REPORT #704

TAX SECTION

New York State Bar Association

Report on Section 336(e)

January 6, 1992

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TAX SECTION
New York State Bar Association

January 6, 1992

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20024

Dear Commissioner Goldberg:

Please find enclosed a report prepared by our Committee on Reorganizations discussing regulations to be issued implementing section 336 (e). This section, which was enacted by the Tax Reform Act of 1986, authorizes the issuance of regulations allowing an election to be made to treat a sale, exchange or distribution by a parent corporation of stock of an 80% owned subsidiary as a taxable sale of the subsidiary !s assets. The purpose of the section is to extend the principles of section 338(h)(10) to transfers of stock not involving a qualified stock purchase or consolidated groups. The report recommends that section 336(e) (and a companion rule in section 338(h)(10)(B)) be implemented to the maximum permissible extent, subject to certain limitations in the case of distributions and sales to related parties.

We hope the report will inspire the Service to issue regulations under section 336(e). As always, we would be pleased to discuss the report with you or members of your staff.

Very truly yours,

James M. Peaslee
Chair

Enclosure

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
COMMITTEE ON REORGANIZATIONS

Report on Section 336(e)

This report[1] examines section 336(e),[2] which was enacted by the Tax Reform Act of 1986[3] (the "1986 Act"), and is intended to provide guidance to the Treasury Department in the preparation of implementing regulations. Section 336(e) generally provides that, under regulations to be prescribed, if a corporation ("Parent") owns stock in another corporation ("Controlled") meeting the requirements of section 1504(a)(2),[4] and Parent sells, exchanges or distributes all of the stock of Controlled, an election (a "Section 336(e) Election") may be made to treat such sale, exchange or distribution as a disposition of the assets of Controlled, and no gain or loss shall be recognized on the sale, exchange or distribution by Parent of the stock of Controlled. The 1986 Act also amended section 338(h)(10)(B) to

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[1] This report was prepared by Kenneth H. Heitner and Richard M. Leder, co-chairs of the Committee on Reorganizations, and Katherine Bristor, Asher Harris, David W. Mayo, Sean M. Mitts and John Taggart. Helpful comments were received from Alan Alpert, Peter C. Canellos, John A. Corry, Paul Crispino, Bruce Davis, James M. Peaslee, Elliot Pisem, Jeffrey Robins, Michael L. Schler, David Schulder, Kenneth R. Silbergleit and David R. Tillinghast.

[2] Section references herein are to the Internal Revenue Code of 1986, unless otherwise indicated.

[3] P.L. 99-514, sec. 631(a), 100 Stat. 2085, 2270-71 (1986).

[4] The requirements of section 1504(a)(2) are ownership of at least 80% of the total voting power of the corporation's stock and at least 80% of the value of such stock. Under section 1504(a)(4), the term "stock" for purposes of section 1504(a)(2) does not include stock that is nonvoting, is limited and preferred as to dividends, does not participate in corporate growth to any significant extent, is not issued with an unreasonable redemption or liquidation premium and is nonconvertible. The Committee believes that the exclusion in section 1504(a)(4) applies for purposes of section 336(e).

authorize regulations permitting section 338(h)(10) elections for nonconsolidated affiliated groups. No regulations have been issued under this authority or section 336(e).

Summary of Recommendations

The principal recommendations of this Committee are:

(1) Full and speedy implementation of sections 336(e) and 338(h)(10)(B) to the maximum permissible extent, subject to certain limitations in the case of distributions and sales to related parties.

(2) Application of section 338(h)(10) principles and methodology to all types of dispositions of Controlled

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Committee on Reorganizations

Report on Section 336(e)

January 6, 1992

distributes all of the stock of Controlled, an election (a "Section 336(e) Election") may be made to treat such sale, exchange or distribution as a disposition of the assets of Controlled, and no gain or loss shall be recognized on the sale, exchange or distribution by Parent of the stock of Controlled. The 1986 Act also amended section 338(h)(10)(B) to authorize regulations permitting section 338(h)(10) elections for nonconsolidated affiliated groups. No regulations have been issued under this authority or section 336(e).

Summary of Recommendations

The principal recommendations of this Committee are:

(1) Full and speedy implementation of sections 336(e) and 338(h)(10)(B) to the maximum permissible extent, subject to certain limitations in the case of distributions and sales to related parties.

(2) Application of section 338(h)(10) principles and methodology to all types of dispositions of Controlled stock (i.e., sales, exchanges and distributions) to which section 336(e) applies. More specifically:

(a) in the case of a sale or exchange. Controlled would be treated as selling all of its assets in a taxable transaction to a newly-created corporation for cash and then liquidating tax-free under section 332 -- with all the consequences that naturally flow from such transactions (except as noted below); and

(b) in the case of a distribution, Controlled would be treated as selling all of its assets in a taxable transaction to a new corporation owned by the distributees in exchange for stock of the purchaser, which stock in turn would be treated as being distributed to Parent tax free under section 332 and then by Parent to its shareholders -- again, except as noted below, with all the consequences that naturally flow from such transactions.

(3) The regulations should expressly reject reorganization treatment and application of other Liquidation Reincorporation Principles (as defined below)[5] in distributions and related party transactions, except in abusive situations where the principal purpose for the transaction is tax avoidance.

(4) Availability of a Section 336(e) Election should be limited to sales, exchanges or distributions of Controlled stock in which there would be, in the absence of a Section 336(e) Election, full recognition of gain or loss by Parent. For example, in the case of a stock transfer governed by section 304, the election should be available only if the deemed redemption is treated under section 302(a) as a sale or exchange.

(5) A Section 336(e) Election should be available with respect to distributions or sales of stock within a consolidated group that are treated as deferred intercompany transactions -- one effect of this is to eliminate the potentially harsh result that exists presently when an intercompany transfer of a subsidiary's stock is followed by an asset (or deemed asset) sale by such subsidiary.

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[5] See Section II.C, infra.

(6) Consistency rules should be conformed with section 338 in situations involving a single purchaser of an 80% interest, but should not be extended to situations involving multiple purchasers; to the extent applicable to Controlled, they should also be applied to all corporations in an 80% chain of ownership below Controlled. Although the consistency rules applicable under sections 338 and 336(e) should be conformed, we reaffirm our recommendation in a prior report of the Tax Section that the consistency rules generally be repealed.

(7) The Section 336(e) Election should be extended to transfers of Controlled stock regardless of whether Parent or Controlled or both are foreign corporations; and in no event is it relevant that one or more shareholders of Parent may be foreign.

I. Background.

Under current law, if at least 80% of the stock of a consolidated subsidiary ("target") is sold to a corporate purchaser, the purchaser and the selling consolidated group may jointly elect to treat the target as having sold all of its assets in a single transaction.[6] As a result of such an election, the selling group realizes gain or loss at a single level only -- that of the target -- and the "new" target in the hands of the purchaser takes a fair market value basis in its assets. The "old" target is deemed to liquidate completely immediately after the asset sale under section 332.[7]

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[6] Section 338(h)(10).

[7] Temp. Treas. Reg. § 1.338(h)(10)-1T(3).

Eligibility for an election under current law section 338(h)(10) is extremely limited. First, the target must be a member of an affiliated group that actually files a consolidated return for the taxable period in which the transaction occurs.[8] Further, the general requirements of a "qualified stock purchase" for purposes of section 338(a) must be met. Thus, stock of the target meeting the requirements of section 1504(a)(2) must be acquired by a single purchasing corporation (or affiliated group) within a twelve-month period, and most sales of stock between related corporations (for purposes of attributing stock pursuant to section 318(a)) are not eligible.[9]

With the repeal of the General Utilities[10] doctrine by the 1986 Act,[11] congress recognized that it would be appropriate, through regulations to be promulgated, to extend section 338(h)(10) and permit the basis of assets of acquired 80% subsidiary corporations to be stepped-up to fair market value in situations not previously covered by section 338(h)(10).[12] Thus, Congress (1) amended section 338(h)(10) to empower the Treasury to promulgate regulations that would expand the definition of an

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[8] This should include a case where the target was the parent corporation's sole subsidiary and was included in the parent's consolidated return prior to the disposition.

[9] Section 338(d)(3) and section 338(h)(3).

[10] General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

[11] Pub. L. No. 99-514, supra n. 3, sec. 631, 100 Stat. at 2269.

[12] The General Explanation of the Tax Reform Act of 1986 provides:

> Congress believed it was appropriate to provide relief from a potential multiple taxation at the corporate level of the same economic gain, which may result when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in basis of the assets of the corporation.

Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 34 6 (1987).

eligible selling consolidated group for purposes of section 338(h)(10) to include an affiliated group that does not file a consolidated return[13] and (2) enacted section 336(e) to empower the Treasury to issue regulations to extend the principles of section 338(h)(10) to other sales, exchanges or distributions of an 80% stock ownership interest (by vote and value) by a single corporate owner of such interest.

No such regulations under sections 338(h)(10)(B) or 336(e) have yet been proposed. The Committee strongly urges the Service to implement these provisions as speedily as possible and, subject to the limitations suggested herein, to the maximum extent possible. Extension of the coverage of section 338(h)(10) to affiliated groups not filing consolidated returns where the provision is otherwise applicable could be achieved either through amendment to the regulations under section 338(h)(10) or as part of regulations promulgated under section 336(e).

II. Characterization of a Section 336(e) Election.

As an initial matter, it is necessary to determine the appropriate conceptual framework within which to analyze the effects of a Section 336(e) Election. The legislative history of section 336(e) makes clear that principles similar to section 338(h)(10) are to apply to a Section 336(e) Election.[14] This makes good sense as a matter of tax policy and, as discussed below, should be followed generally.

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[13] Pub. L. No. 99-514, supra n. 3, sec. 631(b)(3), 100 Stat. at 2271 (codified at section 338(h)(10)(B)).

[14] Staff of the Joint Committee on Taxation, supra n. 12, at 346.

We will consider, first, sales or exchanges of Controlled stock, second, distributions of Controlled stock by Parent to its shareholders, and, finally, the question of whether a deemed disposition of assets resulting from a Section 336(e) Election should automatically be treated as a taxable sale of assets.

A. Sale or Exchange of Controlled Stock.

The application of section 338(h)(10) principles in the context of a sale or exchange by Parent of Controlled stock is relatively straightforward, and the Committee believes such principles provide an appropriate framework for a Section 336(e) Election. Thus, for example, in a case of a sale in respect of which a Section 336(e) Election is made, the following results should obtain:[15]

(i) Controlled should be treated as having sold for cash, subject to its liabilities, all of its assets in a single taxable transaction (whether or not 100% of the stock of the target is, in fact, transferred)[16] to a newly-created corporation owned by the purchasers of Controlled stock (hereafter referred to as "Newco");

(ii) Controlled should be deemed to distribute the sales proceeds in a complete liquidation to Parent (or Parent's share if Parent owns less than 100% of Controlled stock) and

[15] See Temp. Treas. Reg. § 1.338(h)(10)-1T(e)(3); see also PLR 9044063 (Aug. 7, 1990); PLR 8938036 (June 27, 1989). The presentation in the text of the results of a Section 336(e) Election does not take into account special rules that may be applicable to foreign corporations. See Section V.D. below."

[16] Section 336(e); see also section 338(a)(1).

Parent would, in all events, recognize no gain or loss under section 332;[17]

(iii) Controlled should recognize gain or loss on the deemed asset sale,[18] subject to the application of sections 267, 336(d)(2),[19] 1239 and other similar provisions governing taxable asset sales, which should be included in the consolidated return of the group which includes Controlled for the year of sale (if consolidated returns are filed), or in a final return of Controlled (if consolidated returns are not filed);

(iv) Parent should not recognize any gain or loss on the sale of Controlled stock;[20]

(v) Parent should succeed to the tax attributes of Controlled under section 381 as a result of the deemed section 332 liquidation;[21] and

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[17] Section 332(a). The required stock ownership of Parent in Controlled to qualify under section 336(e), i.e., stock meeting the requirements of section 1504(a)(2), is the same stock ownership necessary for qualification of a liquidation under section 332. The Committee suggests that the aggregation rules of Treas. Reg. § 1.1502-34, which are applicable in determining a consolidated group's eligibility for a tax-free liquidation under section 332 (but not the distributing corporation's tax-free treatment under section 3 37), also be applicable in determining whether the stock ownership requirement of section 336(e) is met. See infra, text at n. 52.

[18] Section 1001.

[19] Since Controlled is deemed to liquidate under section 332 immediately following the asset sale, the asset sale would be a liquidating sale to which the loss limitation rules of section 336(d)(2) would apply.

[20] Section 336(e). This result follows from the deemed section 332 liquidation.

[21] Section 381(a)(1).

(vi) Newco should take a fair market value basis for its assets[22] based on the amounts paid for the Controlled stock[23] in accordance with the principles contained in the section 338(h) (10) regulations.[24]

B. Distribution of Controlled Stock.

In general, a distribution in respect of which a Section 336(e) Election is made may be characterized in one of two ways.

Under the first approach ("Model I"),[25] the following steps would be deemed to occur:

(i) Controlled would be treated as having sold all of its assets in a single taxable transaction (whether or not 100% of the stock of Controlled is, in fact, transferred) to a Newco owned by the distributees of the Controlled stock in exchange for stock of Newco and the assumption of Controlled's liabilities;

(ii) Controlled would be deemed to distribute to Parent the sales proceeds (i.e. the Newco stock) in a complete liquidation and Parent would recognize no gain or loss under section 332;

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[22] See section 1012.

