NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON PROPOSED REGULATIONS

IMPLEMENTING SECTION 336(e)

December 31, 2008

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I. Overview.

This report[1] provides comments on proposed regulations under Section 336(e)[2] that were published on August 25, 2008 (the "Proposed Regulations").[3] In general terms, we believe that the Proposed Regulations represent an excellent first step, but, as discussed in detail below, we believe that the regulations can be improved upon in a number of ways and that their scope should be significantly expanded.

A. Background.

Section 336(e) was enacted in 1986 as part of the General Utilities[4] repeal contained in the Tax Reform Act of 1986. The statutory language is simple:

> CERTAIN STOCK SALES AND DISTRIBUTIONS MAY BE TREATED AS ASSET TRANSFERS – Under regulations prescribed by the Secretary, if—
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> (1) a corporation owns stock in another corporation meeting the requirements of section 1504(a)(2), and
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> (2) such corporation sells, exchanges, or distributes all of such stock,
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> an election may be made to treat such sale, exchange, or distribution as a disposition of all of the assets of such other corporation, and no gain or loss shall be recognized on the sale, exchange, or distribution of such stock.

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[1] The principal drafters of this report were Deborah L. Paul and David R. Sicular, with the invaluable assistance of Patrick N. Karsnitz. Helpful comments were received from Kimberly S. Blanchard, Peter C. Canellos, Joshua M. MacLeod, Gary B. Mandel, David W. Mayo, David S. Miller, Michael L. Schler and Jodi J. Schwartz.

[2] Unless otherwise specified, all Section references herein are to the U.S. Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder.

[3] Regulations Enabling Elections for Certain Transactions Under Section 336(e), REG-143544-04, 73 Fed. Reg. 49965 (Aug. 25, 2008) (hereinafter, the "Preamble").

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

The basic purpose of Section 336(e) is clear. As the repeal of General Utilities reaffirmed the double tax system on corporations and shareholders that is the hallmark of Subchapter C, Congress also sought, with Section 336(e), to avoid the triple taxation of corporate earnings that sometimes results.

The Conference Committee discussed both the context of the repeal of General Utilities and the desire to avoid multiple levels of corporate taxation:

> Section 338(h)(10) of present law, in certain circumstances, permits a corporate purchaser and a seller of an 80-percent-controlled subsidiary to elect to treat the sale of the subsidiary stock as if it had been a sale of the underlying assets. Among the requirements for the filing of an election under section 338(h)(10) are that the selling corporation and its target subsidiary are members of an affiliated group filing a consolidated return for the taxable year that includes the acquisition date. If an election is made, the underlying assets of the company that was sold receive a stepped-up, fair market value basis; the selling consolidated group recognizes the gain or loss attributable to the assets; and there is no separate tax on the seller's gain attributable to the stock. This provision offers taxpayers 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. The conference agreement, following the House bill, retains this provision.
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> In addition, the conference agreement permits the expansion of the section 338(h)(10) concept, to the extent provided in regulations, to situations in which the selling corporation owns 80 percent of the value and voting power of the subsidiary, but does not file a consolidated return. *Moreover, 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. 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(c)(2), it may be appropriate to provide special rules for such corporation's section 381(c) tax 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.*
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> *The conferees do not intend this election to affect the manner in which a*

corporation's distribution to its shareholders will be characterized for purposes of determining the shareholder level income tax consequences.[5]

The Proposed Regulations take a significant first step to implement Section 336(e) in the context of domestic corporations disposing of stock of other domestic corporations. In doing so, the Proposed Regulations import many statutory and regulatory concepts from Section 338. In basic terms, the Proposed Regulations provide that if a domestic corporation (for this purpose treating all members of a consolidated group as a single corporation) ("Seller") "disposes" of stock of another domestic corporation ("Target") in a "qualified stock disposition," Seller may make a unilateral election under Section 336(e) to treat the disposition as a sale of assets by Target in the manner, and subject to the limitations, set forth in the Proposed Regulations, and to disregard the stock sale. A qualified stock disposition is defined as any "disposition" in which stock of Target meeting the requirements of Section 1504(a)(2) is sold, exchanged, or distributed during a 12-month disposition period.[6] A disposition is defined as a

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[5] H.R. CONF. REP. 99-841, 1986 U.S.C.C.A.N. 4075 (emphasis added).

[6] Prop. Reg. § 1.336-1(b)(5). We note that the Proposed Regulations do not require that Seller dispose of all of the Target stock that it owns so long as it disposes of stock meeting the requirements of Section 1504(a)(2). We believe that this is an appropriate and sensible interpretation of the statutory language (and in particular the words "such stock") that is generally consistent with rules under Section 338(h)(10), which also permits Seller to retain stock under similar circumstances. We do acknowledge, however, that we read the statute differently in our original Section 336(e) report. See New York State Bar Association, Tax Section, Report on Section 336(e), Part III.B.2 (January 6, 1992) (hereinafter, the "Prior Report") ("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).").

The Proposed Regulations make it clear that the Section 336(e) election applies only to qualified stock dispositions for which the disposition date is on or after the date on which final regulations are published. Prop. Reg. § 1.336-5. A number of commentators have suggested that the election should be made available sooner under temporary regulations (generally in the form of the existing proposed regulations). See Gary B. Mandel, A Survey of the Long Awaited Section 336(e) Regulations; Work Still Needs to be Done, The Tax

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sale, exchange or distribution of stock not reacquired in the 12-month disposition period, excluding carryover basis transactions; transactions described in Section 351, 354, 355 or 356 (with a carve out for Section 355(d) and (e)); transactions in which the transferor does not recognize the full amount of gain or loss; and, transfers to a related party.

If a Section 336(e) election is made, Target is deemed to sell all of its assets under one of two mechanisms set forth in the Proposed Regulations in a transaction in which gain or loss is generally recognized by Target, subject to a loss disallowance rule in transactions that, without regard to the Section 336(e) election, are stock distributions. Unless the disposition is a Section 355 transaction, Target is then deemed to liquidate into Seller in a transaction to which Section 332 will generally apply. The Proposed Regulations also provide rules relating to the manner and timing of the election, the calculation of deemed disposition price (ADADP) and resulting asset basis (AGUB), and certain other matters.

The Proposed Regulations reaffirm the Internal Revenue Service's ("IRS") long-held position that Section 336(e) is not self-executing.[7] Further, the Preamble states that the IRS

Club (November 24, 2008), pg. 21. We express no view on this. Note, also, that if a qualified stock disposition involves a series of transactions over an extended period (up to 12 months), the Proposed Regulations suggest that an election will be available if the last transaction in the series occurs after the regulations are finalized, even if all prior steps occur well before that time. We question whether this result was intended. If so, parties to pre-effective date dispositions of stock representing less than Section 1504(a)(2) amounts might still be well-advised to take Section 336(e) into account even prior to the finalization of the regulations. Finally, we note that in the case of a transaction that signs before the finalization of the regulations but closes after, parties might not be expected to have taken Section 336(e) into account properly in their negotiations. However, fairness might suggest that the election should not be permitted in the case of a transaction subject to a binding contract prior to finalization of the regulations unless the parties so agree.

[7] Despite the somewhat ambiguous statutory language, we believe that the Government's position is correct (based in part on language in the legislative history). We note, however,
(footnote continued)

does not presently intend to authorize the making of Section 336(e) elections in all circumstances within the statutory grant of authority. The Preamble makes clear, however, that the IRS and Treasury are interested in comments regarding expanding the scope to transactions that are not covered by the Proposed Regulations (for example, transactions involving related parties and international transactions).

B. General Principles.

We commend the IRS and Treasury for taking such a thoughtful first step toward regulations implementing Section 336(e). However, while we understand why the Proposed Regulations began with a narrow scope, we believe that the final regulations should be significantly broader for several reasons. We believe that doing so makes good policy sense and is consistent with the purpose of ameliorating triple taxation. Expanding the Proposed Regulations would also be consistent with several decisions that the government has made to give Section 338 a broad scope.[8] As drafted, the Proposed Regulations do not add much flexibility in the context of sales and exchanges because they import the Section 338 requirement that the disposition meet most of the requirements of a "purchase" (as defined in Section 338). As discussed below, we believe that the regulations should not adopt that Section 338 rule.

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that at least one recent commentator disagrees. See Letter From James P. Fuller and Amanda Dranginis to IRS and Treasury, reprinted in Firm Seeks Changes to Proposed Regs on Election to Treat Some Corporate Stock Transfers as Deemed Asset Sales, Doc # 2008-21237, 2008 TNT 195-23 (September 24, 2008); See generally Mandel, supra n. 6, pgs. 17-21.

[8] See, e.g., Treas. Reg. § 1.338(h)(10)-1(c)(1) (expanding Section 338(h)(10) to acquisitions of S corporations).

In addition, we believe that a number of changes should be made to the Proposed Regulations within their existing scope. For example, one area in which the IRS and Treasury contemplate, correctly in our view, that the regulations could be quite useful is for transactions that are (or may be) described in Section 355(d) or (e) (or which seek, but fail, to qualify under Section 355 at all).[9] However, in this setting, two aspects of the Proposed Regulations would deter such protective elections: the prohibition on recognizing any losses and the possibility of a double tax in the case of an intragroup and an external spin. Thus, those problems would need to be addressed in order for taxpayers to make protective Section 336(e) elections in the case of spin-offs that are intended to be tax-free. We believe that the loss disallowance rule is inappropriate as a technical and policy matter and significantly reduces the utility of the election. We also believe that the deemed mechanics of the election can be improved and simplified.

The final regulations under Section 336(e) should be informed by the following overarching principles:

- As discussed above, the election should be broadly available (including in foreign contexts).
- Consistent with the policies embodied in Section 336(e), the regulations should seek to avoid inappropriate multiple levels of taxation (e.g., triple tax on a Section 355 distribution or sale of stock) and the frictional costs (e.g., transfer taxes, retitling costs, and assignability issues) and non-tax collateral impediments to which taxpayers would otherwise be subject as a result of engaging in the long-hand transactions.
- The regulations should permit taxpayers to accomplish using the "short-hand" Section 336(e) election what they could otherwise accomplish by actually engaging in the transactions "long-hand." By the same token, in general, the regulations should not permit parties to accomplish using Section 336(e) what they could not otherwise accomplish by actually engaging in the transactions "long-hand."

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[9] The Proposed Regulations very helpfully permit "protective" elections in this setting.

- The regulations should describe with specificity the long-hand transactions deemed to occur as a result of the Section 336(e) election and the deemed transaction mechanics should generally follow the long-hand transactions. The specific descriptions of the deemed transactions will ensure that taxpayers and the IRS can determine the results of the Section 336(e) election in various areas of application that may not be specifically addressed in the regulations or anticipated today.

- The corporate-level consequences of the deemed long-hand transactions should generally govern the consequences of the Section 336(e) election, and the regulations should not require a departure from the tax consequences that follow from the deemed long-hand transactions unless there is a compelling reason to do so.

- The Section 336(e) election should not affect the taxation of shareholders except in very specific circumstances (e.g., earnings and profits, subpart F, and FIRPTA, discussed below).

- Section 338(h)(10) principles should generally apply. However, the statutory impediments inherent in Section 338 (especially in the definition of "purchase") should not automatically be imported into Section 336(e).

- The Section 336(e) regulations should be limited by reference to their purpose of avoiding inappropriate multiple levels of taxation. Thus, for example, the Section 336(e) election should not be available as a technique to turn a stock disposition into a reorganization.

C. Specific Recommendations.

As discussed in greater detail in the balance of this report, we have the following specific recommendations:

1. The Proposed Regulations' model for the deemed transactions involved in a Section 355(d) or (e) transaction should be eliminated. Instead, the model that applies to sales and exchanges and distributions not qualifying under Section 355 should also apply to Section 355(d) and (e) transactions.

2. The loss disallowance rule should either be eliminated or revised to permit the recognition of built-in asset loss to the extent of built-in asset gain.

3. A Section 336(e) election should generally be available in the case of a disposition of Target stock that is part of a Section 351 transaction or in the case of a disposition of Target stock governed by Section 354 or 356.

4. The "related party" test of Section 338 (based on Section 318) should be modified by eliminating attribution from a partner to a partnership and from a partnership to a partner if the partner's interest in the partnership is less than a specified level. Further,

partnership attribution should not apply if the partnership itself does not bear an economic relationship to the sale transaction.

5. In the case of an intragroup disposition of stock followed by a sale of a Target in which a Section 336(e) election is made, it should be confirmed that Treasury Regulation Section 1.1502-13(f)(5) elective relief is available. If the first disposition is a distribution of the stock of the Target subject to Section 355(f), consideration should be given to permitting a Section 336(e) election on the internal distribution.

6. As is the case under Section 338(h)(10), Section 336(e) elections should be available for acquisitions of S corporations.

7. Section 336(e) elections should be broadly available in respect of foreign Sellers and foreign Targets. The Report also responds to specific issues highlighted in the Preamble that affect such transactions.

8. At least where Seller and Target do not file a consolidated return, the Section 336(e) election should be made by Seller and Target jointly in a time and manner generally consistent with what Section 338 provides.

9. The rules related to ADADP and AGUB, as well as the corresponding rules in Section 338, should be revised where less than 100% of Target's stock is part of the qualified stock disposition.

II. Deemed Transactions as a Result of the Section 336(e) Election.

The Proposed Regulations start, appropriately in our view, by describing the steps that are deemed to occur as a result of the Section 336(e) election. Those steps are consistent with the transactions that are deemed to occur as a result of a Section 338(h)(10) election. Although we generally agree with the approach taken in the Proposed Regulations, we believe there are important ways in which these deemed mechanics can be improved.

A. Sale, Exchange or Distribution other than Section 355(d)(2) or 355(e)(2).

The Proposed Regulations provide that in the case of a sale, exchange or distribution of stock with respect to which a Section 336(e) election is made, and that does not involve, in whole or part, a distribution pursuant to Sections 355(d)(2) or 355(e)(2), the following are deemed to occur:

(1) the Seller is not treated as having sold, exchanged or distributed the stock of Target;[10]

(2) target ("Old Target") is treated as having sold all of its assets to an unrelated person (i.e., new target, "New Target") in a single transaction at the close of the disposition date (before the deemed liquidation in step 4 below); Old Target realizes gain or loss on the deemed asset sale while still owned by Seller, before the close of the disposition date,[11] subject to a loss disallowance rule in the case of dispositions that are distributions;[12]

(3) New Target is treated as having purchased all of its assets from an unrelated person (i.e., Old Target) in a single transaction at the close of the disposition date (before the deemed liquidation in step 4 below);[13]

(4) Old Target and Seller are treated as if Old Target, while still owned by Seller, transferred all of its assets received in the deemed asset disposition (described in step 2) to Seller, before the close of the disposition date, and ceased to exist; [14] and

(5) in the case where Seller distributes Target stock in the disposition, Seller is deemed to purchase from New Target on the disposition date, immediately after the deemed

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[10] Prop. Reg. § 1.336-2(b)(1)(i)(A).

[11] Id.

[12] See Prop. Reg. §§ 1.336-2(b)(1)(i)(B)(2); 1.336-2(b)(2)(i)(B)(2), and the associated examples. As discussed in Part III below, we believe that the loss disallowance rule should be eliminated or significantly modified.

[13] Prop. Reg. § 1.336-2(b)(1)(ii).

[14] Prop. Reg. § 1.336-2(b)(1)(iii)(A).

liquidation of Old Target, the amount of stock distributed to Seller's shareholders and to have distributed such purchased stock.[15] Seller recognizes no gain or loss on the distribution of stock, but Seller's shareholders are taxable under normal principles applicable to distributions.[16] If Seller retains any Target stock, it is deemed to have purchased that stock from New Target on the day after the disposition date for its fair market value. [17]

Steps 1-4 of this model, which we will refer to as the "basic model" throughout, are consistent with the mechanics in Section 338(h)(10) and we believe this mechanic is appropriate for circumstances when Seller sells or exchanges stock of Target, or distributes the stock of Target in a transaction to which Section 355(d)(2) or 355(e)(2) does not apply. We think it would be helpful for the regulations to specify the consideration received in the deemed sale, which we suggest should be the actual consideration received in any sale or exchange, cash in respect of a distribution of stock (or retained stock) plus, in either case, assumption of liabilities at Target.

With respect to Step 4, we have one minor comment. The final regulations should make it explicit that Old Target is deemed to liquidate under Section 332, unless a liquidation of Old Target prior to any disposition of stock in the qualified stock disposition would not have qualified under Section 332. In general, the liquidation will be a Section 332 liquidation unless Target is insolvent[18] or the Spaulding Bakeries rule applies.[19] This seems clearly to be the

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[15] Prop. Reg. § 1.336-2(b)(1)(iv).

[16] Id.

[17] Prop. Reg. § 1.336-2(b)(1)(v).

