REPORT #718

TAX SECTION

New York State Bar Association

Comments on Proposed Section 338

April 22, 1992

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April 22, 1992

The Honorable Fred T. Goldberg, Jr.
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Ave., N.w.
Room 3120
Washington, DC 20220

Re: <u>Comments on Proposed Regulations Under Section 338</u>.

Dear Assistant Secretary Goldberg:

The purpose of this letter is to provide comments of the Tax Section of the New York State Bar Association on select aspects of the proposed regulations under section 338.[1] We believe that, in general, the proposed regulations represent a major improvement over current law in both substance and style, and that the Treasury Department and the Internal Revenue Service should be commended for the constructive approach exemplified by the proposed regulations.[2]

Our comments will be divided in to two parts: (1) a discussion of the changes made with respect to stock and asset consistency in the domestic context;

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1 All references to sections are to the Internal Revenue Code of 1986, or to regulations promulgated thereunder unless otherwise indicated.

2 The principal draftsman of this letter is Dana Trier, co-chair of the Tax Section's Committee on Corporations.

and (2) comments on certain other aspects of the proposed regulations in the context of domestic transactions. The Tax Section intends to submit separate comments on the international provisions of the proposed section 338 regulations (including the international aspects of the proposed asset and stock consistency rules).

I. Asset and Stock Consistency Rules.

In December 1990, the Tax Section submitted a report to the Internal Revenue Service, Treasury Department and the Joint Committee on Taxation on the consistency rules under sections 338(e) and 338(d) (the "Consistency Report").[3] This report set forth, among other things, our recommendations that significant changes be made to the temporary regulations under section 338 as a step in the process of simplifying Subchapter C of the Internal Revenue Code after the repeal of the General Utilities doctrine in the Tax Reform Act of 1986 (the "1986 Act"). To a large extent the positions advocated in the Consistency Report are reflected in the proposed regulations. We believe that the proposed asset and stock consistency regulations should be finalized as proposed, subject to the comments made below.

A. The Proposed Consistency Regulations.

Under the proposed regulations, the consistency rules would apply to a significantly narrower set of circumstances. The focus of the proposed regulations is on preventing acquisitions from being structured to take advantage of the investment adjustment rules to maximize the step-up in basis to a corporate purchaser of business without imposing an incremental tax cost on the sellers. Under the proposed regulations, the consistency rules generally apply if the purchasing corporation acquires an asset directly from target during the target consistency period and target is a subsidiary in a consolidated group so that gain from target's sale of the asset is reflected under the investment adjustment provisions in the basis of target stock and may reduce gain from the sale of target stock. In such a case the proposed regulations operate to require the purchasing corporation to take a carryover basis in the asset unless a section 338 election is made for target. Similar rules apply in cases in which the dividends received deduction has the same effect.

[3] Report on the Role of Section 3 38 Consistency Rules After Repeal of General Utilities Doctrine, New York State Bar Association, Tax Section (November 29, 1990), reprinted in Tax Analysts' Daily Tax Highlights and Documents (December 6, 1990).

The proposed regulations would apply the stock consistency regulations only in cases in which the rules are necessary to prevent avoidance of the asset consistency regulations. Thus, a section 3 38 election with respect to one affiliate will not automatically cause a section 338 election with respect to a subsidiary of the target.

B. Substantive Comments on Proposed Consistency Rules.

To a significant extent, the proposed regulations have rationalized and simplified the consistency rules as recommended by the Consistency Report. In addition to narrowing significantly the substantive scope of the rules as described above, the proposed regulations eliminate the District Director's and Commissioner's discretion in applying the consistency provisions, and eliminate the affirmative action carryover, protective carryover, offset prohibition, and regular exclusion elections.

The core question, then, is whether the central case to which the rules still apply is an appropriate one from a policy point of view. This case, as noted above, is the purchase by one group from another group filing a consolidated returns of the assets of a subsidiary and stock as to which the gain from asset sale is reflected in the basis of the seller. In the Consistency Report, we questioned whether it was necessary or appropriate to apply the consistency rules in these circumstances.[4] Although we continue to believe, as discussed further below, that there are conceptual difficulties raised by application of the consistency rules in that context, we believe that, on balance, the position taken in the proposed regulations is an appropriate interpretation of the limits of the consistency rules under the current statutory provisions of section 338.