[23] The purchase price of the stock of Controlled would be grossed-up to reflect 100% of the value of the assets where there is a sale of less than 100% of the stock of the target. Also, we believe the treatment of stock held by minority shareholders should be the same as if a section 338(h)(10) election were made.

[24] See Temp. Treas. Reg. § 1.338(h)(10)-1T.

[25] See Yin, Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986. 42 Tax L. Rev. 573, 651 (1987).

(iii) Controlled would recognize gain or loss on the deemed asset sale, subject to the application of sections 267, 336(d)(2), 1239 and other similar provisions;[26]

(iv) Since the basis of the stock of Newco would be equal to its value, Parent would not recognize any gain or loss on the deemed distribution of such stock;

(v) Parent would succeed to the tax attributes of Controlled under section 381 as a result of the deemed section 332 liquidation; and

(vi) Newco would take a fair market value basis for its assets based on the value of the stock of Controlled at the time of the distribution.

The second model ("Model 2") involves the following series of steps:[27]

(i) Controlled would be deemed to distribute all of its assets to Parent, subject to liabilities, in a complete liquidation governed by section 332;

(ii) Parent would have a carryover basis in the assets deemed received from Controlled under section 334(b)(1) and would succeed to Controlled's tax attributes under section 381;

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[26] As discussed in section IV.C. below, the transaction generally should not be treated as a "D" reorganization or other nontaxable exchange, notwithstanding the fact that the consideration deemed received by Controlled is stock of Newco.

[27] For a description of this model, see Leduc & Gordon, Two Visions of Subchapter C: Understanding the 1986 Tax Reform Act and the 1987 Revenue Act and Predicting the Near Future. 46 N.Y.U. Inst, on Fed. Tax. 37-27 (1986).

(iii) Parent would be deemed to distribute all of the assets received from Controlled to the distributees of the Controlled stock, and would recognize gain or loss under section 311 or 336, whichever is applicable to the distribution of the Controlled stock without regard to the Section 336(e) Election; and

(iv) the distributees would be treated as forming a Newco and contributing all of the former Controlled assets, subject to liabilities, to Newco.

There are two basic differences in the tax treatment of the parties under Models 1 and 2. First, gain or loss on the disposition of Controlled assets would be recognized by Controlled under Model 1 and by Parent under Model 2. This means that under Model 2, Parent's net operating losses, carryforwards and other beneficial tax attributes (in addition to those of Controlled) would be available to offset any gain recognized on the deemed asset disposition; under Model 1, only Controlled's attributes would be so available.[28] Second, under Model 2, losses from the disposition of Controlled assets would be subject to the loss disallowance rules applicable to distributions under sections 336 and 311, rather than the more limited loss disallowance rules under section 336 that would apply to sales

[28] As stated above, in Model 2, since any gain on the deemed sale of assets would be recognized at the level of Parent, the net operating losses, carryforwards and other beneficial tax attributes of both Parent (and, if applicable, any members of its affiliated group) and Controlled (by reason of the section 332 liquidation, see section 381(a)) would be available to offset such gains. Parent and Controlled may not be members of an affiliated group or may not file consolidated returns. This could occur, for example, in the case of a distribution of a life insurance company that is not an “includible corporation” under section 1504(b), where the parties are prohibited from filing consolidated returns by reason of prior deconsolidation or simply where the parties have chosen not to file a consolidated return.

made in connection with a liquidation[29] and section 267. The Committee believes that Model 1 is the more appropriate characterization.

Most significantly, Model 1 would adopt for distributions the same analytical framework that the Committee believes should be adopted for sales and that previously has been adopted for section 338 (h)(10).[30] There is no hint in either the statute or the legislative history that different models should be used to analyze distributions and sales in respect of which a Section 336(e) Election is made, or that a model different from that adopted for section 338(h)(10) should be used.[31] Further, adopting this approach for both distributions and sales would facilitate analysis of a part-sale, part-distribution transaction, a result that would not obtain if different models were used for sales and distributions. Moreover, to the extent special attributes are present at the level of either Parent or Controlled, Model 1 generally fixes the recognized gain or loss at the Controlled level, which we believe is appropriate.[32]

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[29] See supra, n. 19.

[30] See supra, text at nn. 15-24.

[31] In fact, as noted above, the legislative history indicates that the regulations should look to section 338(h)(10) principles. See H.R. Conf. Rep. 99-841, 99th Cong., 2d Sess. II-204; Staff of the Joint Committee on Taxation, supra n. 12, at 346.

[32] However, as discussed in Part IV, loss on assets contributed by Parent in anticipation of the Section 336(e) Election may be disallowed under section 336(d)(2) and gains on such assets may be taxed to Parent under section 482.

C. Disposition as Taxable Sale.

Section 336(e) treats an election as resulting in a "disposition" of assets but does not say whether the disposition is automatically taxable or is to be treated under general Code principles (including the reorganization provisions of the Code and several judicially created doctrines such as liquidation-reincorporation, alter ego, no liquidation,[33] substance over form and similar doctrines (which are referred to herein collectively as the "Liquidation Reincorporation Principles")). Specifically, the deemed transfer of Controlled's assets to Newco for Newco stock may, depending upon the circumstances, constitute a taxable sale of assets, a reorganization under section 368(a)(1)(D) (or, possibly, another reorganization provision) or be subject to Liquidation Reincorporation Principles. The Committee believes that both of the latter two results generally are inappropriate, because, as discussed below, no step-up in asset basis would result, and Congress created the Section 336(e) Election to achieve a step-up in asset basis and not to recast taxable stock dispositions as reorganizations or other non-full recognition transactions.[34] Accordingly, the Committee recommends that the section 336(e) regulations expressly provide that, except in the limited circumstances discussed below involving potentially abusive situations, a Section 336(e) Election will not be treated as a reorganization under section 368(a)(1)(D) (or tax-free under any other nonrecognition or reorganization provision)[35] or be

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[33] See, e.g., Telephone Answering Service Co. v. Commissioner. 63 T.C. 423 (1974), aff'd by order 546 F.2d 423 (4th Cir. 1976), cert. den'd, 431 U.S. 914 (1977).

[34] See supra. text at n. 12.

[35] For example, under certain circumstances, the deemed asset transfer might constitute a reorganization under section 368 (a)(1)(C) or section 368(a)(1)(F).

subject to Liquidation Reincorporation Principles.[36] Failure to implement this recommendation, at least in the case of certain distributions and related party sales, would frustrate Congressional intent and render the Section 336(e) Election useless for many taxpayers.

If general Code principles were applied, the deemed exchange of Controlled assets for Newco stock that would result under Model 1 from a Section 336(e) Election made in connection with a distribution of Controlled stock by Parent to its stockholders could qualify as a reorganization under section 368(a)(1)(D), at least if Parent is closely-held.[37] Reorganization treatment would have the following consequences. Newco would take a carryover basis in the assets that it was

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[36] Nonetheless, in determining the consequences of an election, it may be appropriate to apply certain anti-abuse rules. See section IV.c, infra.

[37] Section 368(a)(1)(D) requires:

> a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355 or 356 ....

For purposes of section 368(a)(1)(D), the term "control" has the meaning given in section 304(c). Section 368(a)(2)(H). Under section 304(c), the term "control" means ownership of 50% of the total combined voting power of all classes of stock entitled to vote or 50% of the total value of shares of all classes of stock. Section 304(c)(1). For purposes of determining control, the attribution rules of section 318(a) apply, with a modification, so that a corporation is deemed to own the portion of the stock owned by a less than 50% shareholder that owns 5% or more in value of the stock of the corporation. Section 318(a)(3)(C), as modified by section 304(c)(3)(B). Accordingly, the ownership of Newco stock by the shareholders of Parent may be attributed to Parent, in which event, depending on the composition of the ownership of Parent, Parent could be deemed in control of Newco immediately after the transfer of the assets of Controlled.

deemed to receive.[38] Controlled would recognize no gain or loss on such transfer, because it would be deemed to receive solely stock of a party to the reorganization.[39] Controlled would take a substituted basis in the Newco stock deemed received.[40] No gain or loss would be recognized by either Parent or Controlled on the deemed liquidation of Controlled into Parent.[41] Following the deemed liquidation, Parent would have a basis in its stock of Newco equal to its basis in the stock of Controlled.[42] Despite the treatment of the transaction as a reorganization at the Controlled level, upon the deemed distribution of Newco stock by Parent, Parent would recognize gain in an amount equal to the difference between the fair market value of such stock and its basis (assuming section 355 would not apply).[43] The shareholders of Parent would be taxed on the deemed receipt of stock under section 301, and would take a fair market value basis in the

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[38] Section 362(b). Similar results would obtain if the transaction were described in another reorganization provision or if Liquidation Reincorporation Principles were held to apply.

[39] Section 361(a); section 368(b) (defining the term "party to a reorganization").

[40] Section 358(a)(1).

[41] Sections 361(a) and 361(c)(2) (no gain recognized by a party to a reorganization (i.e., Controlled) upon the distribution of the stock of a party to the reorganization (i.e., Newco)); section 354 (no gain or loss on exchange of stock of parties to reorganization by shareholders (i.e., Parent)). See also American Manufacturing Co. v. Commissioner, 55 T.C. 204 (1970) (nonapplicability of section 332).

[42] Section 358.

[43] Section 311(b). Section 361(c), which generally provides that no gain or loss is recognized by a party to a reorganization on the distribution to its shareholders of qualified property, does not apply because Parent is not a party to the reorganization. See section 368(b). A similar result would obtain if the transaction failed to qualify as a reorganization but otherwise was subject to Liquidation Reincorporation Principles. In that event, the transfer might be viewed as if Newco were the alter ego of Controlled and Parent simply distributed Controlled in a transaction governed by section 311 or section 336, as the case may be.

Newco stock received (again assuming the inapplicabilty of section 355).[44] Thus, Parent would have paid a corporate-level tax on the distribution of its Newco stock, which is the same tax it would have paid in respect of a distribution of Controlled stock if no Section 336(e) Election were made, but Newco would have the same basis in its assets after the distribution that Controlled had prior to the distribution. As discussed above the Committee believes that this result is generally contrary to the entire reason for enacting section 336(e) -- to provide a step-up in basis when corporate-level tax is incurred by Parent with respect to a disposition of Controlled stock.[45]

A far more appropriate result would be reached if the deemed sale of assets to Newco is not treated as a reorganization and is not subject to Liquidation Reincorporation Principles. In that case, Controlled would recognize any gain realized on the sale,[46] any loss would be recognized (subject to section 267 and section 336(d)(2)) and Newco would have a basis in the assets deemed purchased equal to such assets' fair market value.[47]

III. Availability of Non-Consolidated Section 338(h)(10) and Section 336(e) Elections.

A. Section 338(h)(10)(b).

Before considering the transactions for which a

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[44] Section 301(d). This assumes that the distribution of the Controlled stock would be taxed to Parent's shareholders under section 301.

[45] See supra, text at n. 12.

[46] See section 1001.

[47] See section 1012. As in the transaction qualifying under section 368(a)(1)(D), no gain or loss would be recognized on the deemed liquidation of Controlled. Section 332. Further, no gain or loss would be recognized on the deemed distribution by Parent of the Newco stock received in such liquidation, because such stock would have a basis in Parent's hands equal to its fair market value.

Section 336(e) Election should be available, we will first address the extension of section 338(h)(10) to affiliated groups not filing consolidated returns pursuant to the regulatory authority provided in section 338(h)(10)(B). The Committee sees no reason for not extending section 338(h)(10) principles to selling groups not filing consolidated returns when a section 3 38 election is otherwise available. Indeed, an extension of section 338(h)(10) would be comparatively simple because the definition of "qualified stock purchase" would exclude from its scope related party sales and most distributions. Similarly, we see no reason why the treatment of any minority interest in Controlled should differ from the treatment under section 338(h)(10) merely because Controlled is not filing a consolidated return with its Parent.

B. Section 336(e).

While an extension of section 338(e)(10) would be helpful, there are numerous situations not covered by section 338(h)(10) where a transfer of assets is desired by the parties for United States tax purposes but cannot be readily effected because of the provisions of other applicable law or because of practical difficulties in transferring assets, including, for example, substantial transfer or other state and local taxes, transfer restrictions and consent requirements. Thus, there is a real practical need to take advantage of the expanded reach of section 336(e), which is not limited to transactions that are qualified stock purchases under section 338. Subject to the limitations discussed below, the Committee sees no tax policy reason why principles similar to those of section 338(h)(10) should not be applied to most stock dispositions where gain is recognized, and therefore urges the broadest possible availability of the Section 336(e) Election.

By its terms, section 336(e) imposes no limitations or requirements on transactions in respect of which a Section 336(e) Election will be available, other than that (a) the seller must be a corporation, (b) the seller must own stock possessing at least 80% of the voting power and 80% of the total value of the stock of Controlled within the meaning of section 1504(a)(2), and (c) the seller must dispose of its entire stock interest in Controlled.

We will address the requirements for making a Section 336(e) Election arising in the following areas: (1) the status of the acquirors of Controlled stock, (2) the amount of stock that must be disposed of by Parent, (3) the requirement that the disposition of stock be taxable, and finally (4) dispositions to related parties. Except as otherwise indicated, the same considerations apply to sales or exchanges and to other dispositions.

1. Status of Acquirors.

There does not appear to be any policy reason why principles similar to those of section 338(h)(10) should be limited to acquisitions by a single corporation. By contrast with section 338, which focuses on the buyer, the focus of section 336(e) is on the seller, which must own at least 80% in vote and value of the stock of Controlled and dispose of it all in a single transaction. A transaction should not be disqualified because the acquirors of Controlled stock are one or more individuals or other noncorporate entities (regardless of number of purchasers). Subject to the discussion in section V below, foreign and other tax-exempt purchasers should also be eligible.