[18] Sections 332(b)(2) and (3).

drafters' intent,[20] but if the disposition occurs in several steps, it does not clearly follow from the mechanics (e.g., Seller could, in theory, own only one share of Target stock at the beginning of the disposition date). We believe that this change will make the final regulations easier to apply than the current rule set forth in the Proposed Regulations and should not raise any concerns that are not inherent in Section 338(h)(10), which also permits transactions occurring over a period of time to qualify.[21]

Step 5 of the deemed transaction set forth in the Proposed Regulations raises issues. First, it is not clear with what consideration the Seller purchases the stock of New Target from New Target – whatever it is, the model does not seem to account for what New Target did

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[19] 27 T.C. 684 (1957) aff'd, 252 F.2d 963 (2d Cir. 1958) (1939 Code predecessor to Section 332 did not apply to a liquidation of a subsidiary into a parent where parent held all of the common and preferred stock of the subsidiary and the value of the subsidiary's assets was less than the liquidating preference of the preferred stock because the parent received no distribution in complete cancellation or redemption of "all . . . stock" of the subsidiary corporation, as required by the statute). See Transactions Involving the Transfer of No Net Value, REG-163314-03, 70 Fed. Reg. 11903 (March 10, 2005); Prop. Reg. §1.332-2; NYSBA Tax Section, Report on Proposed Regulations Regarding Organizations, Reorganizations and Liquidations Involving Insolvent Corporations, Doc # 2006-1304, 2006 TNT 15-10 (January 20, 2006).

[20] Preamble at 49,967. ("After the deemed asset disposition, old target is then treated as liquidating into seller which in most cases will be treated as a distribution in complete liquidation to which section 332 and section 336 or 337 applies."). Prop. Reg. § 1.336-2(k), example 5 (multiple step disposition example finds that a Section 332 liquidation occurred).

[21] See Prop. Reg § 1.336-2(b)(1)(iii)(A) ("The transfer from old target to seller is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur. For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all its stock, one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 332 and section 336 or 337 applies.").

with the consideration. For that reason, this model breaks down to some extent in terms of providing a framework for determining the tax consequences of the election. Second, using this model raises the question of whether the deemed sale might be part of a Section 351 transaction with "boot," which would have unintended consequences. While the regulations can address this with a further assumption in the deemed steps (that New Target received the consideration that it used to acquire the assets of Old Target from its new owners in an unrelated "old and cold" transaction, and to the extent that the consideration is not cash, it had a fair market value basis) this will not solve all Section 351 issues in all possible cases.[22] For these reasons, we would suggest what we think is a more natural rule: that, instead of a purchase of shares from New Target, Seller is deemed to purchase New Target stock that Seller will ultimately distribute in a secondary purchase from the deemed unrelated New Target shareholders with cash equal to the fair market value of the distributed stock.[23]

B. Distributions Under Sections 355(d)(2) or 355(e)(2).

In the case where a Section 336(e) election is made with respect to a disposition that involves, in whole or in part, a distribution described in Section 355(d)(2) or 355(e)(2), the Proposed Regulations apply a sale and repurchase model for the Section 336(e) election (the "sale-to-self model"):

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[22] For example, if Seller distributes 80% of Target's stock and sells 20%, Seller's own deemed transfer would make the overall transaction a Section 351 transfer as it would receive stock constituting control and the distribution would not break control. Section 351(c).

[23] Under Prop. Reg. § 1.336-2(b)(1)(v), for similar reasons, we would also recommend that the deemed transaction be a purchase from deemed New Target shareholders, rather than from New Target.

(1) Old Target is treated as selling its assets to an unrelated person in a single transaction at the close of disposition date and realizes the tax consequences from the deemed disposition before the close of the disposition date while still owned by Seller,[24] except for any losses disallowed by the proposed loss disallowance rule as discussed below;

(2) immediately after the deemed asset disposition described in step 2, Old Target is treated as acquiring all of its assets from the unrelated person to whom it sold the assets in step 1, in a single, separate transaction that occurs at the close of the disposition date;[25]

(3) Seller is treated as distributing the stock of Old Target actually distributed to its shareholders, immediately after the purchase in step 2, recognizing no gain or loss on such distribution.[26] Moreover, if stock of Old Target is sold or exchanged, there is no gain or loss recognized on the sale or exchange;[27]

(4) Old Target is not deemed to liquidate.[28] If Seller retains any Target stock, the Seller is treated as having disposed of the Old Target stock retained on the disposition date in a transaction in which no gain or loss is recognized, and then, on the day after the disposition date, as purchasing the stock so retained from Old Target for its fair market value.[29]

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[24] Prop. Reg. § 1.336-2(b)(2)(i)(A).

[25] Prop. Reg. § 1.336-2(b)(2)(ii).

[26] Prop. Reg. § 1.336-2(b)(2)(iii).

[27] Id.

[28] Prop. Reg. § 1.336-2(b)(2)(i)(A).

[29] Prop. Reg. § 1.336-2(b)(2)(iv).

Before addressing the model (which we believe should be changed), we would first like to applaud the Treasury and the IRS for including Section 355(d) and (e) transactions and permitting taxpayers to make protective Section 336(e) elections.[30] We believe that this protective election will be extremely useful to taxpayers (assuming that issues relating to loss disallowance are resolved), will greatly increase the actual utility of the Section 336(e) election, and will make Section 355 work better.

We do not believe, however, that the final regulations should retain the sale-to-self model. We believe that having a second model in addition to the basic model adds significant and unnecessary complexity to the Proposed Regulations and we believe that the sale-to-self model is especially complex. We also believe that the sale-to-self model is not, in fact, needed to solve the problems that appear to have led to its adoption. Thus, we believe that the perceived benefits of the sale-to-self model are not as significant as might have been assumed and, accordingly, the complexity outweighs any perceived benefits.

We understand that the IRS adopted the sale-to-self model for Section 336(e) elections involving Section 355(d)(2) or 355(e)(2) distributions primarily to ensure that Target, after the distribution, would not be able to make a return of capital distribution because it lacked earnings and profits.[31] The Preamble and prior commentary[32] also indicate that there may be

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[30] Prop. Reg. § 1.336-2(j).

[31] See Preamble at 49,968. ("The IRS and Treasury Department believe that, except as necessary to carry out the purposes of section 336(e), the section 355 consequences generally should continue to apply in such a transaction. For example, if the controlled corporation were treated as a new corporation, with no earnings and profits, the controlled corporation may be able to distribute its assets to its shareholders without recognizing any dividend consequences under section 301(c)(1). Therefore, to preserve the consequences of section

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concerns with inappropriate accounting method changes, although it is not clear how significant a role these latter issues played.[33] These are both legitimate issues, but we do not believe the sale-to-self model is the best way to address them. As discussed below, we do not think that the sale-to-self model is needed to address the earnings and profits issue, as existing law (in particular Section 312(h)) already does a good job in this respect. Indeed, in the garden variety domestic case, existing law may actually provide that the sale-to-self model reaches the same earnings and profits result as the basic model. We are also concerned that the sale-to-self model is cumbersome and raises a number of collateral issues. For all these reasons, we recommend that the final regulations adopt the basic model in Section 355(d) and (e) situations with modifications to deal with accounting methods and other items, if appropriate.[34]

1. Earnings and Profits Issues under the Basic Model and Sale-to-self Model.

The Preamble suggests that the sale-to-self model will ensure that New Target (in the hands of Seller shareholders) retains earnings and profits after the distribution, while the basic model could result in New Target having no earnings and profits going forward. As discussed below (and illustrated in Examples 1 and 2), we believe that this concern is misplaced,

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355 distributions, the proposed regulations provide special rules [i.e., the sale-to-self model].").

32 See Prior Report, Part IV.C.3

33 Preamble at 49,966.

34 We note, too, that neither the sale-to-self model nor our proposed model (nor any other we can think of) is actually fully consistent with Section 355. For example, either if done long-hand would fail the requirements of Section 355(b)(2)(C), because Target is deemed to have just acquired its entire business from an unrelated third party in a taxable transaction. The proposed regulations appropriately address this concern. See Prop. Reg. § 1.336-2(b)(2)(v). The final regulations should do the same.

as appropriate application of Section 312(h) and the regulations thereunder in conjunction with the basic model should address any earnings and profits concerns and ensure that Target has earnings and profits immediately after the distribution.[35] Therefore, we do not believe the sale-to-self model is necessary to address the appropriate division of earnings and profits between Target and Seller, and Target's retention of appropriate earnings and profits.

By way of background, Section 312(h) was designed to address this very concern outside of the Section 336(e) area. Treasury Regulation Section 1.312-10 implements this concept with mechanical rules and principles that generally reduce the earnings and profits of the distributing corporation to reflect the spin-off transaction and require that the controlled corporation's earnings and profits will generally be at least equal to the amount by which the distributing coporation's earnings and profits are reduced.[36]

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[35] The Proposed Regulations address how to apply Treasury Regulation Section 1.312-10 and 1.1502-33(e) in the "sale-to-self" context. See Prop. Reg. §1.336-2(b)(2)(vi). Under our proposal this subsection would be unnecessary.

[36] Treasury Regulation Section 1.312-10(a) provides that if distributing transfers part of its assets constituting an active trade or business to controlled in a transaction to which Section 368(a)(1)(D) applies, and immediately thereafter distributes the stock and securities of controlled in a distribution or exchange to which Section 355 (or so much of Section 356 as relates to Section 355) applies, the earnings and profits of distributing immediately before the transaction must be allocated between distributing and controlled. Where controlled is a new corporation, the allocation is generally made in proportion to the fair market value of the business or businesses and other properties retained by distributing and held by controlled immediately after the transaction. In "proper" cases, the allocation between distributing and controlled can be made in proportion to the net basis of the assets transferred and those retained, or by another method appropriate under the facts and circumstances. Treas. Reg. § 1.312-10(a). See generally Bryan P. Collins, Andrew W. Cordonnier, & Darin A. Zywan, Allocation of E&P in a Spin-Off by a Consolidated Group: New Developments Answer Some Questions But Leave Many Unanswered, 840 PLI/Tax 619, 633-637 (October-December 2008) (discussing the uncertainty in the application of these methods). Treasury Regulation Section 1.312-10(b) provides that in a distribution or exchange to which Section

(footnote continued)

We believe that these rules should apply to a Section 355(d)(2) or (e) transaction where a Section 336(e) election is made and that these rules will ensure that controlled (i.e., Target) will have earnings and profits at least equal to its proportionate share of distributing's (Seller's) pre-transaction earnings and profits (whether or not the Section 355(d)(2) or (e)(2) transaction is a D reorganization). To be specific, we believe that Section 312(h) should be applied after the deemed liquidation of Old Target and immediately before Seller's distribution of New Target stock. Thus, if a Section 336(e) election is made for a Section 355(d) or (e) transaction and the basic model is applied, the earnings and profits of Seller (distributing) will include the earnings and profits of Old Target, including those arising from the deemed sale. Section 312(h) would then apply to those earnings and profits, so New Target is in little danger of being free of earnings and profits after the distribution.

The application of these rules in the consolidated return context is a bit more complicated,[37] but in many cases likely leads to the same result no matter which model is used.

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355 (or so much of Section 356 as relates to Section 355) applies and is not in pursuance of a reorganization plan under Section 368(a)(1)(D), the earnings and profits of distributing (Seller) are decreased by the lesser of (i) the amount by which the earnings and profits of distributing would have been decreased if it had transferred the stock of controlled (Target) to a new corporation in a reorganization to which Section 368(a)(1)(D) applied and immediately thereafter distributed the stock of the new corporation (the "hypothetical Section 368(a)(1)(D) amount") or (ii) the net worth of controlled, which for these purposes means the sum of the basis of all the properties of controlled plus cash minus all liabilities. Moreover, if the earnings and profits of controlled immediately before the transaction are less than the amount of the decrease in earnings and profits of distributing, the earnings and profits of controlled, after the transaction, are deemed to equal the amount of such decrease. Treas. Reg. § 1.312-10(b) (flush language). If earnings and profits of controlled before the transaction are more than the amount of the decrease, controlled's earnings and profits remain unchanged. Id.

[37] Much of the complexity arises from the existing lack of clarity in both Section 312(h) and the related portion of the consolidated return regulations. See Collins supra n. 36.

In that context, earnings and profits of the target subsidiary tier up to the parent seller under Treasury Regulation Section 1.1502-33(b) and are present at both levels. Thus, the Section 336(e) deemed sale earnings and profits would tier up and be taken into account in the calculation of Seller's earnings and profits that are allocated between Target and Seller on the distribution of Target (new or old). As a general matter, the regulations avoid duplication on deconsolidation of the subsidiary by eliminating subsidiary earnings and profits that have been duplicated when the subsidiary leaves the group[38] except to the extent necessary to effectuate the principles of Section 312(h).[39] As illustrated in the examples below, using the sale-to-self model, in the garden variety case where Target has always been a subsidiary of Seller, the rules under Section 312(h), Treasury Regulation Section 1.312-10, and Treasury Regulation Sections 1.1502-33(e)(1) and -(e)(3) may result in Old Target having the same amount of earnings and profits as New Target would have if the basic model applies as we propose.[40] This would be the case if the consolidated return regulations are interpreted to provide that, under the sale-to-self model, on distribution, Old Target's earnings and profits (including those generated on the Section 336(e) deemed sale) would be eliminated under Treasury Regulation Section 1.1502-33(e)(1) to the extent that the earnings and profits have tiered up to Seller under Treasury

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[38] Treas. Reg. § 1.1502-33(e)(1).

[39] Treas. Reg. § 1.1502-33(e)(3) ("The adjustments under paragraph (e)(1) of this section must be modified to the extent necessary to effectuate the principles of section 312(h). Thus, P's earnings and profits rather than S's earnings and profits may be eliminated immediately before S becomes a nonmember. P's earnings and profits are eliminated to the extent that its earnings and profits reflect S's earnings and profits after applying section 312(h) immediately after S becomes a nonmember (determined without taking this paragraph (e) into account).").

[40] See generally Collins supra n.36, at 643-644 (discussing the ambiguity in the application of Treas. Reg. § 1.1502-33(e)(3) and two potential methods of application).

Regulation Section 1.1502-33(b). Treasury Regulation Section 1.312-10(b) would then apply, reducing Seller's earnings and profits (which would include the tiered-up Section 336(e) deemed sale earnings and profits) generally based on relative values of Target and Seller's assets and generally increasing Old Target's earnings and profits to the extent of the reduction of Seller's earnings and profits.[41]

We would expect that using the basic model rather than the sale-to-self model in the Section 355 context would lead to the following results. Upon Old Target's deemed sale of assets to New Target, Old Target's earnings and profits will increase if the assets are sold at a gain. When Old Target liquidates into Seller, Seller will succeed to Old Target's historic earnings and profits and earnings and profits generated on the deemed asset sale pursuant to Section 381.[42] Seller will then purchase the stock of New Target from unrelated New Target shareholders for cash and distribute New Target stock to Seller's shareholders in a transaction to which Section 355 applies.[43] Pursuant to Treasury Regulation Section 1.312-10(b), Seller's earnings and profits will be reduced by the lesser of the hypothetical Section 368(a)(1)(D) amount or the net worth of New Target.[44] Immediately before the distribution, New Target would have no earnings and profits, because for tax purposes it is a new corporation, with no

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[41] There are, however, at least two other ways to read the Treas. Reg. § 1.1502-33 regulations in conjunction with the sale-to-self model. See id. Another advantage of the basic model is that some of these ambiguities disappear.

[42] Where Seller and Old Target filed a consolidated tax return, Seller will not succeed to Old Target's earnings and profits to the extent they would duplicated any earnings and profits that have already tiered up. Treas. Reg. § 1.1502-33(a)(2).

[43] Section 355(d)(2) and (e)(2) technically do not apply if a Section 336(e) election is made because under Section 336(e), no gain or loss is recognized on the stock distribution.

[44] See supra n. 36.

operating history, that just purchased all of its assets for cash. Upon the distribution, however, New Target's earnings and profits will be deemed to equal the amount of the decrease in Seller's earnings and profits. Consequently, by operation of the regulations under Section 312(h), New Target will retain an appropriate amount of earnings and profits after distribution of New Target stock to Seller shareholders. The sale-to-self model could result in a different outcome (generally more earnings and profits at Target) than the basic model where Target has pre-affiliation earnings and profits (or if the consolidated return regulations are interpreted differently), but it is not clear as a policy matter that the regulations should adopt a sale-to-self model to address this issue (or why this is even an appropriate result).

a. Earnings and Profits Examples.

The following examples illustrate the foregoing discussion:

Example 1. No Consolidated Return. Seller forms Target with a contribution of $100, and Seller and Target do not file a consolidated return. In each of years 1 through 5, each of Seller and Target has earnings and profits of $50, and in year 6, except to the extent resulting from the Section 336(e) election described below, neither Seller nor Target has any earnings and profits. At the beginning of year 6, when the fair market value of the assets of Seller (excluding the stock of Target) is $500, and fair market value of the assets of Target is $750, Seller distributes all of the stock of Target in a distribution to which Section 355(a) and 355(d) applies. A Section 336(e) election is made. Solely for purposes of illustration, taxes due as a result of the election are ignored. Assume that the adjusted basis of Target's assets for all purposes (including earnings and profits purposes) is $350.