The basic policy issues raised by the proposed regulations are perhaps best addressed in the context of a specific fact situation. Assume S, T and B are all domestic corporations. Assume that S has previously purchased the stock of T for 300 at a time that T owned asset 1 with a value of 200 and basis of 100 and asset 2 with a value of 100 and a basis of 100.[5] S and T file consolidated returns. Assume that S has decided to sell T's business for 400 at a time when asset 1 is still worth 200 and asset 2 is now worth 200.

[4] Consistency Report at pp. 13-14.

[5] We understand that because of the inherent tax liability relating to asset 1, S would likely have purchased T for something less than 300, but we have assumed the facts in the example for purposes of simplification.

Assume first that S in effect sold the business to two different parties, P and B, through a combination asset and stock sale. Asset 2 is sold first to B for 200, and T recognizes 100 of gain. Under the consolidated return regulations, S will have an investment adjustment of 100 for its stock in T, increasing its basis to 400. Assume then that T pays a dividend of 200 to S (reducing the S basis in T stock to 200), and S sells T (with asset 1) to P for 200. S would, consistent with the loss disallowance regulations, recognize no additional gain on this transaction: the investment adjustment to S arising out of the sale of asset 2 would be given full effect because S realized no loss on the stock sale.

Compare the results if S sold the entire business to B. If S caused T to sell both assets 1 and 2 to B for 400 .and liquidated T, 200 of income would be recognized by the S group, and B would get a cost basis in both assets 1 and 2. If, by contrast, S sold the stock of T for 400, it would recognize 100 of gain, but B would not get a step up in basis for either asset 1 or 2. Under either scenario, the parties would achieve less desirable tax results than in the two-buyer example described above.

Except for the consistency rules (as would be applied by the proposed regulations), S could achieve the same result as it achieved in the two-buyer transaction in selling the entire business to B if it first sold asset 2 to B for 200 (100 gain) (resulting in an increase in its basis in the stock of T to 400), caused T to pay it a dividend of 200 (resulting in a decrease in its basis in the T stock to 200) and then sold the stock of T to B for 200. Again, at the same tax cost to S as a simple sale of T stock, S would enable B to receive a step up in basis for asset 2. The proposed regulations, however, would require B to take a carryover basis in asset 2 in those circumstances. Thus, under the proposed regulations, the end result to the parties would be the same as a sale by S to B of the T stock: S would recognize 100 of income, and B would not be able to achieve a step-up basis for asset 1 or asset 2.

It is clear that the results reached by the proposed regulations frustrate, in some sense, the policies underlying the investment adjustment rules of the consolidated return regulations. A significant role of the investment adjustment rules is to prevent the same income from disposition of assets to be taxed twice within the same affiliated group of corporations. Thus, if a parent corporation owns a subsidiary that in turn owns an appreciated asset, upon the sale of the asset by the subsidiary the income recognized will give rise to an increase in the basis of the parent’s stock so that upon the sale of such stock such gain is not, in effect, taxed again. Stated otherwise, there is not an increased tax burden associated with the parent owning the asset through the consolidated subsidiary rather than directly.

At the same time, both in the consolidated return context and otherwise, a corporation is not, upon the sale of the stock of a subsidiary, generally required to recognize gain on an appreciated asset held by the subsidiary if the corporation’s basis in the stock of the subsidiary, in effect, already reflects such a gain. Thus, for example, in a case in which the parent bought the stock of a subsidiary for 200 which owned an asset with a value of 200 and a basis of 100 at the time of purchase, the parent can immediately resell such stock for 200 without being required to recognize the 100 of gain on the asset held by the subsidiary.

The effect of the proposed consistency regulations will be to impose a significant tax cost to the extent these two generally applicable results are sought to be attained simultaneously with respect to certain assets and subsidiaries held in a consolidated group through one chain. Thus, in the example described above, S cannot simultaneously avoid double taxation on gain from the direct sale of asset 2, and continue the deferral on the built-in gain in asset 1 through a sale of the stock of S without the buyer failing to achieve a step-up in basis in asset 2, even though it was purchased directly by the buyer.