2. Amount of Stock.

The Committee believes, based upon the language of the statute, that Parent must sell, exchange or distribute all of its stock of Controlled, even if such amount is greater than the 80% ownership required by section 1504(a).[48] We have a number of suggestions as to how this requirement should be applied.

As an initial matter, the section 336(e) regulations should permit Parent to aggregate for purposes of the single transaction rule all sales that are made pursuant to a single plan, following principles similar to those established pursuant to section 351 in determining control "immediately after the exchange."[49]

The Committee also recommends that the section 336(e) regulations provide that the disposition of Parent's entire stock interest in Controlled may be accomplished through a combination of sales and distributions of Controlled stock. The Committee recognizes that section 336(e)(2) literally requires disposition of the entire stock interest by sale, exchange or distribution, but it is unlikely that Congress intended such a strict construction. Consider the following example:

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[48] But see Yin, supra n. 25, at 653-654 (arguing that an 80% disposition should be sufficient). While the statute seems clear that Parent must dispose of all of its Controlled stock, it does not necessarily follow that all of the stock must be disposed of in a taxable transaction. See section III.B.3.d, infra. In addition, Parent should be able to retain section 1504(a)(4) stock.

[49] See Treas. Reg. § 1.351-1(a)(1). In this regard, the Internal Revenue Service should consider the adoption of safe harbor rules, under which all sales and dispositions within a period of time or to a single purchaser or related purchasers may be presumed to be pursuant to a single plan.

> Example 1. Parent owns 100% of the stock of Controlled. Pursuant to a plan to dispose of its entire interest in Controlled, Parent sells a 51% interest in Controlled to A and distributes the remaining 49% of its Controlled stock to its shareholders as a dividend.

The disposition requirement of section 336(e) should be considered to be met because Parent has disposed of its entire interest in Controlled pursuant to a single plan. The transaction would be treated as a taxable sale of all of Controlled's assets partly for cash (51%) and partly for Newco stock (49%).[50]

Stock that is redeemed should be treated as sold or exchanged by Parent:

> Example 2. Parent owns 100% of the stock of Controlled, all of which it agrees to sell to A for cash. A structures the transaction as a "reverse merger" of a newly-formed, wholly-owned subsidiary of A ("Newsub") into Controlled. Parent receives only cash in the merger. The cash consideration for the merger is provided to Newsub 40% by A as capital and 60% by lenders to Newsub as loans, which will be secured by Controlled' s assets after the merger.

The transaction is treated as a sale by Parent of 40% of its stock of Controlled to A and a redemption by Controlled of the remaining 60%.[51] Because Parent is disposing of its entire interest in Controlled pursuant to a single plan, the stock disposition requirement is met.[52] Where the qualified stock

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[50] In the foreign context, the distinction between the constructive receipt of cash or Newco stock by Controlled is meaningful under the proposed section 367 regulations. See the discussion infra at n. 141.

[51] See Rev. Rul. 78-250, 1978-1 C.B. 83; Rev. Rul. 73-427, 1973-2 C.B. 301.

[52] See Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 55-745, 1955-2 C.B. 223; see also Rev. Rul. 75447, 1975-2 C.B. 113.

disposition occurs in two or more transactions, such as the part-sale part-redemption transaction of Example 2, each component step is to be treated as a partial asset sale for purposes of applying the mechanical rules applicable to a Section 336(e) Election. Thus, in Example 2, the redemption transaction should be treated as a sale of an undivided 60% interest in Controlled*s assets to Newco, subject to 60% of Controlled's liabilities, in exchange for an amount of cash equal to the acquisition debt; and the sale component should be treated as a sale of the remaining 40% interest in Controlled's assets (subject to the remaining 40% of its liabilities) in exchange for the cash furnished by A. The liabilities of Controlled would not include the acquisition debt in applying the foregoing rules.

Finally, stock held by members of a consolidated group should be aggregated:

> Example 3. Parent owns all of the stock of each of S and T and each of them, in turn, owns 50% of the single class of stock of Controlled. Parent, S, T and Controlled file a consolidated return for 1992. On December 1, 1992, both S and T sell all of their stock of Controlled to I, an individual.

Through the application of Treas. Reg. § 1.1502-34, each of S and T should be deemed to meet the stock ownership requirement of section 336(e)(1).

> Example 4. Assume in Example 3 that S owns 80% and T owns 20% of Controlled. On December 1, 1992, S sells all of its stock of Controlled to I, but T retains its interest.

By reason of the application of the aggregation rules of Treas. Reg. § 1.1504-34, the transaction would not qualify for a Section 336(e) Election.

3. Taxable Dispositions.

The statute could be read to permit the availability of a Section 336(e) Election for both taxable and non-taxable dispositions by Parent of Controlled stock. The legislative history of section 336(e), however, makes clear that the Section 336(e) Election should only be available when the sale, exchange or distribution would otherwise be taxable to Parent.[53] This requirement is appropriate because section 336(e) is intended as an analogue to section 338(h)(10) and is designed to give Newco a fair market value basis in the assets deemed disposed of. Thus, a Section 336(e) Election would not be available where stock is disposed of in exchanges described in section 351,[54] section 354 or section 356 or in any other transaction in which the transferor does not recognize, with respect to the required 80% stock interest, the entire amount of the gain or loss realized on

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[53] The Conference Report states that "the conference agreement provides that, under regulations, principles similar to those of section 338(h)(10) may be applied to taxable sales or distributions of controlled corporation stock." H.R. Conf. Rep. 841, supra n. 31, at II-204. The General Explanation of the Tax Reform Act of 1986 has similar language. See supra n. 12.

[54] A case could be made for permitting a Section 336(e) Election with respect to a section 351 transaction in which the full gain is recognized by the transferor, and the Committee would have no objection if the Treasury were to do so. However, the suggestion in the text relating to the tax-free (or partially tax-free) transaction is based on another principle -- conformity to section 338(h)(10) -- and therefore substantially tracks section 338(h)(3)(ii). We do not believe that as forceful an argument can be made for permitting a Section 336(e) Election with respect to a transaction coming under section 356, even if the full amount of gain is recognized by the transferor, because under section 356, "boot" would be treated as a distribution on Controlled stock and not as a sale or exchange (or a distribution) of Controlled stock, and in many cases the facts would leave a considerable amount of uncertainty as to whether the transaction qualified for a Section 336(e) Election. See the discussion infra, text at nn. 57-62.

the transaction.[55] The Committee believes that application of section 336(e) when 80% of Controlled stock is disposed of in a partial recognition transaction is beyond the scope of Congressional intention[56] and may add additional complexity.

As discussed below, the requirement of a taxable disposition of stock raises issues when stock is transferred in transactions subject to section 304, is distributed to shareholders, is transferred between members of a consolidated group, and is transferred in part in a taxable transaction and in part in a nonrecognition transaction.

a. Section 304.

The Committee believes that a Section 336(e) Election should not be available for a transaction to which section 304 is applicable, except where the transaction is treated as an exchange under section 302(a).[57] The reason for our view may be explained by considering the following example:

> Example 5. Parent owns 100% of the stock of both Controlled and S. Parent does not file a consolidated return with Controlled and S. Parent "sells" all of the stock of controlled to s for $1 million cash.

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[55] Subject to the suggestion in section III.B.3.d below that the full recognition rule be treated as satisfied where an interest meeting the requirement of section 336(e)(1) is disposed of in a fully taxable transaction, even though the remainder of the stock interest is disposed of in a tax-free or partially tax-free transaction.

[56] See supra, n. 52.

[57] Under Prop. Treas. Reg. § 1.1502-80(b), section 304 will not be applied in a consolidated return context. Rather, an intercompany stock sale will be treated as a deferred intercompany transaction under Treas. Reg. § 1.1502-13. See infra, text at nn. 85-92.

The transfer is treated as a redemption of the stock of S (and not of Controlled) from Parent.[58] Because the redemption is not described in section 302(b),[59] the transfer of Controlled stock to S is treated as a contribution by Parent to S of the stock of Controlled.[60]

Thus, the transfer of the stock of Controlled to S is tax-free, and it would be inappropriate to allow a Section 336(e) Election to be made in respect thereof.

The $1 million paid by S to Parent would be treated as a distribution by S with respect to its own stock.[61] To the extent of the combined earnings and profits of S and Controlled,[62] the distribution would constitute a dividend to Parent, for which a dividends received deduction would be available.[63] Thus, the distribution would not be fully taxable. Even if neither S nor Controlled had earnings and profits, Parent would recognize gain only if the distribution exceeded the basis of the S stock (increased by the basis of the contributed Controlled stock).

The Committee believes, however, that a Section 336(e) Election should be available if section 304 is applicable and the transaction is treated as an exchange.

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[58] Section 304(a)(1).

[59] Under section 318(b)(2)(C), Parent is deemed to own 100% of the stock of Controlled both before and after the transfer.

[60] Section 304(a)(1).

[61] Section 302(d).

[62] Section 304(b)(2).

[63] Section 243(a)(3) and (b)(1).

> Example 6. Parent owns 80% of the stock of Controlled, for which its basis is $1 million, and 60% of the stock of S. Parent sells all of its Controlled stock to S for $2 million. 61.

Section 304 applies to this sale, and the transaction is treated as a distribution with respect to the stock of S held by Parent. Under section 304(b)(1), the determination of whether the transaction is an exchange is made with respect to Parent's ownership of the stock of Controlled. After the exchange, Parent is deemed to own 48% of the stock of Controlled, so that the transaction is treated as a substantially disproportionate redemption. The regulations under section 3 04 provide that the basis of the S stock treated as redeemed is equal to Parent's basis in the Controlled stock transferred to S.[64] Thus, while Parent is treated as having contributed the Controlled stock to S and as having its S stock redeemed, Parent recognizes gain equal to the amount it would recognize if the transaction were treated as a sale of the Controlled stock to S. On this basis, the transaction satisfies the full recognition requirement, and a Section 336(e) Election should be available.

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[64] Treas. Reg. § 1.304-2(a) provides:

> [T]he property received shall be treated as received in a distribution in payment in exchange for stock of the acquiring corporation under section 302(a), which stock has a basis equal to the amount by which the shareholder's basis for his stock in the acquiring corporation was increased on account of the contribution to capital as provided for above in this paragraph.

This regulation predates the amendments to section 304 made by the 1986 Act. See P.L. 99-514, supra n. 3, sec. 1875(b), 100 Stat. at 2894. Prior to the 1986 Act, section 304(a)(1) provided that in any section 304 transaction, the stock of the issuing corporation (Controlled) was deemed to be acquired by the acquiring corporation (S) as a capital contribution. The 1986 Act limited the capital contribution treatment to cases where the transaction is treated as a distribution under section 301. The stated purpose of this provision is to treat the acquisition of stock by S in this manner as a “purchase”, thereby permitting S to make a section 338 election with respect to that purchase (assuming the requirements of that section were otherwise met). The legislative history of this provision indicates that it “is not intended to change the present law treatment of the shareholder (including the shareholder's basis in the stock of the acquiring corporation).” See H. Rept. 99-426, 1021 (1985); S. Rep. 99-313, 1047-48 (1986).

b. Distributions.

(1) Complete Liquidation of Subsidiary.

Example 7. GP, a corporation, owns all of the outstanding capital stock of Parent, which in turn owns all of the outstanding capital stock of Controlled. Parent adopts a plan of complete liquidation and distributes all of its assets (including the Controlled stock) to GP, or alternatively, merges into GP.

No gain or loss is recognized to the distributing corporation on the distribution of property to an 80-percent distributee in a distribution to which section 332 applies.[65] Thus, the distribution by Parent of all of its assets (including the stock of Controlled) in complete liquidation would be non-taxable to both Parent and GP. Because such a distribution is a non-taxable transaction to Parent, a Section 336(e) Election should not be available. This would be so even if there was a taxable distribution of a pro rata share of Parent's assets to minority shareholders.[66] As indicated above, the Committee

[65] Section 337(a). Note that section 337 does not apply if Parent is domestic and GP is foreign, unless Controlled is a U.S. real property holding corporation. Section 367(e)(2) and Temp. Treas. Reg. § 1.367(e)-2T(b). If Parent recognizes gain on the distribution of Controlled stock under these rules, a Section 336(e) Election should be permitted. See generally New York State Bar Association Tax Section, Committee on Foreign Activities of U.S. Taxpayers, Report on Proposed and Temporary Regulations Under Section 367(e), 11-13 (July 9, 1990) (the "NYSBA 367(e) Report"), reprinted in Tax Analysts Daily Highlights & Documents, July 12, 1990, 407, 410.

[66] Because section 332 requires that the corporate parent own at least 80% of the liquidating subsidiary, a liquidation may qualify under section 332 if there is a minority interest of up to 20%. Such a liquidation properly should be viewed as consisting of two distributions -- one to the 80-percent distributee and one to the minority. Gain, but not loss, would be recognized to the distributing corporation on the distribution to the minority shareholders. Section 336(a); section 336(d)(3).

believes that a proper reading of section 336(e) requires that the distribution of stock meeting the requirements of section 1504(a)(2) be taxable to the distributing corporation in order for a Section 336(e) Election to be available. Thus, no Section 336(e) Election should be available.

(2) Other Non-taxable Distributions.

> Example 8. Parent has for more than 5 years actively conducted the businesses of divisions A and B. Parent contributes the business of A to newly formed Controlled and distributes the Controlled stock pro rata to its shareholders.
>
> Example 9. Parent transfers all of its assets to Controlled, a previously unrelated corporation, in exchange for 80% of the stock of Controlled. Parent distributes the Controlled stock to its shareholders in complete liquidation of Parent.