- Pursuant to the Section 336(e) election, Target has additional earnings and profits of $400, for a total of $650.
- Under the basic model the result is as follows:
    - When Old Target is deemed to liquidate into Seller, Seller will succeed to Old Target's earnings and profits of $650 (historical earnings and profits of $250 plus earnings and profits on the deemed sale of $400). Immediately before the application of Section 312(h) on the deemed distribution of New Target, Seller will have earnings and profits of $900.

- Applying Section 312(h), assuming that the fair market value method is used,[45] Sellers's earnings and profits will be reduced by $540 ($900 total Seller earnings and profits x 60% (proportion of total assets held by New Target ($750) divided by the total assets held by New Target and Seller $1250)). Seller's earnings and profits will thus be $360.

- New Target has no other earnings and profits because it is deemed to have purchased all of its assets for cash. Its earnings and profits will be increased by the amount of the reduction in Seller's earnings and profits ($540) and so will have $540 of earnings and profits after the distribution.[46] In fact, Target will always have positive earnings and profits unless Seller and Target did not have positive earnings and profits before the transaction. Therefore, the concern raised in the Preamble that Target might lack earnings and profits seems misplaced.

- Under the sale-to-self model the result is as follows:

  - Seller will not succeed to Old Target's earnings and profits under Section 332/381, and thus before the application of Section 312(h), Seller's earnings and profits will be $250. Old Target's earnings and profits will be $650 after the deemed sale-to-self transaction (historical earnings and profits of $250 plus deemed sale earnings and profits of $400).

  - Under Section 312(h), Seller's earnings and profits will be reduced by $150 ($250 total Seller earnings and profits x 60% (proportion of total assets held by Old Target ($750) divided by the total assets held

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[45] Note that the amount under Treas. Reg. § 1.312-10(b)(i) will be less than the amount under Treas. Reg. § 1.312-10(b)(ii). New Target's "net worth" for purposes of § 1.312-10(b)(ii) should be $750 because it will hold all of its assets with fair market value bases as a result of the Section 336(e) election. Indeed, as a result of the Section 336(e) election, assuming a step-up, Target's net worth will be higher than it would have been absent the election and thus in some cases Target's earnings and profits will be higher after a Section 355(d) or (e) transaction with a Section 336(e) election than would have been the case without a Section 336(e) election.

[46] Treas. Reg. § 1.312-10(b) (flush language) (If the earnings and profits of the controlled corporation immediately before the transaction are less than the amount of the decrease in earnings and profits of the distributing corporation . . . the earnings and profits of the controlled corporation, after the transaction, shall be equal to the amount of such decrease. . . .)

by Old Target and Seller $1250)). Thus, Seller's earnings and profits after application of Section 312(h) and Section 1.312-10(b) are $100.

- Old Target's earnings and profits are $650 prior to the application of Section 312(h), which is not less than Seller's reduction, so Old Target's earnings and profits remain unchanged at $650.[47] This is a different result, but not necessarily a better one (Old Target's earnings and profits are higher, but Seller's are substantially lower).

Example 2. Consolidated Return. Assume that the facts are the same as Example 1 except that Seller and Target file a consolidated return until the year 6 distribution. Under the consolidated return regulations, Seller's earnings and profits prior to the Section 336(e) election (which will reflect Target's earnings and profits) will be $500 and Target's will be $250.

- As a result of the Section 336(e) election, Target's earnings and profits will increase by $400 to $650 and this increase will also be reflected in the earnings and profits of Seller, which will be $900.

- Under the basic model, it appears that the result will be the same as in Example 1. Because the earnings and profits of Target will already be reflected at Seller pursuant to Section 1.1502-33(b), Seller will not succeed to any additional earnings and profits of Old Target when Old Target liquidates.[48] The allocation under Section 312(h) and Section 1.312-10(b) is the same as in Example 1

- Under the sale-to-self model, it appears that the analysis is as follows. Ordinarily Old Target's earnings and profits would be eliminated upon its deconsolidation. However, this rule is modified to the extent necessary to effectuate the principles of Section 312(h). The regulations are not, however, a model of clarity as to exactly what this means. At a minimum, it would appear that Seller's earnings and profits would be reduced under the general rules of Section 312(h) and 1.312-10(b), which in this case would mean $540. It appears that Old Target's earnings and profits are

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[47] Treas. Reg. § 1.312-10(b) (flush language) ("If the earnings and profits of the controlled corporation immediately before the transaction are more than the amount of the decrease in the earnings and profits of the distributing corporation, they shall remain unchanged.").

[48] Treas. Reg. § 1.1502-33(a)(2) ("P's earnings and profits must not be adjusted under this section and other rules of law in a manner that has the effect of duplicating an adjustment. For example, if S's earnings and profits are reflected in P's earnings and profits under paragraph (b) of this section, and S transfers its assets to P in a liquidation to which section 332 applies, S's earnings and profits that P succeeds to under section 381 must be adjusted to prevent duplication.")

> not eliminated to this extent[49] and thus Old Target's earnings and profits would be at least $540.[50] As a result of this rule, Old Target's earnings and profits would not be increased under Treasury Regulation Section 1.312-10(b) because they are already equal to Seller's decrease. What is not entirely clear is what happens to Seller's earnings and profits. After application of Section 312(h), Seller's earnings and profits still reflect (at least) $110 of Old Target's historic earnings and profits, so perhaps Seller's earnings and profits are eliminated under the consolidated return regulations to that extent,[51] in which case they will be $250; perhaps not in which case they will be $360. The latter result is the same as under the basic model, the former is the same as the basic model for Old Target, but Seller's earnings and profits will be lower.

It is thus not clear whether the sale-to-self model comes up with a better earnings and profits answer than the basic model and indeed it may come up with a worse answer if the goal is to reduce the likelihood of return of capital distributions. Moreover, the sale-to-self method results in ambiguities in the consolidated return context that the basic model avoids.

2. Other Issues Under the Sale-to-Self Model.

a. Complexity and Unintended Consequences.

As discussed above, we believe that the Section 355 sale-to-self model is not necessary to address earnings and profits concerns. Moreover, the sale-to-self model has other issues. Although it is a long-hand transaction that could in theory take place, it is a cumbersome transaction that we would not expect to see in the real world[52] and its complex steps may result

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[49] Treas. Reg. § 1.1502-33(e)(5), example (f).

[50] Under another possible reading of the regulations, section 312(h) might be applied before Treas. Reg. 1.1502-33 and this would leave S's earnings and profits at $650, the amount where they started. In this case, presumably P's earnings and profits would be $250. See Collins supra n. 36, at 643-644 (discussing alternative interpretations of Treas. Reg. §1.1502-33(e)(3)).

[51] Treas. Reg. 1.1502-33(e)(3).

[52] For example, there could be two transfer taxes paid on the same assets, two sets of UCC filings, mortgage recordings, double the number of assignment agreements, etc.

in numerous unintended tax consequences. For example, Old Target's deemed disposition of stock or securities and subsequent repurchase of the same securities would be a wash sale, the loss on which would be disallowed by Section 1091. If, as we suggest below,[53] the loss disallowance rule of the Proposed Regulations is eliminated, this artificial wash sale loss disallowance would not be appropriate. If, on the other hand, the final regulations retain the proposed loss disallowance rule, the wash sale rules in effect require a carryover basis in the purchased securities, and this might need to be addressed.[54]

A second potential (and presumably unintended) collateral consequence of the sale-to-self model is that it may raise anti-churning issues under Section 197 where it may not be appropriate to do so.[55] We anticipate that there will be other additional collateral problems that have not yet occurred to us.[56]

b. Attribute Location.

The primary difference between the sale-to-self model and the basic model with respect to attributes other than earnings and profits is that, under the sale-to-self model, Old

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[53] See Part III.

[54] Section 1091(d), see Part III(B).

[55] Under the sale-to-self method Old Target will be the same corporation after the sale and repurchase and will be potentially subject to these rules. New Target, however, will be a different corporation for tax purposes and will not be related to Old Target under Section 197(f)(9)(C) because the proposed regulations specifically provide that New Target and Old Target are unrelated (Old Target is deemed to sell to an unrelated person and New Target is deemed to purchase from an unrelated person). Prop. Reg. §§ 1.336-2(b)(1)(i)(A), -2(b)(1)(ii).

[56] At a minimum, we would recommend that if the "sale-to-self" model is retained, the final regulations should provide that the collateral implications of that model (such as anti-churning and wash sale) should not apply.

Target retains its attributes and its historic accounting methods after the distribution because Old Target is never deemed to liquidate, while under the basic model, Seller succeeds to all of the attributes of Old Target under Section 381,[57] and New Target (as a new corporation) can adopt different accounting methods than Old Target. Thus, another rationale for the sale-to-self model might be to ensure that Target retains its accounting methods and Seller does not succeed to Target attributes (such as remaining net operating losses) as a consequence of the Section 336(e) election. It is not clear to us, however, why this is a desirable goal (particularly given that the IRS and Treasury do not apparently have this goal outside of Section 355(d) or (e)).

The preservation of accounting methods raises more complex questions that will also need to be analyzed in other areas. Preserving Old Target accounting methods is, to us, in tension with a transaction otherwise treated as a taxable asset sale. Also, the accounting methods do not carry over to New Target in a Section 338(h)(10) transaction. Finally, in the Section 355 context, whether or not accounting methods and Section 381(c) attributes carry over is in many cases effectively elective – the taxpayer can frequently alter the result by deciding whether or not to accomplish a spin-off transaction as a D reorganization and in that context which assets will be transferred to the new company and which will remain behind.[58] It is true that the basic model leaves attribute carryovers with Seller to the extent not absorbed on the deemed asset sale, but once again this treatment is consistent with Section 338(h)(10) and there is no particular policy under Section 355 that Target, in the hands of Seller's shareholders, have these attributes instead.

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[57] Including, for example, NOL carryovers and capital loss carryovers.

[58] A divisive D reorganization is not a Section 381 transaction, so Section 381 attributes will not carry over to controlled in such a transaction, and thus controlled will be free of historic accounting methods and certain other attributes.

Therefore, we do not believe these concerns justify the adoption of the sale-to-self model. If there are special situations of concern (and we are aware of none), we would recommend that they be addressed through a targeted anti-abuse rule that might, in appropriate cases, require New Target to use Old Target's accounting methods or succeed to specific Old Target attributes.

c. Alternative Approach to Basic Model – New Target is Deemed Section 381(c) Successor to Old Target.

If the IRS and Treasury agree that the sale-to-self model should be eliminated, but believe that the final regulations should also require a carryover of other tax attributes from Old Target to New Target (or wish to adopt a different rule for earnings and profits than discussed above) we would recommend an alternative approach to the sale-to-self model. To avoid the complexity involved in the sale-to-self approach and the potential unintended consequences, we would recommend that the final regulations for Section 355(d)(2) and (e)(2) transactions use the basic model (including Step 5 where Seller is deemed to purchase New Target stock from unrelated New Target shareholders), together with a rule that deems New Target, and not Seller, to be the Section 381 successor of Old Target for any appropriate attribute.[59] The deemed Section 381 carryover from Old Target to New Target should also address any concerns about accounting methods and other tax characteristics carrying over to New Target, without the necessity of importing a new, untested, and elaborate sale-to-self model. Section 312(h) would then be applied after Section 381.

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[59] See Prior Report, Part IV.C.2. (discussing a similar deemed carryover rule).

d. Administrability and Complexity.

In addition to avoiding unintended consequences of the deemed sale-to-self mechanics of the Proposed Regulations, using the same mechanic for Section 355(d)(2) and Section 355(e)(2) transactions (together with the deemed Section 381 carryover rule if necessary) as for sales, exchanges or distributions other than Section 355(d)(2) or (e)(2) distributions would greatly reduce the complexity of the Proposed Regulations and increase their administrability. To the extent it is possible to avoid an additional deemed mechanic (i.e., the sale-to-self model), we would recommend so doing.

III. Loss Disallowance.

A. General Rule.

The Proposed Regulations contain a draconian loss disallowance rule that overrides the tax consequences arising from the deemed asset sale transactions pursuant to a Section 336(e) election by disallowing gross loss to the extent that the underlying actual transaction is a distribution of Target stock.[60] The Proposed Regulations allow losses attributable to the deemed asset sale to the extent associated with an actual sale or exchange of the Target stock. The regulations implement this loss disallowance rule through a loss recognition fraction the numerator of which is the value of the Target stock sold or exchanged and the denominator of which is the total value of stock sold, exchanged, or distributed.[61] The Seller is permitted to recognize only the amount of losses realized multiplied by the loss recognition fraction.

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[60] Prop. Reg. §§ 1.336-2(b)(1)(i)(B)(2); 1.336-2(b)(2)(i)(B)(2), and the associated examples.

[61] Prop. Reg. §§ 1.336-2(b)(1)(i)(B)(2); 1.336-2(b)(2)(i)(B)(2).

Others have noted that this aspect of the regulations raises issues of statutory authority.[62] We believe that it is bad policy and frustrates the Congressional intent to mitigate multiple levels of tax on corporate earnings. First, denial of losses is inconsistent with the deemed asset sale model that the Proposed Regulations adopt, and with the result under Section 338(h)(10), on which that model is based.[63] Nothing in Section 336(e) policy dictates this departure.[64] Indeed, we believe that the loss disallowance rule, as proposed, is inconsistent with a core purpose of Section 336(e), which is to prevent triple taxation. Unless the rule is changed in the final regulations, Section 336(e) may have little or no practical utility in distribution transactions. Second, we do not believe that the policy of Section 311(a) requires the proposed

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[62] Some commentators have questioned whether "Treasury has the authority to disallow the loss in the distribution context." W. Eugene Seago and Edward J. Schnee, Section 336(e) Proposed Regulations Explain Old Law and Make New Law, 109 Journal of Taxation 279, 284 (November 2008); see also Peter C. Canellos, Unpublished Practicing Law Institute Article (October 16, 2008) (on file with authors) ("However, the [proposed loss disallowance rule] results in uneconomic tax consequences, largely undermines the utility of Section 336(e) in mitigating the consequences of an inadvertently taxable spin-off, is easily evaded in planned transactions (including through the use of tiering and selective Section 336(e) elections), and undermines the moral authority of the IRS to deal with transactions designed to combine an overall tax-free spin-off with an anticipatory "taxable" disposition of loss assets within the controlled group.").

[63] Prop. Reg. § 1.336-1(a) ("Generally, except to the extent inconsistent with section 336(e), the results of a section 336(e) election should generally coincide with those of a section 338(h)(10) election.").

[64] See Seago supra n. 62, at 284 ("[T]he disallowance does not further the purpose of Section 336(e), i.e., to prevent triple taxation of the target corporation's income. The decline in value of the assets is the economic loss incurred by the target, but under the Proposed Regulations the loss attributable to the distribution will be deducted only once. That is, the parent's shareholders will ultimately suffer the economic loss and their taxable income will be reduced by the decline in value of the corporation's assets, but neither the parent nor the old target will be allowed a deduction for the loss. When the deemed selling price of the assets is allocated among the target's assets, the new basis in the depreciated assets will be lower than before the hypothetical sale; therefore, the target will never deduct the loss, and the economic loss will be deducted only once, while all gains are taxed twice.").

loss disallowance rule in the context of Section 336(e). Even disregarding the policies of Section 336(e), a far more limited loss disallowance rule would satisfy any Section 311(a) concerns – one that would allow full netting of gain and loss.

The stated rationale for the loss disallowance rule is that no loss would be allowed in the transaction that actually occurs, if that transaction is a non-liquidating distribution of stock.[65] But Section 336(e), by its very nature, deems a different transaction to occur for tax purposes. The deemed transaction would not, if it actually occurred, be subject to Section 311(a). Further, Section 336(e) specifies that the actual distribution transaction has no corporate-level consequences in terms of recognition.[66] Both the basic model and the sale-to-self model result in a deemed sale transaction in which there would have been no limit on the loss that Target could recognize had the deemed transactions actually occurred, subject to Section 267 and similar principles. Although as a non-tax matter, Seller is distributing stock of Target, as a tax matter Section 336(e) deems the transaction to be something else – an asset sale between two corporations, followed by a distribution of the stock of the purchasing corporation, which Seller purchases after the deemed sale.[67] General tax principles should apply to determine the tax

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[65] Jeremiah Coder, Final Portions of Loss Limitation Regs Will Be Changed, IRS Official Says, Tax Notes Today, Doc # 2008-22458, 2008 TNT 205-2 (October 22, 2008).

