectivity rule like that of current section 338 creates a host of problems. Eliminating any anti-selectivity rule creates opportunity for stepping up certain assets but not others. That permits taxpayers effectively to bank deductions; that is, to determine with flexibility not ordinarily permitted under law whether to take deductions or defer them into future years. Thus, taxpayers may prevent the expiration of credits or deductions or the operation of income limitations that other taxpayers must face. No arguments for special rules because of the happenstance of a corporate acquisition appeared persuasive.

The staff also considered a number of weaker anti-selectivity rules. For example, some may argue that even within a single corporation, assets employed in separate trades or businesses ought to be

that the Senate Finance Committee staff itself acknowledged the questionable conceptual foundation underlying the consistency rules contained in the Subchapter C Revision Act.

> permitted different elections. Some advocates of this rule urge that it would eliminate the premium placed on planning and corporate formality under the staff proposal. Although a rule which allowed inconsistent elections for assets of separate trades or businesses might reduce the premium placed on planning, organizing separate subsidiaries would remain attractive for assets used in the same trade or business. Thus, the alternative proposal would still place a premium on planning and formality.

Senate Finance Committee Staff Report, at 96-97.

The first argument in favor of the consistency rules — that they are simpler than the section 338 consistency rules — was asserted prior to the promulgation of the temporary section 338 regulations. The extent to which the complexity of those regulations is attributable to the common elements of both sets of consistency rules appears significant[42]. The second argument, that stricter consistency rules are administratively impracticable, is not an argument for the Subchapter C Revision Act consistency rules but against the section 338 consistency rules. The third argument, that a rule of full recognition whenever gain is recognized is sufficient to collect the full tax due, although intended as an argument in favor of relaxing the anti-selectivity rules outside of an intracorporate framework, actually argues in favor of their general irrelevance.

The only articulation of a possibly valid rationale for the rules in the Senate Finance Committee Staff Report is that they prohibit the "banking" of deductions by denying taxpayers greater flexibility in accelerating income and utilizing expiring NOL deductions or credits, or avoiding income limitations, than otherwise would be available. This issue already has been addressed comprehensively in this

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[42] See Faber, 13 J. Corp. Tax, at 225-27.

report[43] and does not appear persuasive.[44] In the absence of a structural gap in the tax system that allows taxpayers to step up the basis of appreciated property without full gain recognition, the prescription for any remaining "abuses" is a localized remedy that leaves the bulk of corporate transactions unburdened by the inadministrability of the consistency rules. Such a remedy, if needed, only should deprive the taxpayer of the particular tax advantage that is perceived to be abusive rather than triggering more widespread consequences. An alternative or supplemental remedy for egregious cases would be the reliance on traditional judicial doctrines such as the business purpose, sham and step transaction doctrines. These doctrines serve to distinguish between legitimate and illegitimate tax planning.

V. Interim Solutions

Independent of statutory repeal of sections 338(e) and (f), much can be done within the scope of Treasury's

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[43] See text accompanying notes 27-36, supra.

[44] One effective way of generating deductions in limited circumstances is to cause T to sell a loss asset to P prior to the sale of T's stock. Although the Senate Finance Committee Staff Report mentioned "banking" of deductions, the current consistency rules do not treat the acquisition of a loss asset as a tainted asset acquisition. See § 1.338-4T(f)(5)(i).

regulatory authority to simplify the consistency rules and lessen the administrative burden they pose. The remainder of this Report recommends modifications to the section 338 regulations to accomplish this objective. Many of these recommendations originated in our 1985 Bar Report. However, because of the different focus of this Report and the intervening repeal of the General Utilities doctrine, we have added new recommendations and changed some of the 1985 Bar Report recommendations. Differences between the recommendations contained herein and those in the 1985 Bar Report are duly noted.