In general, no gain or loss is recognized by a corporation that is a party to a reorganization on the distribution pursuant to the plan of reorganization of property to its shareholders,[67] In the case of appreciated property, such rule is limited to distributions of "qualified property;" gain is recognized on other distributions as if the property were sold at its fair market value.[68] "Qualified property" includes stock in a corporation, other than the distributing corporation, that is a party to the reorganization and that is received by the distributing corporation in the exchange.[69] In Example 8, Parent's formation of, and contribution of assets to, Controlled would constitute a reorganization under section 368(a)(1)(D) and the distribution of Controlled stock would qualify under section

[67] Section 361(c)(1).

[68] Section 361(c)(2)(A).

[69] Section 361(c)(2)(B)(ii).

355.[70] In Example 9, Parent's transfer of assets to Controlled and subsequent liquidation would constitute a non-divisive reorganization under section 368(a)(1)(D).[71] Under section 361(c), Parent, in each case, would be treated as having made a distribution of qualified property (that is, the stock of Controlled) to its shareholders. Because no gain or loss is recognized to the distributing corporation on a distribution to which section 361 applies, no Section 336(e) Election should be available in respect thereof.

> Example 10. Parent is a holding company whose only assets consist of all of the stock of Controlled and another corporation. Controlled and the other corporation each has actively conducted its respective business for more than 5 years. Parent distributes all of the stock of Controlled pro rata to its shareholders.

In general, if a corporation distributes stock to its shareholders in a transaction to which section 355 applies and which is not in pursuance of a plan of reorganization, no gain or loss is recognized by the distributing corporation.[72] Because Parent's distribution of Controlled stock would qualify under section 355,[73] no Section 336(e) Election should be available for

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[70] Assuming, of course, that the other requirements of section 355 were met, including that there was a valid business purpose for the transaction and that the transaction did not constitute a device for the distribution of earnings and profits.

[71] The same result should obtain if Controlled acquired all of the Parent stock from Parent's shareholders in exchange for Controlled voting stock (in a transaction that in form was structured to qualify under section 368(a)(1)(B)) and, as part of a plan, liquidated Parent. See Rev. Rul. 67-274, 1967-2 C.B. 141 (treating such transaction as a “C” reorganization).

[72] Section 355(c).

[73] See supra, n. 70.

such distribution.[74]

Notwithstanding the unavailability of Section 336(e) Election for a transaction qualifying under section 355, the Committee believes that a corporation making a distribution of stock and claiming the benefits of section 355 should be allowed to make a "protective" Section 336(e) Election in respect of such distribution. The protective Section 336(e) Election would have no effect if the distribution in respect of which it was made qualified under section 355. On the other hand, if such distribution were finally determined not to qualify under section 355 and instead was a distribution taxable under section 311 (for which a Section 336(e) Election generally would be available[75]), the Section 336(e) Election would have the consequences outlined above. The distributed corporation could not, of its own initiative, claim the benefits of the Section 336(e) Election. The regulations permitting a protective Section 336(e) Election should include provisions allowing the distributed corporation to file amended returns in the event the election becomes operative, as well as appropriate tolling provisions to the statute of limitations.

Under section 355(d), the distributing corporation (but not the shareholder receiving the distribution) will recognize gain on the distribution of subsidiary stock if, immediately after the distribution, a shareholder holds a 50-percent or

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[74] Note that, except in limited circumstances, Parent will be required to recognize gain on a distribution of Controlled stock otherwise qualifying under section 355 if the distributee is not a U.S. person. Section 367(e)(1) and Temp. Treas. Reg. § 1.367(e)-1T. See NYSBA Section 367(e) Report, supra n. 65. A Section 336(e) Election should be available if gain recognition is required on such a distribution, provided that gain is recognized on all of the Controlled stock distributed (or at least 80% of the Controlled stock -- see section III.B.3.d, infra).

[75] See the discussion infra at n. 79.

greater interest in the distributing or distributed corporation that is attributable to stock that was acquired by purchase within a five-year period. In such event, distributions of otherwise qualified property are treated as distributions of disqualified property for purposes of both section 355(c) and section 361(c).[76] The Committee believes that a Section 336(e) Election should be available in such event, even though no shareholder-level tax has been paid.[77] As an initial matter, a full corporate-level tax has been paid, which the Committee believes is the essential prerequisite for a Section 336(e) Election to be available. Further, the assets deemed distributed would remain in corporate solution; accordingly, a shareholder-level tax (or at least basis reduction, if Newco had no earnings and profits) would be required to remove the assets from corporate solution by means of a dividend.[78] The legislative history indicates that a Section 336(e) Election should not affect the shareholder treatment of the transaction;[79] thus, a transaction otherwise qualifying under section 355 for which a Section 336(e) Election is available by reason of section 355(d) would continue to be treated as a section 355 transaction at the shareholder level irrespective of the Section 336(e) Election.

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[76] Section 355(d)(1).

[77] It should be noted that in the other distribution transactions in respect of which the Committee believes a Section 336(e) Election should be available (aside from certain situations involving foreign shareholders), a shareholder-level tax would be paid.

[78] Section 301(c). For a discussion of Newco's earnings and profits following a Section 336(e) Election, see infra text at nn. 108-110.

[79] See H.R. Conf. Rep. 99-841, supra n. 31, at II-204; Staff of the Joint Committee on Taxation, supra n. 12, at 346. Thus, for example, a shareholder's basis in its stock of Parent would be allocated between its stock of Parent and Controlled following the distribution based on such stocks' relative fair market values under section 358(b) and Treas. Reg. § 1.358-2(a)(2).

(3) Taxable Distributions.

Example 11. Parent, which owns 100% of the stock of Controlled, distributes to its shareholders as a dividend all of the stock of Controlled in a transaction not qualifying under section 355. The Controlled stock is appreciated in Parent's hands.

Under section 311(b), a corporation making a distribution to its shareholders of appreciated property is required to recognize gain on such distribution if section 355 does not apply as if the distributed property were sold to the distributees at its fair market value. Thus, in Example 11, Parent would be required to recognize gain on the distribution of Controlled stock. A Section 336(e) Election should be allowable in respect of such a distribution.

On the other hand, Parent would not be permitted to recognize a realized loss with respect to Controlled stock on a distribution subject to section 311(a). In such case, a Section 336(e) Election should not be available. The only situation in which the parties would likely wish to make the election in a loss case is where the loss on an asset sale would not be disallowed under section 267 or 336(d)(2) -- in order to avoid the absolute loss disallowance rule of section 311(a). The Committee does not believe section 336(e) was intended for such purpose.[80]

Example 12. Individuals A and B each own 50% of the outstanding capital stock of Parent, which in turn owns all of the outstanding

[80] This rule would make a Section 336(e) Election unavailable for all distributions of Controlled stock in which stock basis is greater than the stock's fair market value, even if the deemed sale of assets would result in an overall gain. The Committee believes that, in general, a Section 3 36(e) Election would not be attractive in a situation in which there is a loss on the stock but a gain on the assets, and that the simplicity to be gained by a "bright-line" rule generally outweighs the benefits to be derived from an asset-based test. Conversely, a Section 336(e) Election would be available if there were a gain on the stock, even if there was an overall loss on the assets. In this case, the Committee believes that sections 267 and 336(d)(2) provide appropriate protection against abuse.

capital stock of Controlled. Parent adopts a plan of complete liquidation and distributes all of its assets, including the Controlled stock, equally to A and B.

Under section 336, gain and, in certain circumstances, loss, is recognized by the distributing corporation on distributions in complete liquidation to which section 332 and section 361 do not apply as if the distributed property were sold to the distributees at its fair market value.[81] In Example 12, assuming section 355 did not apply, Parent would recognize gain or loss (in the case of loss, subject to the discussion in the succeeding paragraph) under section 33 6 and, therefore, a Section 336(e) Election should be available for such a liquidating distribution.

In a liquidation to which section 336 applies, no loss is recognized on the distribution of any property to a related party (within the meaning of section 267) if the distribution is not pro rata[82] or if the property distributed is disqualified property.[83] For this purpose, "disqualified property" is any property acquired by the liquidating corporation in a section 351 transaction or as a contribution to capital during the 5-year period ending on the date of the distribution, or any property if the adjusted basis thereof is determined by reference to the adjusted basis of property that would be disqualified property.[84]

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[81] Section 336(a). The exceptions are contained in section 336(a) (exception for section 337 transactions) and section 361(c)(4) (subpart B of part II of subchapter C, including section 336, does not apply to distributions to which section 361 applies).

[82] Section 336(d)(1)(A)(i).

[83] Section 336(d)(1)(A)(ii). A loss with respect to a liquidating distribution of disqualified property is also limited in certain cases involving tax avoidance plans. Section 336(d)(2).

[84] Section 336(d)(1)(B).

For the reasons stated above with respect to loss disallowance under section 311(a), the Section 336(e) Election should not be available where there is loss disallowance under section 336(d)(1) or (2) with respect to the distribution of controlled stock. Where loss is fully recognized, however, the election should be permitted.

c. Transfers Within Consolidated Groups.

The Committee believes that, while it is a close question, on balance a consolidated group should be permitted to make a Section 336(e) Election in respect of an intercompany sale[85] or taxable distribution of Controlled stock even though the gain or loss is deferred, with the result that Newco would take a stepped-up basis in its assets.

The fact that the intercompany gain on the stock transfer would be deferred should make no difference in applying section 336(e). If all of Parent, Controlled and Parent's shareholders are members of an affiliated group filing a consolidated return, then any gain recognized by Parent on a sale or taxable distribution of assets to another group member would likewise be deferred under the consolidated return regulations.[86] Such gain would be restored under the ordinary consolidated return rules, for example, as the property deemed distributed is depreciated or at the time that such property leaves the group.[87]

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[85] This assumes that Prop. Treas. Reg. § 1.1502-80 is adopted. Otherwise, section 304 normally would apply to an intercompany sale. See, supra, text at nn. 57-64. The issue of applying section 336(e) in the consolidated context would be faced in any event with respect to distributions of Controlled stock.

[86] Treas Reg. § 1.1502-13; Temp. Treas. Reg. § 1.1502- 14T(a).

[87] Treas. Reg. § 1.1502-13(d) and (f).

The Committee's position that transfers within a consolidated group should be eligible for a Section 336(e) Election is heavily influenced by the need to deal with the following problem: under the consolidated return regulations, without a Section 336(e) Election, a distribution of the stock of a subsidiary within the group, followed by the sale of the assets of the subsidiary outside the group and the liquidation of the subsidiary or a sale of the subsidiary's stock and liquidation, or a stock sale and a section 338(h)(10) election, appears to result in a double tax: first, on the gain attributable to the asset sale and second, on the restoration of the deferred gain.[88] (Similar results would obtain in the case of an intragroup sale of stock, rather than an intragroup distribution, followed by a sale of assets and liquidation, or a stock sale and a section 338(h)(10) election.) The Committee understands that several taxpayers have requested relief from this harsh result.[89] The Committee believes that a Section 336(e) Election, with the results described above, would provide the necessary relief, at least in cases involving intragroup transfers of 80% or more of a corporation's stock.

Treasury may determine that it can extend to taxpayers satisfactory relief from the double-tax problem described above in a manner other than through implementation of section 336(e). If Treasury were to adopt such an alternative remedy, the Committee would then have no strong feeling one way or the other

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[88] Although it is not totally clear that the deferred gain would be restored upon the liquidation under Treas. Reg. § 1.1502-13(f)(1)(vi), the Treasury Department apparently takes the position that such gain would be so restored.

[89] See Letter from William Ludgate (Director of Tax Planning at RJR Nabisco) to Terrill A. Hyde (Deputy Tax Legislative Counsel for Regulatory Affairs) (June 26, 1991), reprinted in 91 TNT 148-33 (July 15, 1991); Letter from Richard A. Gordon and P. Anthony Nissley (each of Arthur Andersen) to Kenneth W. Gideon (Assistant Secretary for Tax Policy (May 21, 1991)), reprinted in 91 TNT 112-35 (May 22, 1991).

as to whether the Section 336(e) Election should be available for transfers within a consolidated group. On the one hand, extension of section 336(e) to consolidated return transfers would appear to better conform conceptually with consolidated return deferred intercompany transaction rules which generally provide for the application of separate return principles.[90] On the other hand, it is difficult to see the need for application of section 336(e) to consolidated return transfers outside of solving the "double tax" problem and there is a concern that it would be used primarily by taxpayers to gain a "free" crack at tax avoidance. However, the anti-abuse rule suggested below (with its related presumptions) where the principal purpose of the transaction is tax avoidance should prevent undue concern on that score.[91]

If it is desired to extend the availability of the Section 336(e) Election to consolidated return transfers, it will be necessary to solve a technical problem raised by the aggregation rules of Treas. Reg. § 1.1502-34. As discussed above, the Committee urges that the aggregation rules be applicable for purposes of determining both (i) whether the 80% stock ownership threshold is met, and (ii) whether the entire stock interest is disposed of.[92] It follows from a literal application of the aggregation rules that transfers between members of a consolidated group would not be transfers at all, notwithstanding the fact that the transferor recognizes and defers gain. It is believed that this technical problem could be solved if the Treasury desires to extend section 336(e) treatment to

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[90] Of course, there would not be a pure separate return analogue for an intercompany sale (as contrasted with a distribution) since, unlike the consolidated return context if the proposed consolidated return rule relating to section 304 is adopted, sections 304 and 302(d) would normally apply in the separate return context.