[66] Section 336(e) (flush language) (" . . . an election may be made to treat such sale, exchange or distribution as a disposition of all of the assets of such other corporation, and *no gain or loss shall be recognized on the sale, exchange, or distribution of such stock.*") (emphasis added).

[67] See Prop. Reg. § 1.336-2(g)(1).

results of the deemed transaction.[68] The only "long-hand" transaction that would lead to disallowance of losses on assets of Target would be a liquidation of Target in which Target distributed its assets to Seller, Seller distributed Target's assets to Seller shareholders in kind, and then the shareholders recontributed the assets to a new corporation[69] – a long-hand transaction that is unlikely ever to occur for a number of reasons (including complexity and the difficulty of transferring undivided interests in numerous assets in kind to what might be hundreds or even thousands of shareholders). In addition to being an unrealistic long-hand transaction, it is a different long-hand method than the paradigm that is set forth in the Proposed Regulations or the method we suggest. As we said in Part I, we believe that as a general matter, unless there is a very good reason to deviate, the results of a Section 336(e) election should be the natural tax consequences of the deemed paradigm the regulations adopt. We do not believe there are good reasons to deviate in these circumstances.

Much if not all of the practical utility of Section 336(e) (within the scope of the Proposed Regulations) will be lost with a full loss disallowance rule as proposed. Although, as noted elsewhere, we believe that the scope of Section 336(e) should be significantly expanded, one important area where the Section 336(e) regulations could be very useful in their current scope is an election (actual or protective) in a Section 355(d) or (e) transaction. The availability of an election in that context is at the core of the concerns that Section 336(e) should address – the avoidance of triple taxation. The same is true in a taxable stock distribution outside Section

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[68] Note that our Prior Report took the view that if a Section 336(e) election were made, then the deemed transaction would always be treated as a taxable asset sale, even if general tax principles would have treated it as a reorganization. See Prior Report, II.C.

[69] We note that this is the long-hand transaction we discussed as "Model 2," and ultimately rejected in our Prior Report. See Prior Report, Part II.B.

355, although, in our experience, these are not common. For the reasons illustrated by the example below, a rule disallowing gross loss will make it unlikely that parties will make a protective Section 336(e) election in a distribution to which Section 355(d) or (e) could apply, thereby greatly undermining the Section 336(e) election, because the costs of making the election could be significantly greater than the tax that would otherwise be imposed under Section 355(d)(2), (e)(2) or otherwise on a distribution of Target stock. We do not believe this is consistent with Congress's intent.

The following example illustrates the operation of the proposed loss disallowance rule.

> Example 3. Overall Gain Transaction. On date 1, Seller forms Target and contributes Asset 1 and Asset 2 to Target. Asset 1 has a basis and fair market value of 40, Asset 2 has a basis and fair market value of 10. Seller takes a 50 basis in the stock of Target, which is worth 50. On date 2, when Asset 1 is worth 10 and Asset 2 is worth 90, Seller distributes 100% of Target stock to Seller shareholders in a transaction to which a Section 336(e) election applies. At the time of the distribution, the stock of Target is worth 100.
>
> On a distribution of the stock of Target that is taxable at the corporate level without a Section 336(e) election, Seller would recognize 50 of gain.[70] If, instead, Seller made a Section 336(e) election, under the Proposed Regulations Target would recognize 80 of gain on the deemed sale of Asset 2 (the amount realized (90) less Target's basis in Asset 2 (10)). The 30 loss on the deemed sale of Asset 1 (the amount realized (10) less Target's basis in Asset 1 (40)) would be disallowed. Faced with an incremental tax cost, Seller may well not make a Section 336(e) election precisely in an area where Congress would have intended one to be made.

We believe that the disallowance of loss in these circumstances is inappropriate. A Section 336(e) election treats the transaction as a sale of assets. There would not be any loss disallowance on an actual asset sale. One consequence of the loss disallowance rule in the

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[70] § 311(b).

Proposed Regulations is that the tax liability from a Section 336(e) election may significantly exceed the tax liability that would result if no election were made, even if inside and outside basis are the same. This may make a Section 336(e) election prohibitively expensive and may have an additional deterrent effect where the parties do not have detailed basis and fair market value information and, thus, do not know what the incremental tax liability will be even if, on an overall basis, inside and outside basis are the same. As such, the loss disallowance rule plainly frustrates Congressional intent. For those reasons, we believe there should be no loss disallowance on the deemed asset sale.

We acknowledge that Example 3 presents the most compelling case for allowing asset losses, and that, in a situation where Seller has a loss in the stock of Target or Target has a net loss in its assets, the argument for Target to recognize all of its losses in excess of gains is less compelling because there is no triple tax issue. We believe, however, that even in the loss setting an argument can be made that a coherent model for Section 336(e) and conformity with Section 338(h)(10) leads to the conclusion that all losses should be allowed.

If the IRS and Treasury nonetheless believe that a loss disallowance rule is necessary to protect the integrity of Section 311(a), we have the following comments. First, there is no reason to apply the loss disallowance rule if the distribution to which Section 336(e) applies is in complete liquidation. We understand that this may have been an unintended result in the Proposed Regulations and will be fixed in the final regulations (even if they otherwise contain some form of loss disallowance rule). Second, Section 311(a) disallows a gross stock loss that is in most cases also in effect a net loss (i.e., the fair market value of the target stock

takes into account a netting of the gain and loss assets).[71] Protecting the integrity of Section 311(a) does not require a rule that disallows more than that. It certainly does not require disallowing gross asset losses while recognizing gross asset gains. At a minimum, gross asset losses and gross asset gains should be netted.[72] In Example 3, permitting Target to recognize the loss on the disposition of Asset 1 results in a consistent treatment between Section 336(e) and Section 311. Target should not recognize more gain as a result of making a Section 336(e) election than Seller would have recognized on the distribution of the stock of Target in the absence of a Section 336(e) election, unless there is a difference between net inside basis and net outside basis.

We acknowledge that a fact pattern in which Target has a net built-in loss in its assets raises a more difficult case. Example 4 illustrates this case.

> Example 4. Overall Loss Transaction. Seller holds all of the stock of Target. Seller has a 110 basis in the stock of Target and the stock of Target is worth 100. Target holds Asset 1 and Asset 2. Asset 1 has a basis of 100 and a fair market value of 50, Asset 2 has a basis of 40 and a fair market value of 50. Seller

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[71] In certain (relatively uncommon) cases, Seller may have multiple blocks of Target stock, some with gains and some with losses. In such cases, Section 311(a) could result in a recognition of gross gains, but not losses, but a variety of self-help mechanisms may be available to avoid that result. For example, Seller may contribute the gain stock and loss stock to a newco in a Section 351 transaction and take back $1 of boot (to avoid B reorganization treatment, as necessary), and then distribute the stock of newco rather than Target stock. In a Section 351 transaction, basis tracing is generally unavailable, thus this would in effect permit basis blending and would avoid the harsh result of Section 311(a). See Priv. Ltr. Rul. 200345010 (November 11, 2003) (allowing basis blending of operating assets in a Section 351 contribution; unclear whether operating assets were a mix of gain and loss assets, however).

[72] Indeed, even if this results in a net loss, Section 311(a)'s loss disallowance policy would be fully satisfied if the amount of net asset loss disallowed were the loss that would have been disallowed under Section 311(a) upon a distribution of the stock. Any net asset loss in excess of that amount should still be allowed.

distributes 100% of Target stock to Seller shareholders in a transaction to which a Section 336(e) election applies.

On a distribution of the stock of Target without a Section 336(e) election, Seller would not be permitted to recognize the 10 of built in loss on the Target stock.[73] If a Section 336(e) election applied to the distribution, under the proposed rules Target would recognize 10 of gain (the amount realized on deemed sale of Asset 2 (50) over the basis in Asset 2 (40)). The 50 of loss (the amount realized on the deemed sale of Asset 1 (50) over the basis in Asset 1 (100)) would be disallowed.

Again, the loss disallowance rules result in an inconsistency between a distribution under Section 311(a) and a distribution to which Section 336(e) applies – Section 311(a) would have disallowed 10 of stock loss, but, under the Proposed Regulations, on the deemed asset sale Target would recognize 10 of gross gain and would not be permitted to recognize any of its 50 of realized loss. We believe that this result is not justifiable. On these facts Target should be permitted to net its gains and losses (so that 10 of loss would be allowed). Arguments can also be made that Target's remaining net loss of 40 should be allowed for the reasons discussed at length above.[74] Indeed, we note that the IRS has been far more permissive in allowing selective gross asset loss recognition in recent Section 355 private letting rulings while permitting deferral of all gains.[75] Whatever the merits of those transactions (which allow the recognition of losses

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[73] § 311(a).

[74] A potential middle ground would be to allow net loss only to the extent in excess of what Section 311 would disallow. Under this approach, losses would be allowed to the extent of gains (in this case 10) and, in addition, any remaining losses would be allowed to the extent they exceed the stock loss that would have been realized and disallowed under Section 311 on a stock distribution without a Section 336(e) election (in this case, of the 40 of remaining loss, 10 would be disallowed and the remaining 30 would be allowed). See supra n. 72.

[75] See Priv. Ltr. Rul. 200422003 (May 28, 2004); Priv. Ltr. Rul. 200611003 (March 17, 2006); Mandel supra n. 6, at 31-32; Maryann D Angelo, How to Recognize Loss but No Gain: the Art of Losing Control, 33 J. Corp. Tax'n 34 (Nov./Dec. 2006) (discussing PLR 200611003); See generally Thomas F. Wessel, et. al, Corporate Distributions Under Section 355, 838 PLI/Tax 651 (October-December, 2008).

without the recognition of gains), it is difficult to see why Section 336(e) should deny the recognition of losses where gains are also recognized.[76]

B. Allocation of Excess Basis Resulting from Disallowed Loss.

If the final regulations contain a loss disallowance rule that disallows any loss (e.g., if the rule in the Proposed Regulations is finalized unchanged or the loss disallowance rule permits only netting of built-in asset gains and losses), we believe that the built-in loss at the corporate level should not be eliminated but, instead, should be preserved in the basis of Target's assets. There are a number of ways to do this. One reasonable method might be to allocate the disallowed loss to the basis of the loss assets in proportion to the loss realized with respect to each loss asset.[77]

> Example 5. Reallocation of Disallowed Losses. Seller owns Target. Target owns four assets with the fair market values and bases set forth below. Seller distributes the stock of Target and makes a Section 336(e) election. Assume the final Section 336(e) regulations permit the recognition of built-in loss up to the amount of built-in gain (i.e., netting).

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[76] In our Prior Report, we concluded that because "Parent would not be permitted to recognize a realized loss with respect to Controlled stock on a distribution subject to section 311(a) . . . a Section 336(e) Election should not be available [in such a case.]" Part III.B.3.b(3). Upon reconsideration, we have changed our views on this question for the reasons discussed above.

[77] This calculation would be done after the calculation and allocation of ADADP and AGUB as an adjustment to the basis of the loss assets. Analogous rules regarding allocation of consolidated net operating losses apply in the consolidated return context when a member of the group departs. See Treas. Reg. § 1.1502-21(b)(2)(iv). Other approaches are, of course, possible.

Asset	Basis	Fair Market Value	Built-in Loss
Asset 1	10	100	n/a
Asset 2	100	80	20
Asset 3	100	40	60
Asset 4	100	10	90

On these facts, there is 90 of gross built-in gain and 170 of gross built-in loss. Accordingly, 90 of loss would be recognized and the 80 of loss remaining would be disallowed. The 80 of disallowed loss would be allocated to the basis of the loss assets in proportion to their respective realized losses. There was 20, 60, and 90 of built-in loss in Asset 2, Asset 3, and Asset 4, respectively. Accordingly, after the transactions the bases of Asset 2, Asset 3, and Asset 4 would be as follows. Asset 2's basis would be 89.41 (80 + (20/170 * 80)); Asset 3's basis would be 68.24 (40 + (60/170 * 80); and Asset 4's basis would be 52.35 (10 + (90/170 * 80)).

C. Loss Disallowance in Other Contexts.

In the event that the IRS and Treasury accept our proposal that a Section 336(e) election should be available in certain situations where, absent the election, the disposition of stock would have been governed by Section 351, 354 or 356,[78] the issue will arise as to whether some form of loss disallowance rule should apply to the deemed asset sale pursuant to the Section 336(e) election. For the reasons set forth above with respect to distribution transactions, we do not believe that any loss disallowance rule should be adopted in these other sections. Furthermore, we note that, in the context of Section 351, 354 and 356 transactions, the case for preserving any unrecognized losses in the basis of assets is even more compelling than in the context of distributions because built-in losses would generally have been preserved in the actual stock transaction (subject to Section 362(e)) under applicable carryover basis regimes.

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[78] See Part IV, infra.

IV. Section 351 Transactions and Reorganizations Where All, Some or No Gain is Recognized.

A key requirement for eligibility to make a Section 336(e) election under the Proposed Regulations is that the Target stock "is not sold, exchanged, or distributed in a transaction to which section 351, 354, 355, or 356 applies".[79] In imposing this requirement, the Proposed Regulations import the "purchase" requirement of Section 338. Unlike Section 338, however, the statutory language of Section 336(e) contains no such requirement. Thus, certain choices present themselves in considering eligibility of Section 351 transactions. Specifically, should any Section 351 transactions at all be eligible? Should all Section 351 transactions be treated the same (i.e., all eligible or all ineligible) or should distinctions be drawn among Section 351 transactions such that some are eligible and some are not? If some or all Section 351 transactions should be eligible, should transactions governed by Section 354, 356 or 361 also be eligible? Is it relevant whether the transactions that would be deemed to occur if a Section 336(e) election were made would constitute a reorganization? The analysis of these questions must be informed by the following themes: mitigation of triple taxation, the reference in the legislative history to "taxable" transactions, conformity to Section 338(h)(10), simplicity, avoidance of incentives for taxpayers to take tax-motivated steps to "bust" nonrecognition transactions and respecting the tax treatment of the deemed transactions caused by a Section 336(e) election. While reasonable arguments can be made on all sides of these questions, we believe that a Section 336(e) election should generally be permitted in the case of Section 351 transactions. We recommend that all Section 351 transactions be eligible except insofar as the

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[79] Prop. Reg. § 1.336-1(b)(4)(i)(B). The Proposed Regulations further require that the Target stock "is not sold, exchanged, or distributed in any transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized in the transaction." It is not clear what "regulations" this latter test refers to.

relevant related party rules would preclude eligibility, as discussed in Part V below. At a minimum, we believe that Section 351 transactions in which all Seller's gain is recognized should, in general, be eligible.

A. Section 351 – All Gain Recognized.

The prohibition on making a Section 338 election in the case of a Section 351 transaction leads taxpayers to structure around Section 351 in transactions in which selling shareholders receive stock of the acquiror. We do not believe that Section 336(e) should also require taxpayers to distort their transactions. Example 6 involves a parent corporation that disposes of the stock of a subsidiary in exchange for cash and a small amount of stock in the acquiror corporation. The parties would like to make a Section 338(h)(10) election, but cannot in the basic form of the transaction.

> Example 6. Rollover; Section 351 Transaction; All Gain Recognized; No Section 338 Election Permitted. Suppose that Seller owns the stock of Target, with a basis of 30 and a fair market value of 100. Target's basis in its assets is 30, and the value of Target's assets is 100. Target has no liabilities. Seller and Target file consolidated returns. Investors form Acquiror by contributing 90 of cash to Acquiror. Then, Seller disposes of its shares in Target to Acquiror in exchange for shares of Acquiror worth 10 and cash of 90. The transaction is a Section 351 transaction. As a result, no Section 338 election may be made. Under the Proposed Regulations, no Section 336(e) election may be made either. Absent a Section 336(e) election, Seller would recognize all Seller's 70 of gain in the shares of Target. If a Section 336(e) election were permitted and were made, Target would recognize the 70 of gain in its assets, and then be deemed to liquidate into Seller. Seller would have a basis of 10 in the stock of Acquiror.

In Example 6, if the parties wish to make a Section 338(h)(10) election, they would restructure. Over the years, a number of approaches have arisen for "busting" a Section 351 transaction. For example, a small amount of non-voting stock could be issued to service providers. Alternatively, Target could merge into Acquiror or, if such a merger would qualify as a reorganization, an

indirect subsidiary of Acquiror.[80] Or, the investors could form Holding Company, which in turn forms Acquiror. Then, Holding Company could issue Holding Company stock to Acquiror, and Acquiror could deliver such Holding Company stock and cash to the Target shareholder or shareholders. Each of these approaches creates a tax-driven element to the transaction that potentially creates frictions to the transaction. Issuing stock to service providers who would not otherwise have received such stock changes the transaction's economics. A forward merger could be impractical for conveyancing reasons. The Holding Company/Acquiror approach might be challenging if Holding Company is organized in a jurisdiction which does not permit a subsidiary to own parent stock.