A. Section 1.338-4T(e): Stock Consistency Rules

1. Acquisitive Reorganizations. Although more a point of clarification than of simplification, we reiterate our 1985 Bar Report recommendation that the Regulations make clear that a qualified stock purchase, followed by the acquisition of a target affiliate in a transaction qualifying as a reorganization under section 368, does not come within the stock consistency rules.[45]

2. Regular Exclusion Election. We do not specifically address in this Report the international aspects of our recommendations to repeal (and, on an interim basis,

[45] See 1985 Bar Report, at 147

narrow the scope of) the consistency rules. However, we consider one comment regarding the "regular exclusion election" contained in section 1.338-5T(c)(2)(i) to be within the scope of this Report, since the regular exclusion election is an exception to the stock consistency rules as applied to foreign target affiliates. Section 1.338-5T(c)(2)(i) currently provides that, if an acquiring corporation files a section 338 election with respect to a target corporation that is a domestic corporation, then solely for purposes of the stock consistency rules, the acquiring corporation may elect to exclude certain foreign target affiliates from the status of target affiliate. We recommend that this exclusion election be retained by the section 338 regulations as an interim measure toward eliminating the stock consistency rules.

B. Section 1.338-4T(f): Asset Consistency Rules

1. Eliminate Protective and Affirmative Action Carryover Elections.[46]

Under current law, if P makes a qualified stock purchase of T, and within T's consistency period P acquires any asset of T or a target affiliate in a tainted asset acquisition, and P does not make a protective carryover

[46] This recommendation, as well as recommendations numbered 2, 5 and 6, originally were made in the 1985 Bar Report. See 1985 Bar Report, at 147-49, 152-55.

election with respect to T, an affirmative action carryover election is deemed to have been made (and P will not have the benefit of certain elections designed to mitigate the potential double taxation that could arise from the carryover basis rules), unless the District director decides instead that the tainted asset acquisition should trigger a deemed section 338 election for T. These rules can leave the treatment of a tainted asset acquisition and the creation of a deemed section 338 election entirely to the discretion of the District Director.

In view of the repeal of the General Utilities doctrine, the consistency rules, for as long as they remain in existence, should be as narrow in scope as possible. Therefore, we believe that automatic carryover basis treatment for all tainted asset acquisitions, other than tainted asset acquisitions currently covered by the ICA acquisition rules,[47] combined with the right of the taxpayer to override automatic carryover basis treatment by effectively accepting the consequences of a deemed section

[47] Tainted asset acquisitions covered by the ICA rules should be governed by the deferred intercompany rules in the consolidated return regulations.

338 election,[48] offers a simpler, more administrable system for implementing the consistency rules than does the current system.[49] Accordingly, we recommend elimination of the affirmative action carryover election and protective carryover election, the latter of which in and of itself has added overwhelming complexity to the consistency rules. If our recommendation below[50] to increase the de minimis asset acquisition threshold of section 1.338-4T(f)(7) from 5 percent to a "non-substantiality" standard of 20 percent is adopted, this automatic carryover basis rule would apply only in limited circumstances.

If the automatic carryover basis rule did apply, the taxpayer should have the opportunity to override this rule by effectively accepting the consequences of a deemed section

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[48] See note 51, infra. The procedure for overriding automatic carryover basis treatment would be essentially identical to the procedure for making a normal section 338 election, except for the length of the election period. See note 52 and accompanying text, infra.

[49] This recommendation diverges from our prior recommendations because of our current focus on simplifying the section 338 election process and the intervening repeal of the General Utilities doctrine. See 1985 Bar Report at 147 n.30, 152. While our 1985 alternative recommendation continues to be appropriate, it would require a technical amendment to the statute. Our focus here is on measures that can be taken to simplify compliance with section 338 without requiring congressional action.

[50] See text accompanying notes 63-64, infra

338 election.[51] The right to override automatic carryover basis treatment should be available until the later of (a) some fixed period after the tainted asset acquisition,[52] or (b) the ordinary nine and one-half month period for section 338 elections. In addition, this right should be available only pursuant to section 338(a) and should not be available under section 338(h)(10). Although this rule effectively would extend the election period to one year or longer (i.e., the end of the consistency period), this extension provides no meaningful abuse potential, given the narrow circumstances in which the rule would apply and the limitation of the extension to elections under section 338(a).

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[51] We believe that an absolute carryover basis rule would exceed the regulatory authority granted in section 338 because 338(e)(1) states that, upon a tainted asset acquisition, the purchasing corporation automatically is "treated as having made" a section 338 election. override mechanism would ensure the validity of ### regulations implementing the automatic carryover ## rule. By retaining an override mechanism, this approach adheres closely to the statutory requirement of section 338(e)(1).