[91] See section IV.C., infra.

[92] See supra, text at note 52.

consolidated return transfers. As stated above, we would urge Treasury to do so in order to solve the double tax problem if a satisfactory alternative solution is not adopted.

d. Dispositions in Part Taxable and in Part Tax-Free.

> Example 13. GP, a corporation, owns all of the outstanding capital stock of Parent, which in turn owns all of the outstanding capital stock of Controlled. Parent sells 80% of Controlled*s stock to A and distributes 20% of Controlled*s stock to GP in complete liquidation under section 332.

These facts present an interesting choice for the Treasury. The statute requires only that an 80% stock interest in Controlled be disposed of for a Section 336(e) Election to be available. It would be reasonable, therefore, for the regulations to require only that there be a fully-taxable disposition of at least an 80% interest. Such a requirement would be met in Example 13. Further, the technical requirement of section 33 6(e)(2), that the entire interest in Controlled be disposed of, would be literally met.[93] This latter requirement, however, could be read to require that the entire interest be disposed of in a taxable transaction. The Committee believes, however, that the latter reading is too strict, and that the regulations should adopt the requirement that only 80% of the stock of Controlled must be disposed of in a taxable transaction, so long as Parent's entire interest is in some way disposed of.

4. Related Parties. Section 338 is limited to acquisitions of stock by parties unrelated to the seller. We do not believe that a similar limitation was intended for transactions subject to section 336(e) because of the fact that it applies not only to sales and exchanges, but also to

[93] As in the case of an actual transfer of an interest that is less than 100% of the stock of Controlled, the arm's length sale price would be grossed-up to reflect a deemed sale by Controlled of 100% of its assets.

distributions, which would be made to the beneficial owners of the distributing corporation. More fundamentally, we do not see any reason for preventing a step-up in the tax basis of assets if this is accomplished at the cost of a corporate tax on gain. To the extent there are concerns that gain may not be fully taxed, we believe these concerns should be addressed directly as discussed in section IV below, rather than by attempting to distinguish between related party transactions that are eligible for a Section 336(e) Election and those that are not.

IV. Consequences of a Section 336(e) Election.

A. Effect on Minority Shareholders.

Example 14. Parent owns at least 80%, but less than 100% of the stock of Controlled. Parent sells all of its stock of Controlled.

A corporation owning at least 80% of the stock of another corporation may dispose of such stock in a taxable transaction for which a Section 336(e) Election should be available. The Committee believes in Example 14 that Parent's sale of 80% of Controlled should be treated, for purposes of computing corporate-level gain and Newco's basis, as a sale of all of the assets of Controlled, irrespective of the minority interest therein.[94] This treatment comports with the language of section 336(e), which states that the effect of a Section 336(e) Election is to treat the requisite stock disposition as a "disposition of all of the assets" of Controlled. Further, this treatment is consistent with section 338, which, for purposes of computing gain on the deemed sale of assets, effectively grosses

[94] Except as discussed in section V.D.1.(a)(ii), infra (where Controlled is foreign), there should be no consequences to the minority shareholders resulting from the Section 336(e) Election.

up the purchase price for the target as if all of the target stock was purchased.[95]

B. Loss Limitations.

If a Section 336(e) Election is available in a situation where Controlled and Newco are related within the meaning of section 267(f), the Committee believes that the principles of section 267(f) should govern the deemed asset sale to Newco and defer the recognition of losses to Controlled (which deferred losses would be attributed to Parent upon the deemed section 332 liquidation). Further, the deemed sale should constitute a sale by a liquidating corporation for purposes of section 336(d)(2), so that the special basis rule of that provision would apply to prevent the recognition of a loss with respect to property transferred to Controlled in anticipation of the deemed sale and liquidation of Controlled.

The loss disallowance rules of Prop. Treas. Reg. S 1.1502-20 should not apply to prevent a Section 336(e) Election from being made (on the ground that loss on the sale of the stock would not be recognized). The Committee believes that the concerns that those proposed regulations address, such as duplication of basis arising from purchase price and from recognition of built-in gains and prevention of loss duplication, are not present in the deemed asset sale context. For this reason, sales under section 338(h)(10) are excluded from the

[95] See section 338(a)(1); section 338(b)(1) and (4). Because section 3 36 does not, in our view, permit Parent to retain any Controlled stock, there is no need for a gain recognition election of the type provided in section 338 (b)(3).

loss disallowance regime.[96]

In a case where stock of Controlled is distributed by Parent to its stockholders, it might be asked whether the limitations on the recognition of loss that would apply to a distribution of Controlled's assets by Parent under section 311 or 336 should be applied to the losses recognized by Controlled on the disposition of its assets. We believe that this approach is not needed to prevent abuse since, as stated above, the losses recognized by Controlled will in any event be subject to the special limitations provided in section 336(d)(2) (as a result of the deemed liquidation of Controlled) and section 267. Further, treating the disposition of Controlled assets as a distribution by Parent is inconsistent with the Model 1 approach we advocate.

C. Application of Liquidation-Reincorporation Principles.

The legislative history of the 1986 Act states that the Section 336(e) Election was not intended to permit a corporation to avoid the proper application of the liquidation-reincorporation doctrine.[97] As noted earlier, the Committee believes that general application of the liquidation-

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[96] See Treas. Reg. § 1.1502-20(a)(5), Example (4).

[97] The Conference Report states:

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

reincorporation doctrine in the context of a Section 336(e) Election would be inconsistent with the principle underlying section 336(e): permitting a corporation to elect to treat a stock disposition as an asset disposition with a corresponding step up in tax basis in such assets. The Committee thus believes that the doctrine should be applied only to situations in which the absence of such application clearly would be abusive and contrary to the intent of section 336(e). These would typically involve related party transactions having a principal purpose of obtaining the benefit of the step-up in basis without incurring a corresponding tax cost for the asset sale. In those instances, the application of the doctrine, pursuant to regulations, should be limited to preventing the abuse itself and should not invalidate the Section 336(e) Election.

Liquidation-reincorporation is a general term for attacks by the Internal Revenue Service on transactions in which a corporation ostensibly is liquidated, but all or a part of the essential operating assets of the corporation remain in corporate form, with the stock of the new corporation owned by some or all of the shareholders of the old corporation. The liquidation-reincorporation doctrine was developed primarily to combat transactions in which (a) taxpayers attempted to gain the benefits of a tax-free sale of assets followed by a liquidation under section 337 of the Internal Revenue Code of 1954 (the "1954 Code"), paying no corporate-level tax on the sale of assets, receiving the benefit of a step-up in the basis of the assets, but retaining the advantage of the corporate form with identical (or near-identical) ownership and (b) accumulated earnings were "bailed out" at capital gains rates (prior to the repeal of the capital gains deduction in 1986), through the taxation as capital

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H. R. Conf. Rep. 99-841, supra n. 31, at II-204.

gain of the liquidating distribution.[98] Not surprisingly, repeal of the corporate-level nonrecognition provisions of sections 336 and 337 of the 1954 Code has diminished considerably the appeal of reincorporation transactions.

Although there are several versions of the doctrine, the most usual grounds upon which the liquidation- reincorporation doctrine is asserted are: (i) that the transaction constituted a reorganization under section 368(a)(1)(D),[99] (ii) that the transaction did not truly constitute a liquidation and the distribution of assets to shareholders should be treated as a dividend under section 3 01,[100] or (iii) that the transaction constituted a reorganization under section 368(a)(1)(F).[101]

In the context of a disposition of Controlled stock to a related party in respect of which a Section 336(e) Election is made, the tax result will be the same as in a classic liquidation-reincorporation: liquidation of the pre-existing corporation (and the disappearance, or absorption by its parent, of its tax attributes); continuation of the corporation's business by a newly-formed corporation with no historical tax attributes, with a step- up in the basis of its assets; and

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98 See generally B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 14.54 (5th ed. 1987).

99 E.g., American Manufacturing Co. v. Commissioner, 55 T.C. 204 (1970); James Armour. Inc. v. Commissioner, 43 T.C. 295 (1964).

100 See e.g., Bazley v. Commissioner, 331 U.S. 737 (1947); Telephone Answering Service Co. v. Commissioner. 63 T.C. 423 (1974), aff'd by order, 546 F.2d 423 (4th Cir. 1976), cert. denied, 431 U.S. 914 (1977); Rev. Rul. 76-429, 1976-2 C.B. 97; Rev. Rul. 61-156, 1961-2 C.B. 62.

101 E.g., Reef Corporation v. Commissioner, 368 F.2d (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967). After the amendment of section 368(a)(1)(F) in TEFRA, adding the words “of one corporation,” attacks under section 368(a)(1)(F) seem less likely.

beneficial ownership of the enterprise by the same person or persons.

The Committee does not believe it appropriate to invoke Liquidation Reincorporation Principles, which to a large extent are judicially created, in a manner that would render the legislatively created Section 336(e) Election largely unworkable or otherwise ineffective in achieving the tax results intended explicitly by Congress. Moreover, the fact that under current law the disposition attracts a corporate level tax means that the step-up in tax basis of the assets "has been paid for."

The Committee thus believes that Liquidation Reincorporation Principles should be applied only in limited circumstances to a stock disposition in respect of which a Section 336(e) Election is made. We believe that those circumstances are where (1) Newco is "controlled" by Parent within the meaning of section 304(c), and (2) the principal purpose of the transaction was to secure tax rather than business objectives.

Relying on the section 304(c) control test seems appropriate here since a direct asset transfer by Controlled would normally not achieve the tax result intended by the taxpayer if the transaction qualifies as a reorganization under section 368(a)(1)(D) (which, as a result of section 368(a)(2)(H), depends on section 304(c)). On the other hand, it would not prevent section 336(e) from applying as intended to other nominally related party transactions, such as a non-qualified spinoff of Controlled to public shareholders.

In addition, in order to reduce the uncertainty inherent in applying a "principal purpose" standard, the Committee

proposes the adoption of rebuttable presumptions relating to the tax consequences arising from the transaction. If the control requirement described above is met, a transaction would be presumed to have as its principal purpose the securing of tax benefits if:

> (i) the present value of the anticipated future tax benefits to Newco arising from the transaction (assuming the operation of section 336(e)) is greater than
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> (ii) the current year's actual, out-of-pocket tax cost of the transaction to Parent and Controlled.

Conversely, if the reverse is true -- that is, if (ii) is greater than (i) above -- a presumption would arise that securing tax benefits is not the principal purpose of the transaction. The measurement of the anticipated future tax benefits to Newco would compare the projected tax liability of Controlled (or the consolidated group of which Controlled is a member) for all future years had the sale, exchange or distribution of Controlled stock not occurred with the projected tax liability of Newco (or its consolidated group) for all future years as a result of the Section 336(e) Elections, based to the extent feasible on reporting positions actually adopted by Newco.[102] The current year's tax cost of the transaction to Parent and Controlled would be calculated as the incremental increase in

[102] In measuring the present value of future tax benefits, the question arises as to what discount rate should be used. The Committee believes that taxpayers should be permitted use of the applicable federal rate under section 1274(d) (assuming a term equal to the length of the period during which future tax benefits are expected to arise), but since these rates will generally be lower than a true market cost of funds to a particular taxpayer, taxpayers should be permitted to establish more appropriate discount rates based on actual borrowing costs or the prime rate.

their (or the consolidated group's of which they are members) actual federal income tax liability for the year of the transaction, after taking into account all available loss carryovers and credits.[103]

In either case, the presumption would not be conclusive - instead, the presumption may be rebutted if the taxpayer (or the Service) presents "clear and convincing evidence" that the principal purpose of the transaction was not (or was) to secure the tax benefit involved. The Committee believes that the inclusion of such a presumption in regulations under section 336(e) would be extremely useful both in providing a safeguard against abusive transactions and in increasing the predicatability of the tax consequences of the section 336(e) Election in related party transactions.

This operation of this presumption can be illustrated by the following example:

> Example 15. Parent and Controlled are members of a consolidated group and Parent owns 100% of the stock of Controlled, for which it has a basis of $1,000. Controlled*s basis in its assets (net of liabilities) is $1,500. The Group is subject to tax at 34% on its incremental income and has no available losses or credits to reduce tax liability on the sale. Parent sells all of the stock of Controlled to a related person outside the Group for $1,600 and makes a Section 336(e) Election. Following the stock sale, Parent "controls" Newco within the meaning of section 304(c).

In this example, the current year's tax liability attributable to the transaction is $34 - the tax on the $100 of gain recognized by Controlled on the deemed sale of its assets to Newco. (The fact that the Group's tax would have been larger had the stock sale occurred but no Section 336(e) Election was made is irrelevant for purposes of the presumption.) If the present value

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[103] Thus, for purposes of this rule, use of tax attributes would not constitute an out-of-pocket tax cost.

of current and future tax benefits available to Newco (as compared to those benefits that would have been available to Controlled had the stock sale transaction not occurred) is less than $34, it would be presumed that tax avoidance was not the principal purpose for the transaction.

Set forth below is a discussion of each of the specific examples cited in the Conference Committee Report as situations in which Liquidation Reincorporation Principles might be applied. We emphasize that the limitations on the ordinary effects of a Section 336(e) Election discussed below would apply only to cases in which Newco is controlled by Parent within the meaning of section 304(c).

1. Use of Net Operating Losses to Offset Liquidation Gains.

As indicated above, the Conference Committee voiced a concern that net operating losses (“NOLs”) would be offset inappropriately against liquidation gains.