Because Section 336(e) does not require a corporate purchaser, additional alternative structures could be devised to avoid a Section 351 transaction in the case of a rollover. In the above example, a Section 351 transaction could be avoided simply by having the Investors buy shares directly from Seller and Seller retain shares in Target. However, the approach of dispensing with a holding company altogether may not always work from a non-tax perspective. For example, if a portion of Seller's proceeds will be debt-financed, it may be necessary to form a new holding company to own Target. Consider the following example involving the payment of debt-financed funds to Seller:

> Example 7. Rollover; Debt-Financed Proceeds to Seller. Suppose the facts are the same as in Example 6, except that, of the total 90 of cash to be received by Seller, 45 is funded by the Investors and 45 is funded by debt. Further, assume that 25 of such debt is meant to be issued by Target itself and 20 is intended to be issued by a newly-formed holding company owning Target so that the 20 of holding company debt is structurally subordinated to the 25 of debt issued by Target itself. The most natural way to structure this would be to have Investors

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[80] See Rev. Rul. 84-44, 1984-1 CB 105.

> form Acquiror, which will issue the 20 of structurally subordinated debt. Target would issue the 25 of structurally senior debt and would be treated as redeeming 25 worth of Target shares from Seller. Acquiror would pay Seller 20 of cash and issue 10 Acquiror shares in exchange for 30 worth of Target shares. Whether the Investors contribute their 45 cash to Acquiror (which then uses that cash to acquire the remaining 45 worth of Target shares from Seller) or the Investors pay Seller 45 cash directly in exchange for 45 worth of Target shares (which the Investors would then contribute to Acquiror), the transaction would likely qualify as a Section 351 transaction.

There may be ways to "bust" the Section 351 transaction set forth in Example 7. For example, Target could engage in an F reorganization by having a new holding company placed on top of it and Target converting to a disregarded entity. Then, the structurally subordinated debt could be borrowed by the holding company and the structurally senior debt could be borrowed by the Target-disregarded entity, and the Investors could buy shares directly from Seller. These steps may not always be practical, however. Converting Target to a disregarded entity, such as a limited liability company, may raise conveyancing issues under contracts or debt instruments of Target.

It would be desirable for taxpayers to be able to achieve asset basis step up without having to take steps to avoid Section 351 treatment. Section 336(e) provides that opportunity, because under the statute, there is no prohibition on Section 351 transactions, as there is in Section 338. The most sympathetic type of Section 351 transaction is a Section 351 transaction in which all the Seller's gain is recognized, as in Example 6. Based on the underlying policy of Section 336(e) to avoid inappropriate multiple levels of taxation, we believe that a Section 336(e) election should be permitted in the case of Example 6.[81] Such a transaction

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[81] As discussed below, our Prior Report recommended against permitting the election in an exchange governed by Section 351, 354 or 356, instead requiring that the transaction be one that, absent the election, would result in recognition of all gain or loss realized. However, the
(footnote continued)

resembles a sale or exchange governed by Section 1001 from the Seller's perspective. The Seller and the acquiror are in the same position in terms of gain recognition and basis that they would have been in if Section 351 did not apply.

B. Section 351 – Some Gain or No Gain Recognized.

We have also considered whether a Section 351 transaction in which not all the Target shareholder's gain is recognized should be eligible for a Section 336(e) election. Consider, for example, a Section 351 transaction in which all but one dollar of the shareholder's gain is recognized. Alternatively, consider a Section 351 transaction in which only one dollar of the shareholder's gain is recognized. Indeed, one could consider whether a Section 336(e) election should be available in a Section 351 transaction in which no gain is recognized at all, either because the consideration that Seller receives is all stock or because Seller has a loss in the Target stock. Recall that under Section 336(e), the transaction is recast as an asset sale by the Target and "no gain or loss shall be recognized on the sale, exchange, or distribution" of the Target stock. Section 336(e) overrides the tax consequences that would otherwise have applied to the Seller, raising the question whether it is relevant whether Seller would have had gain recognition under the transaction absent the Section 336(e) election. The statute does not by its

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Prior Report acknowledged that a case could be made for permitting the election in a Section 351 transaction in which all gain was recognized and stated that the Committee would have no objection to permitting the election in that context.

terms require that absent the election the sale, exchange or distribution would have been taxable to Seller.[82]

The purpose of Section 336(e) to avoid multiple layers of corporate-level tax suggests at first blush that a Section 351 transaction in which no gain is recognized by Seller should not be a candidate for a Section 336(e) election. In such a transaction, there is no immediate corporate-level tax, so there is apparently no need to provide an asset basis step up to avoid a double corporate-level tax. But the Section 336(e) election does avoid triple taxation even in cases where no gain or only some gain is recognized to Seller. In a Section 351 transaction, absent a Section 336(e) election, Seller's tax basis in Target is duplicated. Acquiror takes a carryover tax basis in Target, and Seller takes a substituted tax basis in Acquiror. Thus, if Acquiror sells the stock of Target, Acquiror will recognize gain, while the same gain is inherent in Seller's stock in Acquiror. If the parties are willing to recognize asset level gain on what would otherwise be the Section 351 transaction in order to avoid that problem, it seems appropriate to permit that.

At the same time, and further supporting the application of Section 336(e) to Section 351 transactions, it is undesirable to have a "cliff effect." We do not believe, for example, that it would be desirable to have a rule in which the election is available if all gain is recognized, but not available if all gain, other than one dollar of gain, is recognized. Among other things, Seller might not know its basis in the Target stock with exact precision or might be incorrect about its basis. It would be undesirable for the election to become invalid if Seller

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[82] As noted below, however, there is legislative history that suggests that the stock disposition should be a "taxable" transaction, but provides no clarification as to what is, or is not, a taxable transaction for this purpose.

thought all its gain had been recognized but Seller turned out to have miscalculated basis, whether by reason of error, inadequate information or misinterpretation of the law. Eligibility for Section 336(e) should turn on the type of transaction, rather than on Seller's tax accounting for the transaction.

This then leads to the question whether there is any harm in permitting a Section 351 transaction that involves no gain recognition to be eligible for Section 336(e):

> Example 8. Section 351 Transaction; No Gain Recognition. Suppose that Seller owns the stock of Target, with a basis of 30 and a fair market value of 100. Target's basis in its assets is 30, and the value of Target's assets is 100. Target has no liabilities. Seller and Target file consolidated returns. Investors form Acquiror by contributing 900 of cash to Acquiror. Seller contributes its shares in Target to Acquiror in exchange for Acquiror stock worth 100 (representing 10 percent of Acquiror). The 900 of cash contributed by the Investors is used to purchase operating assets. The transaction is a Section 351 transaction.

Under the Proposed Regulations, the Section 351 transaction described in Example 8 would be ineligible for a Section 336(e) election. Further, if the Proposed Regulations were expanded to cover Section 351 transactions in which all gain were recognized, Example 8 would still be ineligible.

However, if the parties wanted to achieve an asset basis step-up at the price of recognizing the 70 of gain in Target's assets, they could restructure. For example, as discussed above, they could cause the transaction to fail Section 351 by having the Acquiror issue a small amount of non-voting preferred stock in Acquiror to service providers. Or, the Investors could form Holding Company, which would form Acquiror. Holding Company would contribute its own stock to Acquiror, and then Seller would transfer the Target stock to Acquiror in exchange for the Holding Company stock. These transactions would be eligible for a Section 336(e) election under the Proposed Regulations (assuming that Seller is not related to Acquiror (or

Holding Company) after the transaction). Another alternative would be to merge Target into a subsidiary of Acquiror several tiers down from Acquiror or convert Target to a disregarded entity and transfer the interests of Target to such a subsidiary of Acquiror. In light of the ability for taxpayers to restructure to avoid Section 351 or otherwise achieve an asset basis step up "long-hand," we believe that transactions that would otherwise be Section 351 transactions should be eligible for a Section 336(e) election provided that all relevant parties agree to treat the transaction as a taxable asset sale.[83] Thus, we believe that, as a policy matter, Example 8 should be eligible for a Section 336(e) election.[84]

One possible concern about permitting a Section 336(e) election in a non-recognition transaction arises from language in Section 336(e)'s legislative history. The 1986

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[83] We acknowledge, however, that the ability of taxpayers to engage in restructurings of this type to avoid Section 351, and, thus (among other things) achieve a basis step up under Section 338(h)(10) (or otherwise) could be considered a "loophole." Under that view, it could be argued that an election that would facilitate a basis step up for transactions that might, absent artificial structuring, have been Section 351 transactions should not be made available. Whatever one's view on Section 351 avoidance generally (and we express none), however, we believe that a Section 336(e) election should still be made available for the reasons set forth in the text relating to avoiding triple taxation. If Section 351 avoidance is viewed as an inappropriate loophole, the Section 351 rules should be appropriately amended to curb it. We would still advocate, however, that a Section 336(e) election be made available for Section 351 transactions.

[84] The Section 336(e) election in this context ameliorates what would otherwise be the triple taxation inherent in the structure resulting in Example 8. At the end of Example 8, the shareholders of Seller own Seller, Seller owns stock in Acquiror and Acquiror owns Target. Since Seller does not own at least 80 percent of Target, Seller and Target would be ineligible for filing consolidated returns. Thus, if the transaction is ineligible for a Section 336(e) election, Subsidiary continues to have 70 of appreciation in its assets, that 70 of appreciation is duplicated in Seller's basis in its stock in Target and, of course, there is no change to the basis that Seller's shareholders have in their basis in Seller stock. Thus, there is now 140 of unrealized gain at the corporate level, while only 70 of economic gain is in the system. The Section 336(e) election ameliorates this by taxing the 70 of Target asset gain currently and giving Target a 100 basis in its assets and Seller a 100 basis in the Acquiror stock.

Conference Report describing Section 336(e) states that "under regulations, principles similar to those of section 338(h)(10) may be applied to taxable sales or distributions of controlled corporation stock" (emphasis added). Under that view, Section 351 transactions in which no gain is recognized would not be eligible.

Some factors militate against that conclusion, however. First, the reference to "taxable" transactions does not appear in the statute itself. Congress easily could have incorporated the concept into the statute by using a variant of the "purchase" concept found in Section 338. But, Congress did not do so. The four corners of Section 336(e) contain no requirement that the disposition be "taxable". One could argue that the statue's requirement of implementing regulations effectively incorporates the "taxable" transaction concept found in the legislative history on the view that Congress expected that regulations would impose similar requirements to those found in Section 338. On balance, however, we believe that that view reads too much into the requirement that regulations implement Section 336(e). Additionally, we believe that it is consistent with Congressional intent to apply Section 336(e) in a manner that ameliorates the triple taxation that would otherwise apply in the context of corporate dispositions, as discussed above. Accordingly, we believe Section 336(e) elections need not be limited to cases where the sale of stock would be subject to full gain and loss recognition.

In the Prior Report, we stated that we believed that a Section 336(e) election should be available only when the transaction would otherwise be fully taxable (i.e., full gain or loss recognition) to Seller. Our position in this Report thus departs from our position in the Prior Report in recommending a wider application of Section 336(e) in this respect. Although the Prior Report referred to the legislative history in reaching its view, the legislative history was not the primary basis for the Prior Report's conclusion. Rather, conformity with Section 338(h)(10)

was the primary basis.[85] We do not now feel as compelled to conform Section 336(e) with Section 338(h)(10). Instead, we believe that Section 336(e) can and should be used to mitigate triple taxation in certain cases that are not covered by Section 338(h)(10). Our current perspective reflects seventeen years of additional experience dealing with Section 338(h)(10). While we believe that in general Section 336(e) should conform to Section 338(h)(10), we also believe that Section 336(e) should be implemented in a manner that cures the anomalies created by certain aspects of the definition of "purchase" contained in Section 338.

If the IRS believes that some Section 351 transactions should be eligible for a Section 336(e) election, but not all, there are ways to draw the line. For example, Section 351 transactions in which a minimum amount of the consideration (e.g., ten percent) is boot could be eligible. Another alternative would be to require that the boot be sufficient to cause recognition of at least a specified percentage of Seller's gain. This latter approach would be troublesome, though, because if Seller has miscalculated its gain, then the entire transaction could become ineligible. We would not favor a test on which such draconian results could follow from incorrect tax accounting by Seller over the years. Assuming that at least some Section 351 transactions are eligible, the IRS could require that the deemed asset sale be treated as a fully taxable transaction, regardless of the amount of boot received in the Section 351 transaction, or the IRS could treat the deemed asset sale as giving rise to partial gain recognition, depending on the amount of boot. We believe that the former approach is more administrable and comports

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[85] The Prior Report stated that the "taxable" requirement was 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." Prior Report, Part III.B.3. It further stated that its recommendation is "based on another principle – conformity to section 338(h)(10)."

better with the statute and the basic model set out in the Proposed Regulations. The distinction is generally between full gain or loss recognition at the Target level and partial gain recognition as illustrated below:

> Example 9: Part Cash/Part Stock; Section 351 Transaction. Suppose that Seller owns the stock of Target, with a basis of 30 and a fair market value of 100. Target's basis in its assets is 30, and the value of Target's assets is 100. Target has no liabilities. Seller and Target file consolidated returns. Investors form Acquiror by contributing 900 of cash to Acquiror. Seller contributes its shares in Target to Acquiror in exchange for Acquiror stock worth 75 and cash of 25. The transaction is a Section 351 transaction. Assuming a Section 336(e) election is permitted and made, the full gain recognition approach would treat the deemed asset sale as fully taxable, giving rise to 70 of gain to Target and a 100 basis of New Target in its assets. This approach is supported by an analysis of the transactions deemed to occur by reason of the election. Specifically, Target is treated as transferring its assets to New Target in exchange for Acquiror stock and cash, and then Target is deemed to liquidate. The deemed transfer of Target's assets to New Target is not a Section 351 transaction, because Target receives the Acquiror shares from New Target, not Acquiror. The partial gain recognition approach would have Target recognize only 25 of gain, giving rise to 55 of asset basis in New Target.

In Example 9, we do not believe that it is appropriate to have only partial gain recognition on the deemed asset sale under Section 336(e). Perhaps the theory for partial recognition could be that there should not be more gain recognized at Target than there would be recognized by Seller absent the election. We do not believe that principle applies to Section 336(e), as a general matter, just as it does not apply to Section 338(h)(10). Another rationale could be that since the transaction is a Section 351 transaction absent the election, then Section 351 principles should apply if an election is made. That rationale would upend the basic model, however, as it would effectively posit that Target transferred its assets to Acquiror in exchange for Acquiror stock and cash. As discussed above in Part II, we believe that the Proposed Regulations are complicated enough without introducing special models for special situations. Thus, we favor full gain

recognition in the case of a scenario like Example 9 involving part-cash and part-stock consideration in a Section 351 transaction.

Also meriting discussion is a Section 351 transaction involving part-cash and part-stock consideration where the stock consideration is sufficient that the deemed transactions would constitute a C reorganization:

> Example 10: Part Cash/Part Stock; Section 351 Transaction; Deemed Transaction is a Reorganization. The facts are the same as in Example 9, except that instead of the consideration being 75 of Acquiror stock and 25 of cash, it is 90 of Acquiror stock and 10 of cash. As before, the transaction (absent the Section 336(e) election) is a Section 351 transaction. Assuming a Section 336(e) election is permitted and made, the full gain recognition approach would treat the deemed asset sale as fully taxable, giving rise to 70 of gain to Target and a 100 basis of New Target in its assets. Alternatively, one could analyze the deemed transactions to determine if they would constitute a reorganization. The above facts appear to qualify as a triangular C reorganization.