[52] This period should be as long as practicable because it likely would be most useful in cases in which the automatic carryover basis rule is triggered inadvertently. To be entirely consistent with the literal terms of section 338(e), which provide for a deemed section 338 election upon occurrence of a tainted asset acquisition, the position may be taken that this override mechanism should not be permitted beyond the end of the consistency period. However, we believe it would be appropriate to allow the taxpayer more time to override automatic carryover basis treatment in the event of tainted asset acquisition occurring on or near the last day of the consistency period.

The mechanism outlined above would allow taxpayers the choice between consistent carryover basis treatment (no section 338 election and automatic carryover basis treatment for the tainted assets) and consistent cost basis treatment (section 338 election with respect to the stock purchase and cost basis treatment for the tainted assets).[53] The certainty and relative simplicity of such a rule would significantly improve the current regulatory regime.

An automatic carryover basis rule would render the protective carryover election unnecessary. Furthermore, by raising the de minimis thresholds as suggested below, fewer inadvertent tainted asset acquisitions would occur. Therefore, we see no reason to retain the protective.carryover election and the exceedingly burdensome forms[54] required to make the election.

2. Eliminate Section 1.338-4T(f)(6) Rules Governing UCA, INA and ICA Acquisitions.

As discussed above, the current regulations permit a taxpayer to avoid a deemed section 338 election by filing a protective carryover election requiring that P generally take

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[53] In the case of non-substantial stock or asset acquisitions, see text accompanying notes 57-64, inconsistent treatment (i.e., cost basis for assets directly acquired without a section 338 election for T) would be permitted under our recommendations.

[54] See note 26, supra.

a carryover basis in any tainted asset acquisition. Tainted asset acquisitions currently subject to these carryover basis rules are divided into three categories: UCA acquisitions, INA acquisitions and ICS acquisitions.[55]

The 1985 Bar Report recommended eliminating the UCA and INA provisions. Though intended to relieve taxpayers of the potential burden of double taxation on gains resulting from the protective carryover and affirmative action elections, the sheer complexity of these rules imposes its own burden on taxpayers. In the situations covered by the UCA and INA rules, the Treasury should follow the simpler general rule recommended above under which taxpayers would take a carryover basis in purchased assets, subject to their, limited right to make a section 338 election.[56]

We reiterate the 1985 Bar Report's recommendation that, in the case of ICA acquisitions, the deferred intercompany gain rules under the consolidated return regulations, rather than the special ICA rules, should apply.[57]

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[55] For a description of the UCA, INA and ICA rules, see 1985 Bar Report, at 153-54.

[56] This recommendation would eliminate the special basis adjustment and the offset prohibition election, which currently ameliorate the potential double taxation arising from carryover basis treatment of an asset.

[57] See 1985 bar Report, at 155

3. De Minimis Threshold for Inadvertent stock Purchase

A qualified stock purchase may occur inadvertently if a purchasing corporation is unaware that the assets it has purchased from an unrelated corporation include stock of a subsidiary or if the purchasing corporation does not realize the significance of such an acquisition. Under the temporary section 338 regulations, if neither an express section 338 election nor a protective carryover election is made, this acquisition will cause an affirmative action carryover election, regardless of the value of the stock acquired. The regulations currently provide no exception from the affirmative action carryover election even though the stock purchased is insubstantial in comparison to the value of all assets acquired. Accordingly, the purchasing corporation cannot under the regulations escape an affirmative action carryover election and the District Director, in his sole discretion,[58] can force the purchasing corporation to take a carryover basis in the assets purchased.

In Revenue Procedure 89-40,[59] the Service recognized the harshness of this rule and created an

[58] The temporary regulations do not limit the District Director's discretion in this area in any way.

[59] 1989-2 C.B 453.

exception for de minimis qualified stock purchases which occur in the context of an asset acquisition. In such cases, District Directors are directed to comply with taxpayer requests to impose a deemed section 338 election in lieu of the affirmative action carryover election. The Revenue Procedure defines a de minimis stock purchase as one in which the aggregate gross fair market value on the acquisition date of all the assets of the target with respect to which there is a qualified stock purchase is not more than the greater of (A) 10% of the aggregate gross fair market value of all the assets (including target stock) purchased from the selling corporation on the date(s) the assets were purchased, or (B) $200,000.