The Committee recognizes that in the context of related party transfers, taxpayers may initiate transactions in which a Section 336(e) Election would be made when the principal purpose of the transaction was to utilize expiring or otherwise limited tax benefits to offset the gain on the sale of Controlled's assets, thereby gaining the benefit of a basis step-up at essentially no tax cost. Such use may arguably be viewed as an abuse of section 336(e). Tax benefits which may be susceptible to this type of abuse include NOLs, foreign tax credits, other credits, and capital loss carryovers.

There are at least three contexts in which this potential abuse may arise. First, and most obvious, is the use of

a Section 336(e) Election to "freshen" an NOL expiring under section 172(b)(1)(C)(ii). In such a case, any gain on the deemed asset sale resulting from the Section 336(e) Election would be sheltered by NOLs and such NOLs would be "rejuvenated" through increased depreciation and amortization deductions of Newco. Second is the use of a Section 336(e) Election to avoid application of the SRLY rules by using SRLY losses of Controlled to offset asset-sale gain resulting from the Section 336(e) Election and effectively recreating those losses in Newco, again through increased depreciation and amortization deductions, without the SRLY taint.[104] Finally, a taxpayer with an NOL that is usable under section 382 only against unrealized built-in gains recognized within five years of an ownership change[105] may employ a Section 336(e) Election to utilize an otherwise unusable NOL.[106]

If a Section 336(e) Election is made for a disposition of stock by Parent where Parent "controls" Newco, and the transaction is undertaken primarily for one or more of these tax avoidance purposes, the Committee believes that it might be appropriate to apply the liquidation reincorporation doctrine. Thus, the regulations might provide that, notwithstanding the general provision that the sale of Controlled*s assets to Newco in exchange for Newco stock does not constitute a reorganization and is not subject to Liquidation Reincorporation Principles, in

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[104] We have considered whether transfers of the stock of Controlled within a consolidated group are somehow particularly subject to abuse. Our conclusion is that, quite to the contrary, there is even less likelihood of an abusive transfer there since the ability to "refresh" a SRLY is far more limited than outside of consolidation because of the deferred intercompany transaction rules.

[105] Section 382(h).

[106] If a sale or distribution as to which a Section 336(e) Election is made is within a consolidated group, the benefit would be limited to the gain restored within the five-year period under the consolidated return rules. Treas. Reg. § 1.1502-13(d) through (f); Prop. Treas. Reg. § 1.1502- 91(h)(3).

these cases the liquidation-reincorporation doctrine may be applied with the result that Newco would take a carryover basis in Controlled's assets and Newco would succeed to Controlled's NOLs and other tax attributes under section 381.

The principal purpose presumption described above would be particularly useful in this context.

> Example 16. Parent, which is the common parent of an affiliated group filing consolidated returns (“Group”), owns 100% of the stock of Controlled, which is engaged in a manufacturing business. Parent's basis in the Controlled stock is $100, and Controlled*s basis in its assets (net of liabilities) is also $100. On December 1, 1991, Parent sells all of its Controlled stock to P for $200. P is a partnership which is related to Parent, with the result that Controlled is, and if a Section 336(e) Election were made, Newco would be, “controlled” by Parent within the meaning of section 304(c). Group has net operating losses which are carried forward into 1991, and are sufficient to shelter all of its income for 1991, including the gain on the deemed sale by Controlled of its assets to Newco.

As a result of the Section 336(e) Election, the assets deemed purchased by Newco have a stepped-up basis, resulting in greater depreciation, amortization and other cost recovery deductions, as compared to the deductions that would be available to Controlled if the transaction had not occurred. Group has no tax liability for 1991 as a result of the transaction. Thus, unless Group can establish that Newco’s enhanced deductions resulting from the basis step-up is not expected to reduce the tax liability on it and Group for future years, say, because of NOLs that would have been available to Group absent the sale, a presumption arises that the principal purpose for the transaction is to secure the tax benefits of the stepped-up asset basis for Newco. Absent clear and convincing proof that securing this benefit was not the principal purpose of the transaction. Liquidation Reincorporation Principles (if otherwise applicable) would be applied.

To enable taxpayers to avoid the potential application of the Liquidation Reincorporation Principles to a Section 336(e) Election where Parent "controls" Newco, we suggest that the section 336(e) regulations make available to taxpayers an "offset prohibition election" along the lines provided in Treas. Reg. § 1.338-4T(f) (6) (iv).[107] If such election were made, Liquidation Reincorporation Principles generally would not be applied. This might be particularly useful, for example, in a distribution by Parent of Controlled stock where Controlled has a SRLY. If such election were not made and if Liquidation Reincorporation Principles were applied, Newco would receive a carryover basis in Controlled's assets even though Parent may recognize gain on the deemed distribution of Newco's stock. The offset prohibition election would give Newco a stepped-up basis and move the taxable gain to Controlled on the sale of its assets while denying it use of its SRLY to shelter such gain.

The making of an offset prohibition election would not automatically assure that Liquidation Reincorporation Principles would not be applied, unless the basis for potential tax abuse is available loss or credit carryovers. If, notwithstanding such an election, the present value of current and future tax benefits resulting from the transaction (say, because of a beneficial change in accounting method) exceeded the tax cost of the

[107] Temp. Treas. Reg. § 1.338-4T(f)(6)(iv) provides for a protective carryover election, which can be made in the event of a qualified stock purchase of a target corporation under section 338. The effect of a protective carryover election is that if a tainted asset acquisition occurs (that is, an asset acquisition that, under the asset consistency rules of section 338(e), could result in a deemed section 338 election) and the transferor and acquiror are not members of a consolidated group, the basis of the asset to the acquiror is the same as its basis to the transferor immediately prior to the tainted acquisition. If an offset prohibition election is made, the acquiror obtains a stepped-up basis in the transferred asset, at the cost of gain recognition by the transferor, which gain (and the tax liability arising therefrom) may not be offset by any deductions (or credits) available to the transferor in the year of transfer.

transaction, the taxpayer would still face the presumption that tax avoidance was the principal purpose for the transaction.

2. Earnings and Profits of Controlled.

With regard to earnings and profits ("ESP"), the Committee believes that as a general rule Parent should succeed to the E&P of Controlled, as if Controlled had liquidated, under the rule of section 381(a)(1) and (c)(2). Thus, after a stock disposition in respect of which a Section 336(e) Election is made, the transferees of the Controlled stock (including the stockholders of Parent, in the case of a distribution), will own stock in Newco, and Newco will have no E&P, because any such E&P would have been eliminated on the deemed liquidation.

The Committee recognizes that, although both a corporate-level (and, in the case of most distributions, a shareholder-level tax) would be incurred on the disposition of controlled stock, Treasury may believe that the elimination of E&P in certain transactions is an inappropriate consequence of the Section 336(e) Election. For example, if the Controlled stock were actually distributed in the context of a liquidation of Parent, Controlled would pay a full corporate-level tax on the gain inherent in its assets deemed sold, and the shareholders of Parent would receive the Newco stock in full or partial exchange for their stock of Parent. This latter exchange would be treated as a capital transaction (i.e., capital gain or loss after offset

of basis in Parent stock).[108] Under the ordinary rules of section 3 81, any E&P of Controlled {as well as Parent) would be eliminated in the deemed liquidation, and never would be taxed as a dividend. Newco would then be free to distribute any cash which it either had prior to the distribution of Parent's stock of Controlled or which it borrowed after such distribution (which would not create E&P at the corporate level) with the distribution taxed to the shareholders as a return of capital rather than as a dividend.[109]

The language of the Conference Committee Report cited above[110] indicates that the conferees did not intend that a Section 336(e) Election should be invalidated merely because it was made under conditions that might lead to potential abuse. The appropriate "remedy" is "to provide special rules for such corporation's section 381(c) attributes . . . ." Thus, the Committee believes that regulations, if any are deemed necessary, should provide a narrowly crafted response to this potential abuse. For example, an anti-abuse rule could provide that, in the related party context, distributions by Newco within a period of two to five years after the distribution of Controlled should be characterized as a dividend to the extent of the E&P of Controlled which was eliminated in the deemed section 332 liquidation. Alternatively, the E&P could be carried over to

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[108] Section 331(a). See section III.B.3.b(1) supra, regarding the availability of a Section 33 6(e) Election in the context of the liquidation of a holding company.

[109] Another transaction which might be addressed is a distribution to which section 355(d) applies. In such a distribution, unlike a liquidating distribution, only Parent would be taxed; however, any E&P in Controlled would remain in corporate solution in Parent. The Committee recognizes, however, that Treasury could deem the shift of E&P to be inappropriate. In such event, the Committee believes that the remedy outlined herein for liquidating distributions might be appropriate.

[110] See supra, n. 97.

Newco applying the principles underlying the liquidation-reincorporation doctrine as described above, instead of being eliminated in the distribution.

3. Accounting Methods.

The Conference Committee Report also states a concern that a stock distribution in respect of which a Section 336(e) Election is made may allow a corporation an opportunity to change its accounting methods.[111] The Committee believes that Newco generally should be allowed to adopt new accounting periods, methods and conventions upon the deemed acquisition of Controlled's assets. This result is consistent with the treatment of Newco as a new corporation following the Section 336(e) Election, and reflects the facts that Newco has no historic tax attributes and, as a purchaser of assets, has a full fair market value basis in its assets. The Committee recognizes that it would be possible, however, to change accounting methods by making a Section 336(e) Election when permission to make such a change might not otherwise be granted, and a direct sale of assets would not achieve such a result (e.g., because it would be treated as a reorganization under section 368(a)(1)(D)). Thus, if the principal purpose of the transaction is to achieve this accounting method change, Liquidation Reincorporation Principles should be applied.

Again, the principal purpose presumption could be applied to determine whether the principal purpose of a transaction is to obtain the benefit of an accounting method change.

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[111] H.R. Conf. Rep. 99-841, supra n. 31, at II-204.

> Example 17. Parent, which is the common parent of an affiliated group filing consolidated returns ("Group"), owns 100% of the stock of Controlled, which is engaged in a manufacturing business. Parent's basis in the Controlled stock is $100, and Controlled's basis in its assets (net of liabilities) is also $100. Controlled uses the FIFO method of inventory accounting. On December 1, 1991, Parent sells all of its Controlled stock to P for $120 and makes a Section 336(e) Election. P is a partnership which is related to X, with the result that Newco is "controlled" by Parent within the meaning of section 3 04(c). Newco adopts the LIFO method of inventory accounting.

If the present value of the tax savings achieved by reason of the $2 0 step-up in asset basis combined with the change from FIFO to LIFO accounting is less than Group's tax liability resulting from the transaction, it would be presumed that the transaction was not undertaken with the principal purpose of obtaining these tax objectives.

V. Other Issues Arising Under Section 336(e).

A. Consistency Rules.

In a previous report of the Tax Section (the "Consistency Report"), we took the position that the consistency rules under section 338 were no longer appropriate in light of the repeal of the General Utilities doctrine and urged their repeal.[112] For the reasons discussed in the Consistency Report, we also believe that the consistency rules should not be extended to Section 336(e) Elections.

The section 338 consistency rules are divided into two parts: section 338(e) contains the asset consistency rule and section 338(f) contains the stock consistency rule. In general,

[112] New York State Bar Association, Tax Section, Report on the Role of Section 338 Consistency Rules After Repeal of the General Utilities Doctrine, 7-8 (Nov. 29, 1990).

the asset consistency rule provides that a section 338 election will be deemed to have been made by a purchasing corporation if, at any time during the consistency period, it acquires any asset of a target corporation or a target affiliate. The stock consistency rule requires that all qualified stock purchases by a purchasing corporation during a consistency period with respect to a target and one or more target affiliates be treated the same; that is, if a section 338 election was made for the first purchase, it applies to all subsequent purchases, and if no section 3 38 election was made for the first purchase, it may not be made for subsequent purchases.

The Consistency Report concluded that:

> [t]he 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 enacted when section 338 was introduced in 1982. . . . [B]ecause 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.[113]

Recognizing that the repeal of the consistency rules by Congress would likely take a good deal of time to effect, the Consistency Report recommended several ways in which Treasury could narrow the scope of its regulations under the consistency rules in the absence of Congressional repeal.[114] Since there is no statutory mandate that consistency rules be incorporated in regulations issued under section 336(e), Treasury is in theory free to implement section 336(e) without the undesirable baggage of the consistency rules. We believe, however, that it would not

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[113] Id. at 7.

[114] Id. at 31-48.

be sensible tax policy to create a dichotomy between sections 336(e) and 338(h)(10) of the magnitude that would exist if consistency rules were not applied to section 336(e) at the same time as the section 338(h)(10) consistency rules remain in existence. This is particularly so in light of the Congressional mandate to apply section 338(h)(10) principles in implementing section 336(e).

Consistency rules applicable to Section 336(e) Elections that conform to those applicable under section 338 are logically necessary in the following situations: (i) where there are two or more sales by Parent, or its affiliated group, of separate 80% interests to the same or affiliated purchasers, (ii) the subsidiary itself (Controlled) for which a Section 336(e) Election is made has stock ownership in lower-tier subsidiaries meeting the requirements of section 336(e), and (iii) a single seller or more than one affiliated sellers transfer assets of one business to a purchaser and transfer the stock of subsidiaries to the same or affiliated purchasers.