In cases where the deemed transactions qualify as a triangular C reorganization, arguably, a Section 336(e) election should not be permissible because Section 336(e) was not intended to facilitate reorganizations and the deemed asset sale would not have resulted in an asset basis step-up. While it is a close question, subject to the related party issues discussed below,[86] we believe that a Section 336(e) election should be permitted but that the deemed asset sale should be treated as fully taxable. We believe that the deemed transactions resulting from a Section 336(e) election should never themselves be recharacterized as a reorganization. While, as discussed below, one approach to addressing related party transactions would be to provide that if the deemed transactions would constitute a Nondivisive D reorganization, the election should not be allowed, we do not believe that the deemed transactions constituting a triangular C should

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[86] See Part V.

prevent eligibility for the election as there does not seem to be any abuse involved in parties making the Section 336(e) election in these circumstances.[87]

There are arguments, however, for precluding a Section 336(e) election if the deemed transactions would be a triangular C reorganization. In general, we believe that a Section 336(e) election should not be used to accomplish something that could not be accomplished long-hand. Further, our arguments regarding loss disallowance respect the structure and tax effect of the deemed Section 336(e) transactions. Precluding a Section 336(e) election where the deemed transactions would not result in a taxable transaction would arguably be more consistent with the basic model. Under such an approach, in order to make a Section 336(e) election, parties would be required to "bust" the C reorganization. However, we are disinclined to force taxpayers to take tax-motivated steps to "bust" a C reorganization. In light of the uncertainty of the "cause to be directed" doctrine making the consequence of an extra tier potentially uncertain, there may be frictional costs to busting a C reorganization that we would like to avoid. Further, triangular C reorganizations may often occur outside the related party context. Accordingly, we are more inclined to allow the election for transactions with unrelated parties that would, if they actually occurred, be triangular C reorganizations, and we are more inclined to prohibit the election for triangular C reorganizations involving related parties. The purpose of Section 336(e) to mitigate triple taxation is served by permitting the Section 336(e) election in this circumstance. Indeed, while our Prior Report required that the actual transaction

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[87] See further discussion in Part V below.

be taxable, our Prior Report did not condition eligibility for Section 336(e) on the deemed transactions being taxable.[88]

C. Reorganizations.

If the Treasury and the IRS determine to permit a Section 336(e) election in the case of a Section 351 transaction, then consideration should also be given to whether a Section 336(e) election ought to be permitted in the case of other types of nonrecognition transactions, such as those governed by Section 354, 356 and 361. For example, B reorganizations and Section 368(a)(2)(E) reorganizations involve dispositions of stock of a target. If the other requirements for eligibility for a Section 336(e) are satisfied, then the fact that the target shareholder disposes in a transaction that is governed by Section 354 or 356 might not be an impediment to Section 336(e) eligibility. The same types of considerations would apply as in the case of a Section 351 transaction.

Section 361 presents different considerations, however, as it addresses a corporate transferor that is a party to a reorganization. For example, suppose that a target corporation in a Section 368(a)(2)(D) transaction owns stock of a subsidiary. In the forward merger, the subsidiary stock is transferred to the surviving corporation in a transaction that is governed by Section 361. We do not believe that Section 361 transactions should be eligible for Section 336(e) elections as this would be inconsistent with the corporate-level nonrecognition treatment provided by Section 361. It would also lead to unwarranted complexity. Section 361 is intended to permit acquisitive and divisive transactions to occur without corporate level tax. Permitting Section 336(e) elections in this context would effectively allow corporations to cherrypick

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[88] Prior Report, Part II.C.

between recognition and nonrecognition treatment in the case of assets held in subsidiaries. The election would thus raise a consistency issue. While the consistency rules of Section 338 have been dramatically narrowed over the years, the rules that remain relate to choosing between outside and inside basis in the context of a recognition transaction. In the context of a transaction that is generally a nonrecognition transaction at the corporate level, we would be concerned about allowing taxpayers to choose which among its assets held in subsidiaries would be subject to recognition treatment and which would be subject to nonrecognition treatment.

D. General

1. Effect on Other Property Transferors or Minority Shareholders.

If any Section 351, 354 or 356 transactions are eligible for Section 336(e), one remaining issue is whether other persons involved in the transaction should be affected by the election. In the case of a Section 351 transaction, property transferors other than Seller may be counting on Seller to constitute a property transferor in order to qualify the transaction under Section 351. In the case of a B reorganization or a Section 368(a)(2)(E) reorganization, minority shareholders of the target may be seeking nonrecognition on the basis of the actual transaction, rather than the deemed Section 336(e) transactions.

We believe that such other persons generally should not be affected by the election. Corporate-level tax is, after all, paid on all the assets of the target, which argues against collecting additional tax on the exchange engaged in by the minority shareholders in a reorganization or the other property transferors in a Section 351 transaction. Further, the policy arguments, discussed above, in favor of permitting a Section 336(e) election for the parent corporation do not seem inconsistent with the policy arguments favoring tax-free incorporation

of assets for the other property transferors in a Section 351 or tax-free exchanges for the minority shareholders in a reorganization.

Moreover, in many cases, the other transferors in a potential Section 351 and the minority shareholders in a potential reorganization may be unaware whether a Section 336(e) election will be made. Indeed, the decision whether to make a Section 336(e) election may not be made until long after the transaction has occurred.

Finally, the transfer of stock of the target to a transferee corporation as part of a potential Section 351 transaction involving other property transferors could involve only a small amount of target stock. Section 336(e) requires that at least 80 percent of the vote and value of the target be disposed of, but the relevant dispositions could occur in multiple transactions and to more than one transferee. Thus, in a situation where less than 80 percent of the target is transferred to the corporate transferee, even a sophisticated other property transferor may not be able to infer that the transfer of target stock as part of the potential Section 351 transaction was eligible for Section 336(e), because the other property transferor may not be aware that, in the aggregate, 80 percent of the vote and value of the target was being disposed of in a qualified stock disposition.

It could be argued, however, that if a Section 336(e) election is made, then the Section 336(e) deemed transactions should be taken into account in determining whether the overall transaction is a Section 351. Under Section 336(e), new target would be treated as receiving corporate transferee stock from the corporate transferee and then transferring it to a person (old target) that did not transfer property to the corporate transferee. These steps would generally not count favorably toward the Section 351 control test. Under this view, providing a

basis step up to new target, while at the same time permitting the other property transferors to transfer without gain recognition under Section 351 is arguably inconsistent with the policy of Section 351, which is intended to permit parties jointly to transfer to the corporate transferee on a tax-free basis. However, basis step-up on transferred assets can occur in the context of a Section 351 transaction. Under Section 362(b), the corporate transferee's basis in the transferred property is increased by the amount of gain recognized to the property transferor. Thus, the asset basis step-up for new target resulting from the Section 336(e) election, reflecting gain recognition at old target, seems compatible with Section 351 treatment for the other property transferors.

2. S Corporations.

Note that if our suggestions relating to S corporations are adopted, all transferring shareholders would recognize gain under the rule we propose for S corporation elections.

3. Inside/Outside Basis Differences; Losses.

The above examples in this Part IV generally involved equal inside and outside asset basis, and they involve gain, rather than loss. Neither a disparity between inside and outside asset basis nor the existence of loss, rather than gain, should result in ineligibility for Section 336(e). Such factual situations do not preclude eligibility for Section 338(h)(10) nor do they preclude eligibility for Section 336(e) under the Proposed Regulations in the sales and exchanges to which the Proposed Regulations apply. A Section 351 transaction is no different in this respect. As discussed below in Part V.C, in the context of transactions involving related persons, Section 267 could apply to disallow or defer a loss recognized as a result of the election.

V. Dispositions to Related Persons.

The Proposed Regulations provide that a transaction is not a disposition, and thus cannot be part of a qualified stock disposition, if the stock is sold, exchanged or distribution to a related person. The definition of related person is imported from Section 338 and provides that two persons are related if stock owned by one of the persons would be attributed under Section 318(a) (other than Section 318(a)(4)) to the other.

We believe that the related party rule of the Proposed Regulations is too restrictive and should be liberalized in the final regulations. The definition of related person, by incorporating the attribution rules of Section 318(a), casts an extremely broad net that is difficult to justify from a policy perspective. This is also true under Section 338, but there the statutory language mandates that result. Section 336(e), however, has no such statutory mandate and, while we recognize that the principles motivating Section 338(h)(10) and Section 336(e) are parallel, as outlined in the legislative history, we do not believe that every technical requirement for Section 338 must be imported into Section 336(e).[89] Section 336(e) can and should be used to mitigate triple taxation in cases where Section 338(h)(10) would not apply.

Indeed, even if a more sensible definition of "related party" could be crafted, it is not clear to us that a flat prohibition on Section 336(e) elections in the case of related parties is necessarily appropriate. The legislative history to Section 336(e) contemplates that the implementing regulations could apply the provision to related person dispositions:

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[89] For example, we see no reason that the Section 338 requirement to have a purchasing corporation should be imported into Section 336(e).

> 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(c)(2), it may be appropriate to provide special rules for such corporation's section 381(c) tax 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.[90]

As discussed below, the Prior Report recommended that Section 336(e) elections be permitted in related party transactions, subject to an anti-abuse rule aimed at addressing the possibility of parties refreshing net operating losses, avoiding the separate return limitation year rules and triggering built-in gains in order to use a net operating loss that is otherwise limited by Section 382 (the "Principal Purpose Approach").[91]

We understand, however, that there could be concerns with the recommendation in our Prior Report, both because of difficulties in administering an anti-abuse rule and because it would permit a Section 336(e) election in cases where assets do not leave the economic group. Of course, the anti-abuse rule in our Prior Report was meant to address those concerns. Nonetheless, if these are the rationales for a prohibition on elections for related party transactions, the definition of related party should be revised so that it is more of an economic family concept. There are a number of ways to do this, including: (1) defining related person using the Section 338(h)(3)(A)(iii) definition but limiting upstream and downstream partnership attribution to partners owning at least a specified percentage of the partnership and then only if

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[90] The Committee Report refers to Section 368(c)(2), which is now Section 368(a)(2)(H)(i). The "control" concept contained in that section raises difficult technical and policy issues, discussed below. Notably, even in cases where a control relationship exists, the Conference Report contemplates that elections might be permitted.

[91] Prior Report, Part IV.C.

the partnership bears some economic relationship to the transaction (the "Modified Attribution Approach"), (2) defining related persons by reference to whether the transactions that would be deemed to occur under a Section 336(e) election constitute a nondivisive D reorganization or certain types of triangular C reorganizations involving Section 304(c) control (the "Deemed Reorganization Approach"), or (iii) defining related persons using Section 267 principles (with revisions) (the "Section 267 Approach"). On balance, although the recommendation in the Prior Report has its merits, we favor an approach that precludes a Section 336(e) election in the case of related person transactions properly defined. Of the possible alternatives for narrowing the definition of related person, we believe the Modified Attribution Approach works the best.

A. Revise Definition of Related Person.

1. The Modified Section 318 Attribution Approach.

The Section 338 definition of related person that appears in the Proposed Regulations is very broad because related persons are defined using Section 318. Under the Section 338 test, a Section 338 election may not be made if the stock of Target is "acquired from a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) thereof), be attributed to the person acquiring such stock".[92] Thus, for example, if a corporation's ("Seller Corp's") stock is widely held and publicly traded, Seller Corp owns Target that it wants to sell to a "Buyer Corp" that is owned by a private equity fund that is treated as a partnership for tax purposes, and Seller Corp owns a small stake (say 0.5%) in the private equity

[92] Section 338(h)(3)(A)(iii). The language is not a model of clarity. As interpreted by the IRS, one is to suppose that the seller owned stock in any corporation, e.g., X Corp. If the X Corp stock would be attributed to the corporate purchaser from the seller under Section 318, then the sale by the seller to the purchaser of the Target is not a purchase. See Priv. Ltr. Rul. 9747001 (Nov 21, 1997). Proposed Regulation Section 1.336-1(b)(11) articulates the same test.

fund, the sale might not be eligible for a Section 338(h)(10) election.[93] Under Section 318(a)(3)(A), if Seller Corp owned stock in any corporation, such stock would be attributed to the private equity fund partnership, and then (assuming the private equity fund owns at least 50 percent in value of the stock of Buyer Corp), under Section 318(a)(3)(C), from the private equity fund to Buyer Corp.

But, as a policy matter, such a minor relationship ought not to preclude eligibility for a Section 338(h)(10) election, and Section 336(e) (which is not burdened with the statutory definition in Section 338) certainly does not require such a minor relationship to preclude eligibility. Indeed, the IRS has ruled that Section 304 does not apply in a circumstance where one public company sells a subsidiary to another and the two public companies happen to be joint venture partners in a partnership.[94] A Section 336(e) election should be permitted in such circumstances.

Much of the overbreadth of the Section 338/318 structure could be ameliorated by narrowing the partnership attribution rules contained in Sections 318(a)(2)(A) and 318(a)(3)(A). Those rules provide that a partnership is deemed to own stock owned by any partner and any partner is deemed to own its proportionate share of stock held by the partnership, in each case, without requiring that the partner own any minimum threshold interest. Under the Modified Attribution Approach that we recommend, those rules would be revised in this context so that a

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[93] Priv. Ltr. Rul. 200637022 (Sept. 15, 2006) suggests that the sale would be so eligible. That ruling holds that sales by a US parent corporation of stock of its foreign targets to foreign subsidiaries of an unrelated foreign parent corporation are not Section 304 transactions despite a commonly owned partnership

[94] Id.

minimum threshold partnership interest would be required before attribution applies and further that attribution would apply only if the partnership bears an economic relationship to the sale transaction.[95] There are a number of choices for a revised ownership threshold: it could be 50% (by analogy to Section 318(a)(3)(C)), 25% (by analogy to the PFIC lookthrough rules), 10% (by analogy to Section 902 (indirect foreign tax credit)) and 871(h)/881(c) (portfolio interest)), or even 5% (by analogy to Section 267(e)(3) and Section 1563(e)(2)). If five percent is chosen, it could be refined with a rule similar to Section 304(c)(3)(B)(ii).

Applying this Modified Attribution Approach to the sale transaction described in Private Letter Ruling 200637022, the partners each had a significant ownership interest in the partnership, but the partnership was unrelated to the sale transaction. Thus, under the Modified Attribution Approach, a Section 336(e) election would have been permitted (assuming that a Section 338 election were not). In this example, the economic relationship prong of the test would be determinative.

This test would also permit a Section 336(e) election to be made in the example in which Seller Corp owns a partnership interest in the private equity fund that owns Buyer Corp. Consider the most moderate of the ownership threshold proposals – five percent. The election would be permitted assuming that Seller Corp owned less than five percent of the private equity fund partnership. In that example, the fact that the partnership owns Buyer Corp means that the partnership bears an economic relationship to the transaction. Accordingly, in that example, the five percent prong of the test would be determinative.

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[95] Given the differences between modern partnerships and classical partnership, a strong case can be made for amending Section 318 in all cases to include an appropriate threshold, but that is a question for another day.

Another scenario in which the related person test in the Proposed Regulations is overbroad involves a sale by one private equity fund to another. The Modified Attribution Approach would ameliorate the overbreadth. Specifically, assume that one private equity fund owns Seller Corp which owns Target, and a second private equity fund owns Buyer Corp. Seller Corp wishes to sell Target to Buyer Corp for cash. While the general partners of the two private equity funds are different, there may be substantial overlap among the limited partners of the two funds. Under the Proposed Regulations, the test would be whether stock in any corporation owned by Seller Corporation would be attributed to Buyer Corp. Under Section 318(a)(2)(C), stock owned by Seller Corp would be attributed to its owner, the first private equity fund, and then, under Section 318(a)(2)(A), from that fund to its owners, including the limited partners. Then, under Section 318(a)(3)(A), the stock would be attributed from the limited partners that own interests in both private equity funds to the second private equity fund and finally, under Section 318(a)(3)(C) from the second private equity fund to Buyer Corp. But, the limited partners are passive investors. At least as a policy matter, a basis step-up transaction should not be precluded in this circumstance, whether under Section 338(h)(10) or 336(e). In most cases, parties would likely not be able to determine whether Seller Corp and Buyer Corp are related under the Section 338 test and may well make a Section 338(h)(10) election, recognizing the possible risk that limited partner overlap would preclude such an election. Under the Modified Attribution Approach that we outline, only limited partners that own at least five percent of the capital and profits of both fund partnerships would be part of the attribution chain, and thus parties would have greater comfort that their transaction would qualify for Section 336(e). Mechanically, parties would likely make the Section 336(e) election protectively, because they would expect that the transaction qualified under Section 338 as a qualified stock purchase.

2. The Deemed Reorganization Approach.

An alternative approach to capturing relatedness would be the Deemed Reorganization Approach. Under that approach, Section 336(e) elections should not be permitted if the deemed transaction would constitute a reorganization under Section 368(a)(1)(D) by reason of Section 354 or 356 (a "Nondivisive D Reorganization") or if the deemed transactions would constitute a triangular C reorganization and Seller would have Section 304(c) control of New Target[96] after the transaction. This approach stems from references in the legislative history to Section 368(c)(2) "control" and a notion that Section 336(e) should not be used to accomplish something (a taxable transaction) that could not have been accomplished long-hand.

The legislative history implies that the drafters were concerned about a pre-existing control relationship between the acquiror or acquirors and the target. The legislative history refers to the possibility of an election "to treat a stock transfer of controlled corporation stock to persons related to such corporation within the meaning of section 368(c)(2)". Section 368(c)(2) is now 368(a)(2)(H)(i). That section cross-references Section 304(c), which defines "control", not "related". The references in the legislative history support the Deemed Reorganization Approach, because Section 368(a)(2)(H)(i), like Section 368(c)(2) before it, refers to Section 304(c) "[f]or purposes of determining whether a transaction qualifies under" Section 368(a)(1)(D). The drafters were thus concerned about transactions that would, in the absence of a Section 336(e) election, have qualified as a Nondivisive D Reorganization. A

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[96] The test could be based on Seller's relationship with New Target or on Target's relationship with the acquiror or acquirors. The legislative history refers to a relationship between the controlled corporation and "persons related to such corporation."

question arises then how to square the purposes of Section 336(e) – avoiding multiple corporate level taxation by providing a basis step-up – with the reorganization provisions, as applied to the transaction that Section 336(e) deems to have occurred. Consider the following case where the deemed transactions arising from a Section 336(e) election would result in a reorganization:

> Example 11. Related Party All-Cash Sale. Suppose that Seller owns Sub 1 and Sub 2. Seller sells Sub 1 to Sub 2 for cash. Suppose that a Section 336(e) election is permitted in such a case and that Seller makes the election. The transaction would be treated as if Sub 1 sold its assets to New Sub 1 for cash and then liquidated into Seller. Under Temporary Treasury Regulation Section 1.368-2T(l), this would be a Nondivisive D Reorganization.[97] As such, Sub 1 would not recognize any gain or loss on the transaction, and Sub 1's attributes would flow into New Sub 1.