We believe that several changes to the de minimis stock acquisition exception are appropriate in the context of scaled-down consistency rules. First, an asset acquisition occurring at any time within the consistency period of a qualified stock purchase of T should not constitute a tainted asset acquisition if the fair market value of T stock does not exceed an appropriate threshold. Second, only qualified stock purchases that are substantial in relation to the assets acquired by P should result in tainted asset acquisitions triggering the automatic carryover basis rule and the right to override automatic carryover basis

treatment. We therefore recommend that the existing de minimis threshold be increased to a "non-substantiality" standard of 20% of the aggregate gross fair market value of all assets purchased from the selling corporation.[60] Under these rules, in the case of a stock purchase that is not substantial in relation to the assets acquired by P, P would take a cost basis in the acquired assets (other than those assets still held by T), yet would not be subject to a deemed section 338 election with respect to T. If the stock purchase were substantial, in accordance with our recommendations outlined above,[61] P would take an automatic carryover basis in the tainted assets in the absence of a section 338 election by P. Finally, these rules should be incorporated in the section 338 regulations pursuant to the regulatory authority granted by section 338(e)(2)(D).

We note that this recommendation differs from the existing de minimis exception. Revenue Procedure 89-40 merely allows a taxpayer to choose a consistent cost basis (by means of a section 338 election) instead of a consistent

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60 If the taxpayer made a reasonable, good faith attempt to value the stock (e.g., by obtaining an independent appraisal), this valuation should govern for purposes of determining whether a stock acquisition met the non-substantiality standard.

61 See text accompanying notes 46-54, supra.

carryover basis (by means of an affirmative action carryover election), whereas our recommendation would permit inconsistent treatment (cost basis in acquired assets without a section 338 election) in the case of a non-substantial stock purchase.

4. De Minimis Threshold for Tainted Asset Acquisitions.

Under the authority of section 338(e)(2)(D), the regulations currently provide an exception from the tainted asset acquisition rule if P or a member of the P group acquires a de *minimis* amount of assets from T or a target affiliate. This exception applies only if the aggregate gross fair market value of all tainted asset acquisitions that are not otherwise subject to an exception to section 338(e)(1) (other than a carryover basis election or this *de minimis* exception) does not exceed the "de *minimis* amount." For this purpose, the "de *minimis* amount" is the lesser of the sum of 5% amounts for T and all affected targets or $50,00 0. The "5% amount" of a target is an amount equal to 5% of the sum of (A) the target's grossed-up stock basis and (B) the target's liabilities on the acquisition date (not including tax liabilities that would arise if a section 338 election were made for the target).

Under the current regulations, the consequences of a protective carryover election[62] extend to de minimis asset acquisitions. If the taxpayer has made a protective carryover election, any asset acquisition, including a de minimis asset acquisition, takes a carryover basis.[63] In the interest of limiting the scope of the consistency rules, we recommend that in the case of certain non-substantial asset acquisitions (as defined below) the taxpayer be allowed a cost basis in such assets.

For the reasons stated above with respect to the "non-substantiality" rule on inadvertent stock purchases, we further recommend that the $50,000 cap be eliminated and that the de minimis threshold be.replaced with a non-substantiality standard in which the "5 percent amount" would be increased to 20 percent.[64]

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[62] The consequences of an affirmative action carryover election with respect to a de minimis asset acquisition are unclear. Compare § 1.338-4T(f)(6)(iii) (Q&A 2(ii)) with § 1.338-4T(f)(6)(ii) (Q&A 3 (Ex. 2)). See Silverman and Keyes, Section 338 and Leveraged Buy-Out Transactions, 1990 P.L.I. Tax Law and Practice Course Handbook No. 303 391-92.

[63] § 1.338-4T(f)(6)(iii) (Q&A 2(ii)).

[64] In accordance with recommendation (1) above, the references to "carryover basis election" would be deleted. Furthermore, as stated above with respect to non-substantial stock acquisitions, see note 60, supra, if the taxpayer made a reasonable, good faith attempt to value the asset, this valuation should govern for purposes of determining whether a stock acquisition met the non-substantiality standard.

5. Like-Kind Exchanges.

The 1985 Bar Report noted that section 1031 like-kind exchanges do not qualify for the carryover basis exception of section 338(e)(2)(B). Nevertheless, we recommended that an exception for like-kind exchanges be made available under the authority granted in section 338(e)(2)(D).[65] We reiterate that recommendation.