The full policy implications of this result are clearer when it is compared with the case in which asset 2 is held directly by S. In that case, S and B could, under the proposed regulations, engage in a part stock and part asset transaction without impairing B’s ability to achieve a step-up in basis in asset 2 and without S being required to recognize more gain than it would on a simple stock sale.

Nonetheless, it appears that application of the consistency rules of section 3 38 in these circumstances is generally in accordance with the policies underlying the original enactment of those rules. When the consistency rules were originally enacted in 1982, prior to the final repeal of the General Utilities doctrine, the focus was on the case in which the seller and buyer selectively agreed to a part stock sale and asset sale to the extent that a step-up in basis could be achieved by buyer without an increased tax cost to seller. In that context, the reason this type of selectivity was possible was because the General Utilities doctrine generally shielded the seller from gain, except to the extent statutory recapture or similar has nonstatutory concepts applied. Indeed, as noted in the Consistency Report, the consistency rules were viewed at the time of enactment as in part a substitute for repeal of the General Utilities doctrine.

While repeal of the General Utilities doctrine certainly removes much of the rationale for the consistency rules, selectivity remains potentially tax efficient because, among other things, the investment adjustment rules operate as described above. There is some arbitrariness to the lines drawn in applying the rules in that context: the same selectivity that is proscribed if there is one buyer (or related buyers) is permitted if unrelated buyers are involved. The sanction of a required carryover basis to buyer also may exceed the tax advantage to seller arising from the form of the transaction. But the proposed regulations do not differ from the statute itself in these respects. Moreover, although it may be questioned whether, as described above, a different overall tax result is justified when the asset sold is held directly by the seller, limitation of the rules to the case , in which the investment adjustment rules are operative can perhaps be justified because greater tailoring at the time of sale is involved. Thus, given the statute, we believe that the proposed regulations represent a reasonable approach to implementing the consistency rules in the context of domestic transactions.

C. Effective Dates

In light of the very substantial benefits of the simplified approach taken by the proposed regulations, we believe that the proposed regulations should be effective no later than the date initially proposed. This approach has been taken in other proposed regulations, including the recently proposed regulations under section 1504(b)(5)(A) and (B). In any case, since the temporary regulations arguably should have been amended as soon as possible after the 1986 Act, the earliest possible effective date of the proposed regulations is appropriate. Thus, if for some reason general finalization of the proposed regulations is otherwise delayed, we suggest that the Treasury Department and the Internal Revenue Service make provision for reliance on the proposed consistency rules in the interim.

II. Additional Comments

Apart from the revisions to the consistency regulations, the proposed regulations generally do not make major changes to the temporary regulations with respect to the application of section 338 to domestic transactions. We previously commented extensively on the temporary regulations.[6] Nevertheless, we believe several specific comments are in order.

A. <u>Modified ADSP (“MADSP”)</u>

In the case of a target acquisition for which a section 338(h)(10) election is made, the proposed regulations provide that the deemed sales price at which each asset of the target corporation is sold must be determined under the “MADSP” formula. The MADSP formula is based on the grossed-up basis of the purchaser’s recently purchased stock, as determined under Prop. Treas. Reg. § 1.338(b)-2T (other than § 1.338(b)-2T(c)(2)). In essence, gain or loss realized by the selling group is directly tied to the basis that the purchaser takes in the target stock. However, the purchaser’s basis in target stock may reflect acquisition costs that must be capitalized, such as legal expenses and investment banking fees.

The amount of gain or loss that a selling group realizes in a sale of target stock subject to a section 338(h)(10) election should not reflect capitalized acquisition costs of the purchaser. In effect, causing such gain to be realized by seller is equivalent to taxing the seller on amounts paid to third parties. Accordingly, the MADSP formula should be amended to ensure that the selling group is taxable only by reference to amounts it actually receives.