As discussed in the introduction, we believe that Section 336(e) was not intended to provide taxpayers with a means to effect a reorganization. Thus, if a Section 336(e) election were permitted in the case of Example 11, the election should result in a taxable asset sale by Sub 1. On the other hand, Section 336(e) should not permit a result that could not have been accomplished long-hand. That implies that Section 336(e) should result in a Nondivisive D Reorganization in Example 11.

A resolution of this conflict that is consistent with the concerns expressed in the legislative history regarding liquidation reincorporation would be to preclude a Section 336(e) election if the transaction as recast would be a Nondivisive D Reorganization.[98] In a Nondivisive D Reorganization, Sub 1's attributes would generally flow to the acquiror, and not the Seller. By

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[97] See Temp. Treas. Reg. § 1.368-2T(l)(3), Example 3.

[98] An alternative approach would be to permit the election but let it have whatever consequences would flow from the deemed transaction, i.e., a reorganization and no basis step-up. As mentioned in the text, we do not believe that a Section 336(e) election should be used to create an asset reorganization.

precluding a Section 336(e) election in the case of a transaction that would be a Nondivisive D Reorganization, the Deemed Reorganization Approach would not permit attributes to flow up to Seller, as they would in a deemed liquidation of Sub 1 into Seller.

Under the Deemed Reorganization Approach, we also would not permit a Section 336(e) election for certain related person transactions that would be recast as a triangular reorganization under Section 368(a)(1)(C):

> Example 12. Related Party All-Stock Sale. The facts are the same as in Example 11, except that Seller sells Sub 1 to Sub 2 for Sub 2 stock, instead of cash. Suppose that a Section 336(e) election is permitted in such a case and that Seller makes the election. The transaction would be treated as if Sub 1 sold its assets to New Sub 1 for Sub 2 stock and then liquidated into Seller. Under Treasury Regulation Section 1.368-2(d), such a transaction would be a triangular C reorganization.[99] As such, Sub 1 would not recognize any gain or loss on the transaction, and Sub 1's attributes would flow into New Sub 1.

As in the case of Example 11, a Section 336(e) election should not be permitted for Example 12, or any similar transaction if the recast would be a triangular C reorganization and Sub 1's shareholders own Section 304(c) control of New Sub 1 after the transaction.[100]

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[99] See Temp. Treas. Reg. § 1.368-2T(l)(3), Example 3.

[100] We distinguish between related person and non-related person transactions whose recast would be a triangular C reorganization. Recall that we believe that Example 8, a Section 351 transaction in which the consideration is all stock, should be eligible for a Section 336(e) election, while we believe that Example 12 should not be eligible. The difference between the two cases is that, in Example 8, Seller does not own Section 304(c) control of New Target after the transaction, while in Example 12, Seller does own Section 304(c) control of New Sub 1 after the transaction. This distinction is grounded in our belief that Section 336(e) should be available in the case of transactions between unrelated parties that would, in the absence of Section 336(e) be tax-free because parties could in many cases, restructure to make them taxable. However, because the legislative history expresses concern about manipulation in the case of related person transactions, we have concluded that Section 336(e) should not be available for related party transactions that are susceptible to manipulation.

The Deemed Reorganization Approach would generally treat parties as related only if they bear a meaningful economic relationship to one another. Section 304(c) would apply to determine whether the Seller owns control of the transferee corporation. While Section 304(c) does contain ambiguities, the approach would generally not lead to anomalous results based on partnership attribution.[101] For example, on the facts of Private Letter Ruling 200637022, if a Section 336(e) election were made, the sale of subsidiaries from one publicly traded company to another would not constitute a Nondivisive D Reorganization (or a triangular C reorganization with Section 304(c) control) despite the existence of a jointly owned partnership. Similarly, there would be no such reorganizations in the case of the Seller selling stock to a private equity fund portfolio company where the Seller owns a small interest in the private equity fund, nor in the case of a sale by a private equity fund portfolio company to another private equity fund. In all these cases, if the consideration is all cash, then there would not be any stock of New Target actually issued and Temporary Treasury Regulation Section 1.368-2T(l) would not deem any stock to be issued because that regulation requires that the transferor and transferee be owned by the same person or persons in identical proportions.[102] The analysis becomes more complex if a portion of the consideration is stock (or stock in Target is retained):

> Example 13. Private Equity Fund Sale to Private Equity Fund Acquiror Corp for Cash and Stock. Suppose that Private Equity Fund One owns Seller Corp, which owns Target. Private Equity Fund Two forms Acquiror Corp. Acquiror Corp

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[101] Under this approach, a stock sale that would otherwise be a Section 304(c) transaction would be tested like any other, i.e., if the deemed transactions would be a Nondivisive D Reorganization or if they would be a triangular C reorganization and a control relationship exists, then a Section 336(e) election would not be permitted.

[102] Temp. Treas. Reg. § 1.368-2T(l).

purchases Target for cash and a small amount of Acquiror stock. If a Section 336(e) election were made, the transaction would be treated as if Target sold its assets to New Target for cash and Acquiror stock and then Target liquidated into Seller Corp. Regardless of the degree of overlap among the limited partners of Private Equity Fund One and Two, the transaction should not qualify as a Nondivisive D Reorganization, because Section 368(a)(1)(D) requires that New Target stock, not Acquiror stock, be issued.[103]

Example 14. Private Equity Fund Sale to Private Equity Fund for Cash and Stock. The facts are the same as in Example 13, except that Private Equity Fund Two buys the stock of Target directly, without any Acquiror Corp and Private Equity Fund One retains a small number of shares of Target. If a Section 336(e) election were made, the transaction would be treated as if Target sold its assets to New Target for cash and New Target stock. Whether the transaction qualifies as a Nondivisive D Reorganization could depend on the degree of overlap of the limited partners of the two funds, because Nondivisive D Reorganization qualification would require that Seller own Section 304(c) control of New Target. Seller Corp would be attributed stock of New Target that is attributed to the overlapping limited partners. However, it is unclear how the continuity of interest test would be applied in this circumstance.

If the IRS adopts the Deemed Reorganization Approach, then the IRS should clarify certain aspects of the scope of Nondivisive D Reorganizations, such as how continuity of proprietary interest applies.[104]

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[103] Section 368(a)(1)(D) requires that stock "of the corporation to which the assets are transferred" be distributed in a Section 354, 355 or 356 transaction.

[104] Consider the following example: Seller owns 99 percent of Target, and A, an unrelated individual, owns one percent of Target. A also owns 100 percent of the stock of Acquiring. Target is worth $100. Target merges into Acquiring for $99 of cash (which Seller receives) and $1 of Acquiring stock (which A receives). The example appears to meet the statutory tests for a Nondivisive D Reorganization. However, we believe that the example should not qualify as a Nondivisive D Reorganization, because it lacks continuity of proprietary interest. See Treasury Regulation Section 1.368-1(b) (providing that continuity of proprietary interest as described in Treasury Regulation Section 1.368-1(e) is required for reorganization treatment "except as provided in section 368(a)(1)(D)"). Section 368(a)(1)(D) does not otherwise provide. We interpret the exception to refer to the notion that divisive D reorganizations are not governed by -1(e) and are instead subject to the continuity rules set forth in Treasury Regulation Section 1.355-2(c). Supporting this interpretation is the statement in Treasury Regulation Section 1.368-1(b) to the effect that E and F reorganizations do not require continuity of proprietary interest at all. If the intention was to

(footnote continued)

Another aspect of the Deemed Reorganization Approach that would bear clarification would be how the test should be analyzed in a case where Target is not wholly owned by Parent. Minority shareholders might or might not participate in the actual sale transaction. If they do not participate, then they could be viewed as receiving New Target stock in the transaction. Note that if, based on Parent's participation, the transaction would otherwise have qualified as a triangular C reorganization, the receipt of New Target stock by the minority shareholders will cause the transaction to fail C reorganization status.[105] Presumably, although the Section 336(e) election should not affect the minority shareholders, determining eligibility under the Deemed Reorganization Approach should take into account any consideration received, or Target stock retained, by the minority shareholders.

3. The Section 267 Approach.

The Section 267 Approach is another possible way to determine relatedness for purposes of Section 336(e) eligibility. The test could be whether Seller and Target bear a Section 267 relationship to one another after the transaction or whether Seller bears a Section 267 relationship to any acquiror. Sections 267(c), 267(e)(3) and 1563(e) contain the relevant attribution rules, and have the advantage that Section 267 does not have a partner to partnership attribution rule and already has a five percent threshold for partnership to partner attribution. Unfortunately, Section 267 attribution has another problem - the partner-to-individual-partner

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exempt Nondivisive D Reorganizations from the continuity of proprietary interest requirement altogether, we would have expected the regulations to make that similarly clear. If the example were a Nondivisive D Reorganization, such treatment would be a trap for the unwary. The parties are related in only a very small degree and would normally expect that the transaction would give rise to corporate level gain or loss and a basis step up or down in the assets of Target.

[105] Treas. Reg. § 1.368-2(d)(1).

attribution rule contained in Section 267(c)(3). If the Section 267 Approach is adopted, then this rule should be excluded as modern day partners frequently have little knowledge much less control over the shares of stock that their partners own.

4. Distributions.

Although the discussion above focuses on sales or exchanges, related person distributions raise similar concerns and we believe that the same rule that applies in the sale or exchange context should generally apply to distributions. Otherwise parties will simply effect a related person distribution and make a Section 336(e) election in circumstances where related person sales are prohibited. Under each of the alternatives for redefining related party, although the details are different, we expect that in each case distributions by widely held corporations will not be caught, but distributions by closely held corporations may be. Under the approach we favor (Modified Attribution), most distributions to shareholders who own (actually or constructively) less than 50 percent of Seller will not be considered related person transactions. Under the Deemed Reorganization Approach, the calculation is further complicated by the special rules of Section 304(c)(3)(B) for shareholders who hold between 5 and 50 percent. Under the Section 267 Approach, the test would either be whether Seller and Target are members of the same controlled group after the transaction or whether Seller bears a Section 267 relationship to any distributee.

B. Permit Elections Subject to Anti-Abuse Rule.

The Prior Report outlined an approach under which Section 336(e) elections for related party transactions were not per se prohibited, but instead would be subject to an anti-abuse rule if New Target was controlled by Seller within the meaning of Section 304(c) and the principal purpose of the transaction was to secure tax rather than business objectives. The Prior

Report also proposed a rebuttable presumption that a transaction had a prohibited principal purpose if the present value of the anticipated future tax benefits to New Target arising from the transaction (assuming Section 336(e) applied) were greater than the current year's actual out-of-pocket tax cost of the transaction to Seller and Target. Conversely, if the reverse were true, there would be a rebuttable presumption to the effect that the principal purpose was not securing tax benefits.[106] The Prior Report treated any transaction with respect to which a Section 336(e) election was made as a taxable sale of assets, regardless whether the deemed transactions would, under general tax principles, constitute a reorganization. We continue to believe that an approach based on principal purpose along the lines outlined in the Prior Report would be viable and consistent with the intent of Section 336(e), although we now prefer the Modified Attribution Approach discussed above.

C. Losses on Related Party Transactions.

Whatever the approach adopted to address related party transactions, Section 267 and other loss disallowance or deferral rules should apply to the deemed transactions, thereby minimizing the potential for abuse in the case of target corporations with losses. Further, we believe that Section 267 should apply the way it would apply if the deemed Section 336(e) transactions were actually undertaken. Thus, Section 267 should disallow or defer gross losses. Our position with respect to Section 267 is distinguishable from our position with respect to

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[106] Id. In the Prior Report, we argued that sales between members of a consolidated group should be eligible for a Section 336(e) election. But, this was primarily to address the double tax problem discussed in Part VI below, i.e., if a member of the group transfers the stock of another member in a taxable transaction and then the sold member is transferred outside of the group in a transaction with respect to which a Section 338(h)(10) election is made (or its assets are sold and then it liquidates), then it appears that the deferred intercompany gain from the initial transfer is triggered and asset level gain is recognized on the sale outside the group.

distributions of stock of the target and Section 311. As mentioned above in Part III, we believe that disallowance of gross losses on distributions frustrates Congressional intent to mitigate triple taxation in the case of distributions of stock. Disallowance or deferral of gross losses under Section 267 does not. Indeed, Congress itself expressed concerns about permitting Section 336(e) elections in the context of related party transactions.

VI. Intragroup Sale or Spin followed by External Sale or Spin with Section 336(e) or 338(h)(10) Election.

The Preamble requested comments regarding situations in which the stock of Target is transferred within an affiliated group and then is retransferred to a third party in a transaction for which a Section 336(e) election is made. These transactions could potentially result in double tax at the corporate level:

> Example 15. Intragroup Sale Followed by Deemed Asset Sale to Third Party and Deemed Liquidation of Target. Seller owns Sub 1 and Sub 2. Sub 1 owns Target. Sub 1 sells the stock of Target to Sub 2 for cash resulting in a deferred intercompany gain in the stock of Target. Then, Sub 2 sells the stock of Target in a separate transaction in which either a Section 336(e) or a Section 338(h)(10) election is made. The election results in recognition of gain in the assets of Target. Further, the deemed liquidation resulting from the election results in the deferred intercompany gain being taken into income.[107] Thus, both asset level gain and stock level gain in Target is apparently recognized.

The double tax consequences described above should not apply. The double tax runs contrary to the purpose of the intercompany transaction regulations to "clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax

[107] Treas. Reg. § 1.1502-13(c), -13(f)(7)(i), Example 5.

liability)."[108] The intercompany transaction should not distort the group's taxable income or tax liability. However, we do not believe that all intercompany transactions should be made eligible for a Section 336(e) election in order to address that double tax problem.[109] We believe that a targeted solution is feasible.

Indeed, the consolidated return regulations already address the problem. Specifically, Treasury Regulation Section 1.1502-13(f)(5)(ii)(C) contemplates a scenario where an intragroup transfer of stock of a member is followed by a disposition of such member outside the group in a Section 338(h)(10) or similar transaction. The Regulation solves the double tax problem by permitting the taxpayer to elect to treat the deemed liquidation of Target into Sub 2 as a Section 331 liquidation for the sole purpose of providing Sub 2 with a loss, which offsets Sub 1's deferred intercompany gain that arose on the disposition of Target to Sub 2. The Regulation applies not only in cases where Target is sold outside the group with a Section 338(h)(10) election, but also "if T transfers all of its assets to a nonmember and completely liquidates in a transaction comparable to the section 338(h)(10) transaction" described in the Regulation.[110] A forward taxable merger is cited as a "comparable" transaction. A Section 336(e) election transaction should also be considered a "comparable" transaction eligible for

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[108] Treas. Reg. § 1.1502-13.

[109] The Prior Report stated that it was a close call as to whether intercompany transactions within a consolidated group should be eligible for Section 336(e) and took the view that they should be so eligible primarily so that the double tax described in the example in the text could be eliminated. The Prior Report also stated that if an alternative means of addressing that double tax problem were implemented, then the Committee would not feel strongly one way or another about whether intercompany transactions within a consolidated group should be eligible for a Section 336(e) election. Prior Report, at III.B.3.c.

[110] Treas. Reg. § 1.1502-13(f)(5)(ii)(C)(3).

elective relief under that regulation.[111] However, it should be made clear that just as Section 338(h)(10) does not preclude recognition of the loss that the -13(f)(5) election provides, Section 336(e) also does not preclude recognition of the loss on the disposition of Target that -13(f)(5) would provide.[112]

An alternative approach would be to permit a Section 336(e) election on the intragroup transfer, retroactively if necessary such that Target picks up gain on its assets, Sub 1's sale of Target stock is disregarded and New Target gets a basis step up in its assets. We believe that that approach is unduly complicated. Significant time may elapse between the intragroup sale and the third party sale of Target. In Example 15, Sub 2's ownership of Target would have affected Sub 2's earnings and profits and possibly other attributes as well. Thus, to permit a Section 336(e) election on the intercompany sale would require that tax accounting be redone. It may be difficult to redo the accounting if the relevant returns for the group have already been filed.