In light of the foregoing discussion, we make the following two recommendations as to adoption of consistency rules under section 336(e). First, the interim rules set forth in the Consistency Report to simplify the consistency rules should be adopted. Second, the applicability of the consistency rules should be limited to those situations where multiple sales of stock and/or assets are made to a single purchaser (or certain related purchasers). For example, consistency might be required where Controlled itself owns stock of corporations meeting the section 1504 requirements,[115] or where the same purchaser acquires

[115] In this event, each such subsidiary would be deemed to liquidate into its immediate parent until the last such subsidiary liquidates into Controlled. Compare Treas. Reg. § 1.338(h)(10)-1T(e)(3) and Ex. 6.

the stock of Controlled and its sister company. Consistency should not be required, however, where Parent separately sells stock of two controlled subsidiaries to unrelated buyers. Application of the consistency rules in this or similar situations would make them even more complex and burdensome than under section 338.

Where the purchaser is a single corporation, the application of the consistency rules can and should be conformed completely to the section 338 rules. Thus, the determination of who are related purchasers for purposes of determining whether a single purchaser exists should, in the case of corporate purchasers, be made by reference to section 338(h)(8), which treats members of an affiliated group as one purchaser. There is no section 338 analogue for non-corporate purchasers. For the reasons stated above, we suggest the adoption of attribution rules that are not overly broad and are consistent with the purpose of section 336(e).

In addition, to the extent consistency rules are applicable, rules similar to Temp. Treas. Reg. § 1.338-6T should apply. Under this rule, if Controlled owns stock of a subsidiary {“Sub”) meeting the section 336(e) ownership requirements and, by reason of a Section 336(e) Election and application of consistency rules, a deemed sale of Sub's assets occurs, no gain or loss would be recognized by Controlled on the deemed sale of Sub stock.

As a technical matter, the regulations need to make clear that a Section 336(e) Election creates an asset acquisition for purposes of section 338(f) and that a section 338 election creates an asset acquisition for purposes of section 336(e).

B. Responsibility for Payment of Tax.

The section 338(h)(10) regulations provide that the target shall continue to be liable for the taxes of the consolidated group after its acquisition by the purchaser for all taxable years for which it was a member of the selling group.[116] While the Committee would prefer that the rule for both section 338(h)(10) and section 336(e) be that Parent (or where applicable the selling consolidated group) is solely responsible for the payment of all taxes attributable to Controlled's activities prior to the sale, including the taxes generated by the sale, we believe that the section 336(e) rule should conform to the section 338(h)(10) rule.

C. Joint Election.

The Committee believes that the Section 336(e) Election should be made jointly by Parent and Newco (i.e., Controlled, subsequent to the disposition) in the case of a sale or exchange. The original version of section 336(e) provided that "such corporation [referring to Parent] may elect." The Technical and Miscellaneous Revenue Act of 1988 amended section 336(e) by inserting in lieu of the above quoted words "an election may be made."[117] While this language is not itself a pinnacle of clarity, it is clear from the legislative history that the purposes of the amendment was to prevent a unilateral election by parent in the case of a sale or exchange.[118] Moreover, the revised language

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116 See Treas. Reg. § 1.1502-6(a); Temp. Treas. Reg. § 1.338-4T(1)(1); Temp. Treas. Reg. § 338(h)(10)-1T(e)(8).

117 Pub. L. No. 100-647, sec. 1006(e)(3), 102 Stat, 3342, 3400.

118 S. Rep. 100-445, 100th Cong., 2d Sess. 59 (1988).

follows the precise language of section 338(h)(10), which has been construed in the regulations to require a joint election.[119] In the case of a distribution by Parent of Controlled stock, however, the election should be made at the sole discretion of Parent before the distribution. For purposes of section 338(h)(10), the election is to be made jointly by the purchaser and the seller. In the case of section 336(e), however, where the purchasers of the stock of Controlled might be a widespread and diverse group, requiring each purchaser to consent or participate in the election would be unwieldy (or worse).[120] Therefore, we suggest that the election be made jointly by Parent and Newco on behalf of the purchasing group by Newco as it is constituted following the section 336(e) sale. Controlled could, of course, be contractually bound to make the election (in its capacity as "Newco") following the transfer of its stock.

D. Transactions Involving Foreign Corporations

The Committee believes that, in general, the Section 336(e) Election should be available upon the disposition of Controlled stock regardless of the domestic or foreign status of Controlled or Parent. In some instances, however, it may be appropriate to treat transactions involving foreign Parents and Controlleds differently from similar transactions involving solely U.S. corporations. Further, the status of transferee(s) of the Controlled stock as either domestic or foreign should never be relevant to the availability of the Section 336(e) Election.

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[119] Temp. Treas. Reg. § 1.338(h)(10)-1T(d)(1).

[120] This would be particularly true if the Section 336(e) Election is to be made with respect to dispositions of Controlled stock over a period of time pursuant to a single plan. See supra text at n. 49.

The application of the principles described in the preceding sections of this report to cross-border transactions is discussed below.

1. Sales and Exchanges of Controlled Stock.

a. Domestic Parent and Foreign Controlled.

In the absence of a Section 336(e) Election, gain on the sale of the stock of foreign Controlled is fully taxed to domestic Parent. Under section 1248, this gain is treated as a dividend to the extent of Parent's pro rata share of Controlled's earnings and profits ("E&P") accumulated while it was a controlled foreign corporation ("CFC") of Parent, and Parent is entitled to a deemed-paid foreign tax credit with respect to such deemed dividend.[121]

If the Section 336(e) Election is made with respect to the sale of Controlled, Controlled would be treated as having sold all of its assets. Controlled would not be subject to U.S. tax on the gain arising from the deemed sale except to the extent the assets deemed sold were used in a U.S. trade or business or are U.S. real property interests. Parent may be required to include the gain in its income to the extent it constitutes subpart F income. Upon the deemed liquidation of Controlled, section 332 would not apply unless Parent included in gross income the "all earnings and profits amount," (the "all E&P amount") which would include, presumably, the gain recognized on

[121] Treas. Reg. § 1.1248-1(d)(1).

the deemed sale of Controlled's assets.[122] This inclusion would be treated as a dividend to Parent,[123] carrying with it a deemed-paid credit under section 902 (subject to the application of section 338 (h) (16) principles, discussed below).[124]

Note, in this regard, that inclusion of the all E&P amount is elective on the part of the distributee under the current section 367 regulations. (Recently proposed amendments to the section 367 regulations would continue this treatment by providing for a gain recognition election on the liquidation of Controlled.[125]) If Parent does not elect to include this amount, it is taxable on the deemed liquidation of Controlled under section 331 and the full gain realized by Parent is recognized by it, subject to dividend characterization under section 1248.[126] The effect is no different than if the Section 336(e) Election had not been made in the first instance, except that the amount of the section 1248 dividend would be increased to reflect the gain realized by Controlled on the deemed sale of its assets. In either case (i.e., whether or not section 332 applies to the liquidation), as a result of the deemed liquidation of Controlled, Parent will succeed to Controiled's tax attributes under section 381. Under the proposed section 367 regulations, however, a gain recognition election by Parent will reduce certain tax attributes which would otherwise carry over to

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122 Temp. Treas. Reg. § 7.367(b)-5(b).

123 Temp. Treas. Reg. § 7.367(b)-3(b).

124 Temp. Treas. Reg. § 7.367(b)-3(f).

125 Prop. Treas. Reg. § 1.367(b)-3(b)(2)(i) and (iii).

126 Temp. Treas. Reg. § 7.367(b)-13, Ex. 2.

Parent.[127] In addition, the proposed regulations provide that only unused foreign tax credits available to Controlled under section 906 will carry over to Parent.[128]

> Example 18. Domestic Parent owns 100% of the stock of foreign Controlled. Controlled's basis in its assets is $2,000, and it has E&P (none of which was previously taxed under subpart F) of $1,000, all of which accumulated while Controlled was a CFC of Parent. Controlled has no liabilities. Parent's basis for the Controlled stock is $1,500. Parent sells all of the Controlled stock to Buyer for $5,000 of cash, and makes a Section 336(e) Election.
>
> > (a) All E&P Amount Included. Controlled recognizes gain of $3,000 on the deemed sale of its assets, increasing its E&P to $4,000. The all E&P amount is $4,000, which Parent includes as a dividend from Controlled, carrying deemed-paid foreign tax credits under section 902.
> >
> > (b) Gain Recognition Election Made. Controlled*s E&P is $4,000, as in (a) above. Under both the current and proposed section 367 regulations, Parent recognizes gain of $3,500 on the distribution of cash in complete liquidation of Controlled. Under section 1248, all of this gain is treated as a dividend, bringing deemed-paid foreign tax credits. Under the proposed regulations, any NOLs and capital loss carryforwards of Controlled are reduced by $500. Because all of the proceeds of the deemed liquidation of Controlled consist of cash, the basis reduction rule of the proposed regulations is inapplicable.

The Committee believes that this elective treatment by Parent should be applicable in the case of a deemed liquidation of Controlled pursuant to a Section 336(e) Election.

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[127] Prop. Treas. Reg. § 1.367(b)-3(b)(2)(iii)(A). Note that Parent will succeed to Controlled's net operating loss carryforwards only to the extent they were derived from a U.S. business. See Rev. Rul. 72-421, 1972-2 C.B. 166.

[128] Prop. Treas. Reg. § 1.367(b)-3(d). Parent should, of course, be able to carry forward deemed-paid credits attributable to the inclusion of the all E&P amount or (if the gain recognition election is made) the section 1248 dividend.

(1) Effect of Section 338(h)(16).

The Section 336(e) Election raises substantially the same issues as those addressed by section 338(h)(16). Under that section, except as provided in regulations (which have not yet been promulgated), section 338 generally does not apply for purposes of determining the source or character of any item for purposes of sections 901 through 908. The principal effect of section 338(h)(16) is that, except to the extent section 1248 applies without regard to the deemed asset sale, gain recognized by Parent is treated as domestic source (unless section 865(f), section 865(h) or a special treaty rule applies) and is included in the passive basket for section 904(d) purposes.[129] Absent this rule, the additional dividend inclusion resulting from "enhanced" E&P generated by the deemed asset sale would be a foreign- source dividend, classified under the CFC look-through rules of section 904(d)(3).

> Example 19. The facts are the same as Example 18(a). Absent the Section 336(e) Election, Parent would have $3,500 of gain, $500 of which would be treated as a dividend under section 1248. For foreign tax credit limitation purposes, this $500 would be foreign source income, and its character would be determined under the look-through rules of section 904(d)(3). The remainder of Parent's gain is capital gain and would be passive income under section 904(d), and would be domestic source unless section 865(f) or section 865(h) (or special treaty rule) applied. If the Section 336(e) Election is made, all of the gain to Parent would be a dividend under section 1248. However, under section 338(h)(10) principles, $500 of this dividend is foreign source and is characterized under the look-through rules, and the balance of the dividend is sourced and characterized in the same manner as the capital gain described above.

The legislative history makes clear Congress' intent that the principles of section 338(h)(16) apply in the section 336(e) context.[130] Thus, regulations under section 336(e) should

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[129] See H. Rep. 100-795, 100th Cong., 2d Sess. 314-315.

[130] See id. at 315.

provide for the application of the principles of section 336(h)(16) (including any exceptions thereto to be provided in forthcoming regulations under that section) in the case of a Section 336(e) Election with respect to the stock of Controlled.

(2) Treatment of Minority Stockholders.

An additional question arises as to the treatment of minority shareholders of the target as a result of the Section 336(e) Election. In the section 338 context, Temp. Treas. Reg. § 1.338-5T(g) generally provides that the gain from the deemed sale is included in E&P for purposes of applying section 1248 to all stockholders otherwise meeting the ownership requirements of section 1248, including minority stockholders.[131] If such a minority shareholder does not sell in the qualified stock purchase, the shareholder apparently must nevertheless include any subpart F income arising as a result of the deemed sale.[132] In addition, in such event, the E&P (and associated foreign tax credits) of old target, enhanced by the gain on the deemed sale of old target's assets, carry over to new target solely with respect to the stock retained by the minority shareholder. This carryover amount is capped by the amount that would have been treated as a dividend under section 1248 had the minority shareholder sold the stock of old target in the qualified stock purchase.[133]

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[131] If the stockholder does not meet the section 1248 ownership requirements, the deemed sale under section 338 has no impact.

[132] See Temp. Treas. Reg. § 1.338-5T(f).

[133] See Temp. Treas. Reg. § 1.338-5T(g)(2)(iii) and (g)(6)

The Committee questions the appropriateness of treating a nonselling minority shareholder in this manner, given the lack of control such shareholder has over whether a Section 336(e) Election is made. However, this lack of control is also present in the section 3 38 context, and the Committee sees no basis for providing different treatment under section 336(e).

b. Foreign Parent.

(1) Domestic Controlled.

Under a Section 336(e) Election on the sale of a domestic Controlled by a foreign Parent, the principles discussed above in the solely domestic context should apply without modification. Controlled would recognize gain on the deemed sale of its assets, the full amount of which is subject to tax in the United States. The distribution of proceeds to Parent should be tax-free under section 332. Section 367(e)(2), which denies tax-free treatment to the liquidating corporation on a distribution to a foreign 80-percent distributee in a section 332 liquidation, is rendered irrelevant in this context because Controlled recognizes the entire gain on its assets in any event.

If Parent has direct or indirect U.S. owners, the Section 33 6(e) Election has the effect of creating no gain at the Parent level, whereas if the election had not been made, gain would be recognized by Parent which would be subpart F income. The effect of the Section 336(e) Election is appropriate, however, because Controlled has recognized the full gain on its assets. If Parent also recognized subpart F income attributable to stock gain, the effect would essentially be a double tax, since the stock gain generally would be duplicative of the corporate level gain recognized by Controlled.