B. <u>Joint and Several Liability</u>

In general, in the case of a stock acquisition subject to a section 338(h)(10) election, the target corporation is treated as if it sold all of its assets to the purchaser and liquidated under section 332. Gain or loss is recognized on the deemed asset sale, but not on the actual stock sale. The proposed regulations provide that, notwithstanding the treatment of target as having sold its assets and liquidated, “new” target — the deemed transferee of “old” target’s assets — will remain jointly and severally liable under Treas. Reg. § 1.1502-6(a) for the tax liabilities of the selling group (including the tax liability associated with the deemed asset sale).

Although it was generally understood that this result obtained under the temporary regulations, it has been suggested by commentators that the imposition of joint and several liability on new target is inappropriate and inconsistent with

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6 <u>See</u> Committee on Corporations of the New York State Bar Association Tax Section, Report on the Temporary Section 3 38 Regulations (Nov. 25, 1985), <u>reprinted</u> in 30 Tax Notes 137 (Jan. 13, 1986).

the underlying policy of section 338(h)(10). It is clear that in an actual acquisition of the assets of a target followed by an actual 332 liquidation, the purchaser of the assets (new target) would not, as a matter of federal tax law, be jointly and severally liable for the taxes of the group. Thus, it has been argued that the proposed regulations would attach materially different tax results based solely on the form of a target acquisition as a stock or asset sale, contrary to the purpose of section 338(h)(10) to equalize the tax treatment of stock and asset acquisitions. In light of the interest in this issue reflected in the commentary on the proposed regulations, the Tax Section has specifically considered this issue.

While we recognize the rationale for the contrary position, the Tax Section believes that the position taken in the proposed regulations on this issue is an appropriate one. We believe that it is rational to treat separately the issue of income recognition and creditors' rights in this context, particularly since with respect to the rights of other creditors the transaction will have the effect of a stock sale.

C. The Definition of Qualified Stock Purchase

We have previously commented at length on the definition of a qualified stock purchase.[7] In general, the proposed regulations simplify and restate the provisions in the temporary regulations dealing with the definition of a qualified stock purchase, but do not make significant changes. We believe that many of the comments in our previous report remain valid. We would highlight the following:

1. The definition of purchase should include stock received upon the conversion of a debt instrument into the stock of the same issuer to the extent that the debt instrument was purchased.[8] As amended in 1984, section 338(h)(3)(A)(ii) excludes from the definition of purchase, among other things, the receipt of stock in an exchange described in section 354. It is possible that the conversion of debt to stock of the same issuer will technically qualify as a tax-free recapitalization. We continue to believe that this result is inappropriate and that the proposed regulations should clarify the definition of purchase to include stock received upon the conversion of a purchased debt instrument of the same issuer.

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[7] Id at 139-145.

[8] Id at 139-140.

2. The definition of purchase should include stock received directly from the issuer in exchange for money.[9] Although this transaction is economically the same as a purchase, it would qualify for nonrecognition under section 351 and thus be excluded from the definition of a purchase under section 338(h)(3)(A)(ii). The Internal Revenue Service has recognized the appropriateness of extending the definition of purchase to cover such stock acquisitions in Notice 89-102, dealing with the tax treatment of thrift institutions receiving federal financial assistance. We continue to believe that it makes no sense to exclude from the definition of purchase such section 351 transactions, although certain other adjustments may be necessary under the proposed regulations in such a context.

3. The definition of a purchase in the case of stock acquired from related parties should address acquisitions of target stock from partnerships.[10] Section 338(h)(3)(A)(iii) provides that stock is not purchased if it is acquired from a person the ownership of whose stock would, under section 318(a) (other than section 318(a)(4)) be attributed to the person acquiring such stock. However, section 338(h)(3)(C)(i) provides that this latter rule shall not apply in the case of an acquisition of stock from a related corporation if at least 50 percent in value of its stock was acquired by purchase. Section 338(h)(3)(C)(i) by its terms does not apply to acquisitions of stock from a partnership if more than 50 percent of the interests therein were acquired by purchase. We continue to believe that the Service and Treasury have the authority to and should extend the principles of section 338(h)(3)(C)(i) to partnerships.

Sincerely yours,

John A. Corry
Chair, Tax Section

Identical Letter Sent to
The Honorable Shirley Peterson

[9] Id at 142.

[10] Id at 142.

cc: The Honorable Shirley Peterson
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