6. Section 1.338-4T(f)(2): Asset cquisitions by T from Target Affiliates.

Q&A 2 of Temporary Treasury Regulation section 1.338-4T(f)(2) requires that asset acquisitions by T from a target affiliate after the acquisition date of T be treated as tainted asset acquisitions. For this purpose, after its acquisition date, T is treated as any other member of the purchasing group. In the 1985 Bar Report,[66] we argued that such purchases should not be treated as tainted asset acquisitions because "the resulting selectivity could have

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[65] See 1985 Bar Report, at 149.

[66] See 1985 Bar Report, at 148; 1984 Bar Report, at 178-79; 1983 Bar Report, at 25.

occurred in the absence of the qualified stock purchase." We reiterate that contention and our recommendation that the result in Q&A 2 be reversed.[67]

7 Purging Tainted Asset Acquisitions.

Under the existing consistency rules the adverse consequences of a tainted asset acquisition can be avoided by disposing of the tainted asset within 90 days of its 68 acquisition.[68] This rule appears to be based on the fact that the purchasing corporation cannot derive significant tax advantages from an asset it must relinquish within 90 days. However, if an asset is disposed of at any time during the same taxable year in which it is acquired, the purchaser also does not realize significant tax benefits.[69] Accordingly, we propose that the period for purging tainted assets be extended to the longer of (a) 90 days after the acquisition, or (b) the last day of the purchasing corporation's taxable year in which the asset acquisition occurred.

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[67] As we have noted previously, an exception to this rule would be appropriate where T would have been unable to achieve as advantageous a tax result in the absence of P's acquisition of T. See 1985 Bar Report, at 148 n.32.

[68] § 1.338-4T(f)(6)(ii) (Q&A 1)

[69] Section 168(d)(4)(A); Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 104 (Joint Comm. Print 1987).

C. Consistency and Acquisition Periods

We recommend that the Service's power to extend the consistency and acquisition periods pursuant to section 1.338-4T(g) be eliminated.

Section 338(h)(4)(A) defines the consistency period to include generally the one year period before the beginning of the acquisition period, the acquisition period (up to and including the acquisition date) of not more than twelve months and the one year period beginning the day after the acquisition date. Section 338(h)(4)(B) includes in the consistency period any period during which the Secretary determines that there was in effect a plan to make more than one qualified stock purchase or tainted asset acquisition with respect to the target corporation or any target affiliate.

The current regulations authorize the Service to extend consistency periods backward and forward. The Service may extend the consistency period backward to the day before the period of any triggering asset acquisition (as defined below) if the acquiring corporation had a plan to make a qualified stock purchase of the target on that date and the plan remained in effect through the acquisition date of the target.[70] Similarly, the Service may extend the

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[70] § 1.338-4T(g)(1) (Q&A 1(i)).

consistency period forward to the day after the acquisition date of a target affiliate or the day after a triggering asset acquisition if the acquiring corporation had a plan to make these acquisitions at the close of the normal consistency period and that plan remained in effect through the date of the acquisition.[71] For this purpose, a triggering asset acquisition is an asset acquisition which, if it had occurred during the normal consistency period, would have been a tainted asset acquisition.[72] Although there is no specific statutory authority for the rule, the regulations also provide that the twelve-month- acquisition period can be extended if the Commissioner determines that there was a plan of the acquiring group to make a qualified stock purchase within that extended period and the extension of the twelve-month period is necessary to carry out the purposes of the consistency rules.[73]

The 1985 Bar Report did not recommend elimination of the Service's power to extend the consistency period.[74] However, in light of the repeal of the <u>General Utilities</u>

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[71] §1.338-4T (g) (1) (Q&A 1(ii))
[72] §1.338-4T (g) (1) (Q&A 1(iIi))
[73] §1.338-4T (g) (1) (Q&A 2)
[74] <u>See</u> 1985 Bar Report, at 155.

doctrine, we now believe the regulations should not expand the consistency period beyond one year before and after the acquisition period, which we also believe should not be expanded beyond one year. Because the price of basis step-up is now full recognition of gain, we believe a “bright line” test is appropriate for these periods, except, perhaps, where the taxpayer has a binding contract within the period. Where taxpayers must fully recognize gain to achieve basis step-up, we believe it is fair to allow taxpayers the flexibility to plan separate transactions outside the statutory time period with confidence that one transaction will not affect another.