In addition, a collateral consequence of the Section 336(e) Election is that Parent generally succeeds to the E&P of Controlled under section 381.[134] This E&P generally represents income on which tax has been imposed when earned by Controlled. In order to prevent double taxation of this E&P, the Committee recommends that such E&P be treated as post-1986 undistributed U.S. earnings within the meaning of section 245(a)(5).[135] Such treatment would allow the U.S. stockholders of Parent to take a dividends-received deduction when the E&P is later distributed by Parent.

(2) Foreign Controlled.

The Temporary Regulations under section 338 provide that the election thereunder is available regardless of the fact that the purchasing corporation or the target, or both, are foreign.[136] Thus, if the qualified stock purchase is a transaction by which the target enters the U.S. tax system (e.g., becomes a CFC or noncontrolled 902 corporation), the tax history of the target may be purged upon the qualified stock purchase: target's asset bases

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[134] See Temp. Treas. Reg. § 1.367(e)-2T(b)(3)(v).

[135] Section 245(a) provides for a dividends-received deduction for the U.S. source portion of a dividend paid by a foreign corporation, which is calculated as the ratio of the foreign corporation's post-1986 undistributed U.S. earnings to its total undistributed earnings. In addition, section 243(e) provides generally that dividends paid by a foreign corporation from E&P accumulated by a predecessor domestic corporation shall be treated as dividends from a domestic corporation. Section 243(e) was not amended in connection with the substantial amendments to section 245 in 1986, and the interaction of the two provisions is unclear. For example, under section 245(a)(5), post-1986 undistributed U.S. earinings include, inter alia, dividends received by a foreign corporation from an 80%-owned U.S. subsidiary, regardless of the year in which the E&P of the subsidiary were generated. Section 243 contains no similar ordering rule for determining when a distribution by a foreign corporation is made out of a domestic predecessor's E&P.

[136] See generally Temp. Treas. Reg. § 1.338-1T(k).

may be stepped-up and its E&P eliminated. Such an election can have collateral tax consequences on direct or indirect shareholders of the target prior to the transaction.[137] Except for the application of Liquidation Reincorporation Principles (discussed below), the Committee believes that section 336(e) should similarly be available when both Parent and Controlled are foreign corporations.

When both Parent and Controlled are foreign, gain to Controlled is taxable by the United States on a deemed sale of its assets under section 336(e) only with respect to property used in a United States trade or business and United States real property interests. In addition, assuming Controlled is a CFC, gain on the deemed sale may generate subpart F income currently taxable to Parent's United States shareholders.

No gain or loss is recognized to Parent on the constructive liquidation of the target. Because the regulations under section 367(b) and section 367(e)(2) exempt foreign-to-foreign liquidations from those provisions, sections 332 and 337 apply to this liquidation.[138] Under section 381, Parent would succeed to Controlled's tax attributes -- presumably including its E&P resulting from the deemed asset sale.[139]

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[137] Temp. Treas. Reg. § 1.338-5T.

[138] Temp. Treas. Reg. § 7.367(b)-5(c); Temp. Treas. Reg. § 1.367(e)-2T(c). Gain is required to be recognized by Controlled with respect to property used in a U.S. trade or business, but such gain is recognized in any event on the deemed asset sale.

[139] This would also appear to be an appropriate context for application of section 338(h)(16), since the source and character of these earnings and profits would have an effect on deemed-paid credits when dividends are paid by Parent in the future.

The Committee recognizes that if the foreign Parent is a CFC, the effect of a Section 336(e) Election may be to place its U.S. stockholders in a better position than if no election were made. Absent the election, gain on the sale of Controlled stock would be subpart F (foreign personal holding company) income, and passive income under section 904(d).[140] There may be no subpart F income on the deemed asset sale. As noted above, a Section 336(e) Election has the effect of treating the proceeds of the stock sale as a distribution in complete liquidation of Controlled under section 332, resulting in no gain or loss recognition to the seller (and, thus, no subpart F income) on the stock disposition. Nevertheless, if Controlled had actually sold its assets and liquidated into Parent, no greater amount of subpart F income would be recognized than on a deemed asset sale under section 336(e). The Committee believes that such parity in results for the United States shareholders of Controlled is appropriate.

2. Distributions Involving Foreign Corporations.

The Committee believes that, where foreign corporations are involved, the Section 336(e) Election should be equally available to distributions and sales of Controlled stock. Generally, the treatment of a distribution where Parent or Controlled (or both) is a foreign corporation should be the same as for a sale. However, the distribution case involves an

[140] Section 954(c). The proposed Tax Simplification Act of 1991 would treat this stock gain as a dividend under section 1248 principles if both Parent and Controlled are CFCs. H.R. 2777, sec. 311(a). The effect of this provision would be to apply "look-through" rules to determine the character of the stock gain for foreign tax credit limitation purposes under section 904(d). The stock gain would continue to be subpart F income under the bill. See, generally, staff of the Joint Committee on Taxation, Technical Explanation of the Tax Simplification Act of 1991 (H.R. 2777 and S. 1394) (1991), p. 63.

additional step that is not present in the sale case -- namely, the deemed distribution of Newco stock to Parent's shareholders.

a. Domestic Parent and Foreign Controlled.

In this case, Controlled is treated as having transferred its assets in a taxable exchange for Newco stock, followed by a complete liquidation of Controlled. Here, Parent's basis in its Newco stock should be equal to its fair market value. Because Parent must recognize full gain on this transaction (either through inclusion of the all E&P amount or by recognizing gain on the Controlled stock in the deemed liquidation), there should be no additional gain recognition to Parent on the stock distribution by Parent to its shareholders.

Prop. Treas. Reg. § 1.367(b)-3(b)(2)(iii) would change this result. Under those regulations, the tax attributes to which Parent succeeds under section 381 are reduced if a gain recognition election is made to the extent the amount of gain recognized is less than the all E&P amount. This attribute reduction applies first to NOLs and capital loss carryforwards, and any additional reduction is applied to the basis of the assets received by Parent in the liquidation (other than money). Applying this rule to a Section 336(e) Election made in respect of a distribution would require the reduction of Parent's basis in Newco stock, and additional gain upon the deemed distribution of that stock by Parent to its shareholders.

> Example 20. The facts are the same as Example 18(b), except that Parent distributes the Controlled stock, having a fair market value of $5,000, pro rata to its shareholders (and section 355 does not apply). Because the gain recognition election is made, Parent recognizes gain of $3,500, all of which is treated as a dividend under section 1248. Under the proposed regulations, the carryover basis of the Newco stock ($5,000) is reduced by $500 -- the excess of the all E&P amount ($4,000) over the gain recognized

on the distribution ($3,500) — to $4,500. Because Parent is deemed to distribute immediately the Newco stock to its shareholders, additional gain is recognized to Parent under section 311 in an amount equal to the excess of the value of the stock over its basis.

As a result of the basis adjustment, Parent's total income and gain recognized is $4,000. In contrast, if Parent sells the Newco stock for $5,000 cash, the Section 336(e) Election results in $3,500 of recognized income and gain.[141]

The Committee believes that taxing Parent on this additional gain is inappropriate. However, a discussion of the merits of the proposed section 367 regulations, which lead to the results described above, is beyond the scope of this report.

b. Foreign Parent. Domestic Controlled.

The Committee believes that the Section 336(e) Election should be available with respect to the distribution of the stock of a domestic Controlled by a foreign Parent regardless of whether a distributee shareholder of Parent is foreign or domestic. The Section 336(e) Election allows for a step-up in the basis of the assets of Controlled, at the cost of a tax on Controlled on the unrealized appreciation of such assets. Because there generally will be United States corporate-level tax imposed on the deemed asset sale by Controlled, the Committee believes that, the Section 336(e) Election should be available with regard to such a distribution.

[141] See Example 18.

c. Treatment of Distributees.

As previously stated, the Committee believes that the Section 336(e) Election should be available on a distribution of Controlled stock regardless of the status of the distributee as domestic or foreign.

In the case of a domestic Parent distributing to one or more foreign shareholders, if the distribution is treated as a dividend under section 301(a), Parent would be obligated to withhold 30% of the value of the stock under sections 871 and 881, unless the tax rate is reduced by an applicable treaty.[142] Because the amount of withholding does not change if a Section 336(e) Election is made, no new withholding issues are raised by the Section 3 36(e) Election.[143]

In the case of a foreign CFC Parent distributing to a United States shareholder, separate issues arise if Controlled is domestic. As previously noted, full gain recognition occurs at the Controlled level if a Section 336(e) Election is made. In this situation, the Committee reiterates its recommendation regarding the treatment of Controlled's E&P (which carries over to Parent on the deemed section 332 liquidation under section 381) as post-1986 U.S. earnings for purposes of section 245.[144] If the distribution to the U.S. shareholder is a dividend under section 3 01, this treatment would have an immediate impact on

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[142] This assumes that Parent is reimbursed for the withholding tax. If this is not the case, the amount of the withholding tax would actually be greater than 30% of the value of the Controlled stock, since the amount of the distribution must be “grossed up” to reflect the withholding tax.

[143] The Committee recognizes that, in valuing the distribution, the parties will need to take into account the benefit, if any, of a potential Section 336(e) Election.

[144] See supra, text at n. 135.

the taxation of that shareholder.

3. Application of Consistency Rules.

Under section 338(h)(6)(B), except as provided in regulations, a foreign corporation is excluded from the definition of a "target affiliate." The Temporary Regulations under section 3 38 generally provide that a foreign corporation is a target affiliate unless an election is made to exclude all foreign affiliates from target affiliate status (the "regular exclusion election").[145]

To the extent stock consistency rules under section 338 are to apply in the section 336(e) context, the Committee believes generally that rules applicable to foreign target affiliates under the section 338 temporary regulations should also apply under section 336(e). Thus, in the case of a domestic controlled, a regular exclusion election with respect to Controlled's foreign subsidiaies should be available under section 336(e). The rules of Temp. Treas. Reg. § 1.338-6T would also apply if a regular exclusion election is not made or if Controlled is a foreign corporation for which an express Section 336(e) Election is made.

4. Application of Liquidation Reincorporation Doctrine in Foreign Context.

As previously stated, the Committee is of the view that the liquidation reincorporation doctrine should not be applicable to deny section 336(e) treatment unless the principal purpose for

[145] Temp. Treas. Reg. § 1.338-5T(c)(2). The election is not available if the original target is a foreign corporation.

the transaction is tax avoidance. In the context where Parent and/or Controlled are foreign, the Committee has identified potential situations where the doctrine might apply under this standard.

As previously noted, a Section 3 36(e) Election in this context can have the effect of converting gain that is subpart F income to Parent into non-subpart F income to Controlled on an asset sale (with the E&P attributable to this gain carrying over to Parent on the deemed section 332 liquidation).

> Example 21. Parent and Controlled are foreign corporations and Parent owns all of the stock of Controlled. Parent sells all of the stock of Controlled to a related Purchaser that is not a corporation, and makes a Section 336(e) Election. The effect of the election is as follows:
>
> > (i) Controlled is deemed to sell all of its assets to Newco, which may or may not generate subpart F income to United States Stockholders of Parent.[146]
> >
> > (ii) Controlled is deemed to liquidate into Parent under sections 332 and 337. No gain is recognized as a result of the liquidation.[147]
> >
> > (iii) Under section 381, Parent succeeds to the tax attributes of Controlled, including its E&P and associated foreign tax credits.

This is an appropriate result where Parent and Purchaser are unrelated, because an actual sale of assets by Controlled followed by its liquidation would produce identical results. This transaction, however, could be used in the related party context to shift E&P (and associated foreign tax credits) from Controlled

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[146] The deemed sale by Controlled may result in foreign personal holding company income, which is subpart F income under section 954(c) (regardless of whether the Purchaser is related). In addition, the deemed sale may also result in foreign base company sales income under section 954(d) - i.e., gain on the sale of personal property to a related party. In many cases, however, gain on the deemed sale will not be foreign base company sales income under the "same country" exception of section 954(d)(1)(A) and (B).

[147] Temp. Treas. Reg. §§ 7.367(b)-5(c) and 1.367(e)-2T(c).

to Parent while providing a step-up in basis in Controlled's assets with no U.S. tax. We do not think this is appropriate if the principal purpose for the transaction is to obtain this tax result.[148]

In addition to manipulation of E&P and foreign tax credits, a Section 336(e) Election might be used to prepare foreign corporations for entry into the U.S. tax system.

> Example 22. X, an individual, owns all of the stock of Parent, which in turn owns all of the stock of corporations A, B and C. X anticipates that, in 1992, he will become a resident of the United States for tax purposes, with the result that Parent, A, B and C will be CFCs. In December, 1991, Parent distributes the stock of A, B and C to X.

Here, application of section 336(e) would result in a purge of the tax histories of A, B and C. The Committee believes that Liquidation Reincorporation Principles should be applied in this context if the principal purpose for the distribution by Parent is to obtain this tax result.

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[148] Note that if the related purchaser is a corporation (whether foreign or domestic), a Section 336(e) Election would not be available since section 304 would apply to the sale of Controlled stock.

In addition, in the case of a distribution of the Controlled stock by Parent (rather than a sale to a reload party), it is less likely that the transaction could be undertaken free of U.S. tax. If the distributee is domestic, then the distribution would be either a dividend from Parent, currently taxable under section 301 (unless Parent has previously-taxed income - see section 959), or a redemption on which gain would be recognized under sections 302 and 1248. If the distributee is foreign, the dividend or redemption gain would be subpart F income taxable currently to the distributee's United States shareholders. See section 954(c). In either case, the U.S. tax may be reduced by foreign tax credits available to the distributee (or, if foreign, its United States shareholders), including deemed-paid credits with respect to taxes paid by Parent and Controlled.