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[111] Example 15 is an extension of a more basic consolidated return example, specifically, an intercompany sale of the stock of Target followed by the liquidation of Target. Under the matching rule of Treasury Regulation Section 1.1502-13(c), the deferred intercompany gain on the intercompany sale is triggered upon the liquidation. See Treas. Reg.§ 1.1502-13(f)(7)(i), Example 8. That structure, stock sale followed by liquidation, is one step short of the steps involved in Example 15, stock sale followed by asset sale followed by liquidation. The former case results in one level of tax—on the stock sale—while the latter case, were it not for the assistance provided by -13(f)(5) would result in double tax.

[112] Section 338(h)(10) provides that no gain or loss is recognized on the stock sale "to the extent provided in regulations". Section 336(e) provides that no gain or loss is recognized on the stock sale. It does not contain the "to the extent" modifier, but all of Section 336(e) is "[u]nder regulations prescribed by the Secretary". Thus, we believe the IRS has authority to apply -13(f)(5) in the context of a Section 336(e) election.

The two approaches differ in terms of where in the group Target's attributes end up. In the approach of the consolidated return regulations, Target's attributes flow up to Sub 2 in the deemed liquidation resulting from the Section 338(h)(10) or 336(e) election made on the external transaction. In the second approach, permitting the Section 336(e) election on the internal transaction, Target's attributes flow up to Sub 1 in the deemed liquidation. Recall that the Conference Report stated:

> 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(c)(2), it may be appropriate to provide special rules for such corporation's section 381(c) tax 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.

The first approach does not present the concerns in the Senate Report because it does not make a Section 336(e) election available to an intragroup transfer. The existing Treasury Regulation Section 1.1502-13(f) rules appear to have opted for the attributes flowing to Sub 2. This does not seem objectionable to us.

A similar issue arises in the case of an intragroup distribution, followed by an external distribution if the intragroup distribution is taxable under Section 355(d) or (e) or fails Section 355 altogether:

> Example 16. Intragroup Distribution Followed by External Distribution. Seller owns Sub 1, and Sub 1 owns Target. Sub 1 distributes the stock of Target to Seller in a transaction intended to be tax-free to Sub 1 and Seller under Section 355. Seller then distributes the stock of Target to its shareholders in a transaction intended to be tax-free to Seller and its shareholders under Section 355. A Section 336(e) election is made on the latter spin, protectively, in case the spin turns out to be taxable to Seller. Acquiror acquires Target in a transaction that causes Section 355(e) to apply. Accordingly, the intragroup spin is outside

Section 355 altogether,[113] and the external spin is subject to Section 355(e). The intragroup spin results in gain recognition to Sub 1 on the stock of Target. As a result of the Section 336(e) election, the external spin results in gain recognition on the assets of Target. Thus, tax is imposed twice, once on the stock of Target and once on its assets.

Either of the two approaches described above – allowing the Seller to elect under Treasury Regulation Section 1.1502-13(f)(5)(ii)(C) or permitting Seller to make a Section 336(e) election with respect to Target on the intragroup spin – could address the double tax described in Example 16. Administratively, permitting a Section 336(e) election on the intragroup spin may not be as complicated in Example 16 as permitting a Section 336(e) election on an intragroup sale (Example 15) would be, because the intragroup spin is likely to be close in time to the external spin. We believe that the -13(f) election would, under the existing regulations, be available in Example 16.[114]

We believe that eliminating the double tax in either of those ways is consistent with the purposes of 355(f) and 358(g). Those provisions appear chiefly to be concerned with obtaining the right basis in the stock of a spun company, avoiding multiple levels of tax, preventing shifting of basis in the stock of one corporation to another and causing the gain to be recognized in the appropriate member of the group.

Section 355(f) aims to avoid multiple levels of corporate tax on a double spin that is subject to Section 355(e) by turning off Section 355 and the basis allocation rules of Section 358 for the internal spin and instead providing Seller with a fair market value basis in the stock

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[113] See Section 355(f).

[114] Section 311(a) and its underlying policy should not preclude recognition of the loss granted by -13(f) because the construct is that the loss arises in a Section 331 liquidation, and not in a distribution by Seller of the Target stock.

of the internally spun subsidiary.[115] Our suggested approaches to addressing the double tax problem in Example 16 above also aims to avoid multiple levels of corporate tax.

Section 355(f) itself can create anomalous basis and gain results, however. Recognizing this, Congress authorized Regulations to "eliminate some or all of the gain recognition required under section 355(f) in connection with the issuance of regulations that would cause appropriate basis results . . . so that concerns regarding present law section 355 basis rules . . . would be eliminated."[116] Our suggested approaches are consistent with that purpose.

Section 358(g) authorizes regulations to address intragroup distributions to provide appropriate adjustments to stock basis. The Senate Report identifies a concern relating

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[115] Suppose that P owns S, and S owns T. S distributes the stock of T to P, which then distributes the stock of T to P's shareholders. If Section 355(e) applies, then, under Section 355(f), the first spin is ineligible for Section 355 altogether. Under Section 355(e), S would recognize gain on the internal spin. P's basis in S increases by the amount of the gain recognized by S and decreases by the value of T. P would take a fair market value basis in the stock in T. On the subsequent spin by P of the T stock, Section 355(e) would apply, but no further gain would be recognized, because P's basis in T is fair market value. Absent Section 355(f), P's basis in S would increase by the gain recognized on the internal spin. But, presumably it would not be reduced by the value of T. Instead, P's basis in S would be allocated between S and T. Thus, P would not obtain a fair market value basis in T. P's basis could be higher or lower depending on the amount of gain recognized in T and the relative values of S and T. In light of the fact that Section 355(e) would tax all the gain in the stock of T in the internal spin, Section 355(f) fixes T's basis at fair market value after the internal spin so that the subsequent spin (or a subsequent sale of S) would not give rise to additional gain.

[116] Senate Finance Committee Report (S. 949), as released on June 20, 1997 relating to the Taxpayer Relief Act of 1997 (P.L. 105-34) [hereinafter, "Senate Report"]. One way in which Section 355(f) creates anomalous gain recognition results is, in the above example, if P distributed the stock of S, rather than T. In that event, under Section 355(e) and (f), gain would still be recognized on the internal spin on the stock of T. In addition, Section 355(e) would result in gain recognition on the external spin with respect to the stock of S. Congress authorized Regulations to ameliorate that double tax.

to excess loss accounts and a concern relating to basis shifting. As to excess loss accounts, the Senate Report expresses concern about the elimination, of an excess loss account in a lower-tier subsidiary through an internal spin-off, which creates the "potential for the subsidiary to leave the group without recapture of the excess loss account, even though the group has benefited from the losses or distributions in excess of basis that led to the existence of the excess loss account."[117] We do not believe that our proposals permit the elimination of an excess loss account because the Section 336(e) election would result in recognition of asset level gain. Although the -13(f)(5) approach would in effect eliminate or reduce a deferred intercompany gain (or excess loss account) on the internal spin, the Section 336(e) election would result in gain recognition by T. Moreover, because, typically, the greater an excess loss account, the lower T's basis in its assets, our approach would tend to have the result that the excess loss account would generally in effect be recaptured through greater gain on the deemed asset sale by T. Thus, we believe that our approaches do not present the concerns expressed in the legislative history and would not undermine this purpose of Section 358(g).

A second concern identified by the Senate Report relates to shifting basis in the context of an internal spin: "If a disproportionate amount of asset basis (as compared to value) is in one of the companies . . ., present law rules under section 358(c) can produce an increase in stock basis relative to asset basis in one corporation, and a corresponding decrease in stock basis

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[117] See Treas. Reg. § 1.1502-19(g), Example 3. In that example, P owned S which owned T. P had an excess loss account in the stock of S, and S had an excess loss account in the stock of T. S distributes the stock of T to P in a Section 355 transaction. Under Section 358, the lower-tier excess loss account is eliminated, and P's excess loss account in the stock of S is allocated between S and T. Then, P distributes the stock in T to P's shareholders in a Section 355 transaction. The excess loss account in the T stock (i.e., the portion so allocated to the T stock as a result of the internal spin) is triggered into income. That Regulation thus permits a lower-tier excess loss account to be eliminated.

relative to asset basis in the other company".[118] Suppose P owns S, which owns T, and P has high stock basis in S, S has high basis in its assets but low basis in the stock in T, and T has low basis in its assets. If S spins T to P, then a portion of the high stock basis in S is shifted to T. T could then be sold after a period of time with little gain. Meanwhile, the assets of S could be sold with little gain, as well. This concern is not implicated by our proposals because our proposals do not shift outside basis from one entity to another.

In short, we do not believe that the purposes of Section 355(f) or 358(g) imply that a taxpayer that recognizes asset level gain in a lower tier subsidiary should also be required to recognize gain on the stock of that subsidiary. Under our proposals, either Section 336(e) would apply to the intragroup spin or Treasury Regulation Section 1.1502-13(f)(5) would apply.

VII. Expansion to S Corporations.

We recommend that a Section 336(e) election be available in the case of a target corporation that is an S corporation. A Section 336(e) election would serve the same purpose in the S corporation context as it serves in the Subchapter C context, namely, to avoid the imposition of a layer of taxation unintended by the applicable regime. Subchapter C imposes corporate tax on earnings which, when added to the shareholder-level tax on dividends, results in two levels of tax. The Section 336(e) election helps to avoid the triple tax that would arise absent an asset basis step-up. By the same token, Subchapter S aims to impose a single tax on Subchapter S corporate earnings. A Section 336(e) election would help to avoid a second level of tax that would arise absent the inside asset basis step-up. The IRS recognized the point when it permitted Section 338(h)(10) elections for Subchapter S corporations. As has been discussed

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[118] Senate Report.

above, Section 336(e) should be implemented in a manner that is consistent with Section 338(h)(10). Consider the following example:

> Example 17. Target S Corp; Sale to an Individual; No Section 338 Election Permitted. Suppose that individuals A, B and C own the stock of Target, an S corporation, equally. Suppose that the value of Target's assets is 90, Target's basis in its assets is 30, A, B and C each have a basis in their shares of 10 and Target has no liabilities. A, B and C sell their shares in Target to D, another individual, for cash of 90 (i.e., 30 each to A, B and C). A Section 338(h)(10) election is not permitted, because the purchaser is not a corporation. Thus, A, B and C will each recognize gain of 20 on the sale of their shares (or a total of 60 gain recognized to the shareholders). The basis of Target in its assets is not adjusted. Thus, if Target were then to sell its assets for their value of 90, Target would recognize 60 of gain, which would flow up to D, the new owner of Target, The 60 of economic gain in Target's assets is thus taxed twice, once on the sale by A, B and C of their shares, and once on the sale by Target of its assets. D would have a built-in loss in D's Target stock of 60 (equal to D's initial basis of 90 plus the 60 basis step up resulting from Target's asset sale gain less the value of the Target stock of 90). If D recognizes that loss and is able to utilize it to offset the asset gain, then the loss would eliminate the double tax. But, this may not in fact occur for a number of reasons – e.g., the loss cannot be used unless it is recognized on a sale of the stock or a liquidation of Target, which may not occur for many years, if ever; all or a portion of the 60 asset sale gain may be ordinary while the loss on the stock would generally be capital; or D may die in which case D's heirs would take the stock with a stepped-down basis of 90, its fair market value.

Double tax on Target's gain in Example 17 is inconsistent with the purpose of Subchapter S to impose only one layer of tax on Subchapter S income. Making a Section 336(e) election available in this setting would solve that problem.

Moreover, one of the chief cases where we believe that Section 336(e) could be especially useful is the case of the acquisition of an S corporation from one or more shareholders in a transaction in which the shareholders "roll over" some of their shares, i.e., some of the consideration is stock. Example 18 illustrates this relatively common type of transaction:

> Example 18. Target S Corp; Rollover; No Section 338 Election Permitted. Suppose that individual A owns the stock of Target, an S corporation, with a basis

> of 30 and a fair market value of 100. Investors form Acquiror by contributing 90 of cash to Acquiror. Then, A contributes A's shares in Target to Acquiror in exchange for shares of Acquiror worth 10 and cash of 90. The transaction is a Section 351 transaction. As a result, no Section 338 election may be made. A recognizes all A's 70 of gain in the shares of Target, because A's gain realized of 70 is less than the 90 of cash boot that A received. Acquiror's basis in the stock of Target is 100, its fair market value, and A's basis in the Acquiror shares equals their fair market value of 10.

Under current law, absent the parties taking steps to prevent Section 351 from applying, the transaction would be ineligible for a Section 338(h)(10) election because a Section 351 transaction is not a "purchase" under Section 338. We do not believe it serves any tax policy purpose for parties to take the kinds of steps that are often taken to prevent Section 351 from applying. As long as the parties are willing to pay tax on the asset level gain, we do not see any harm to permitting a Section 336(e) election in the case of an S corporation target and, for the reasons discussed in Part IV above, a Section 351 transaction.

The statute permits a Section 336(e) election if "a corporation owns stock in another corporation meeting the requirements of section 1504(a)(2)", thus raising an authority question. Importantly, the IRS overcame a similar authority question in permitting Section 338(h)(10) elections in the case of S corporations. Section 338(h)(10) provides that an election may be made if the target is "a member of the selling consolidated group." "Selling consolidated group" is defined to mean a group that "files a consolidated return" or, under regulations, an "affiliated group of corporations" that includes the target corporation, whether or not the group files consolidated returns. Plainly, an S corporation is not a member of a selling consolidated group under these definitions. Nonetheless, Treasury Regulation Section 1.338(h)(10)-1(c) permits a Section 338(h)(10) election for an S corporation target.

Indeed, in applying Section 338(h)(10) to S corporations, the IRS overcame an additional statutory hurdle by providing that the S election terminates after the deemed transactions resulting from the Section 338(h)(10) election. Under Section 1362(d)(2)(B), an S corporation election is terminated when a corporation ceases to be a small business corporation. The termination is effective "on and after the date of cessation." Nonetheless, Treasury Regulation Section 1.338(h)(10)-1(d)(3)(i) provides that, in the case of a Section 338(h)(10) election with respect to an S corporation target, the target's election "continues in effect through the close of the acquisition date (including the time of the deemed asset sale and the deemed liquidation) notwithstanding section 1362(d)(2)(B)."

Just as the Treasury and IRS overcame these hurdles in the context of Section 338(h)(10), we believe that they should do so here.[119] The election serves an important policy purpose of bolstering the single level of tax on corporate earnings that is the intention of Subchapter S. That policy applies equally to Section 336(e), and we are not aware of any abuses that would arise by applying Section 336(e) to Subchapter S corporations. Both such elections serve the Congressional intent inherent in Subchapter S. Moreover, we are not aware of any abuses involving Section 338(h)(10) elections and S corporations.

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[119] We note that a Section 338 election would be permissible in any event for an S corporation if the acquiror is a corporation and the other requirements of Section 338 are met. Thus, it may be that the IRS viewed the application of Section 338(h)(10) to S corporations as an extension of the application of Section 338 to S corporations. The IRS also may have drawn support from Section 338(i), which provides that the "Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

Statutory authority for applying Section 336(e) to S corporation targets could potentially be found, for example, in Section 338(i).[120] That provision authorizes regulations that advance the purposes of Section 338. But, as discussed above, the purposes of Section 338 are in many ways the same as the purposes of Section 336(e). As stated in the Conference Report to the enactment of Section 336(e), "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."[121]

We believe our recommendation to the effect that the target itself must sign the Section 336(e) election form protects the purchaser. Consistent with Section 338(h)(10), we would also require that all S corporation shareholders, whether or not they are sellers, consent to the Section 336(e) election in order for it to be valid, thus protecting the shareholders.[122]

As a policy matter, extending Section 336(e) to S corporations seems appropriate and desirable to us. The logical extension of avoiding triple taxation in the Subchapter C area is to avoid double taxation in the Subchapter S area. Permitting Section 336(e) elections in connection with transactions involving S corporations would serve that purpose.

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[120] See supra n. 119.

[121] H.R. CONF. REP. 99-841, 1986 U.S.C.C.A.N. 4075.

[122] Treas. Reg. § 1.338(h)(10)-1(c)(3) requires the S corporation shareholders to sign Form 8023, and specifies that such shareholders that do not sell must also consent.

VIII. Section 336(e) Elections involving Foreign Corporations.

As noted in the Prior Report, we believe that the Section 336(e) election should apply to all qualifying dispositions of Target stock, regardless of whether Seller, Target, or both are foreign corporations.[123] Section 338 elections apply to foreign and domestic corporations, and we see no principled means of distinguishing Section 336(e) elections from Section 338 elections in this regard. As discussed above, the election will facilitate appropriate U.S. tax results that could have been accomplished in a long-hand transaction, but without the frictional costs that would make a long-hand transaction more burdensome. As in the domestic area, the models described above should apply to Section 336(e) elections involving foreign corporations, and the consequences of the deemed transactions would generally follow under other provisions of the Code and Regulations, as discussed below, although as in the case elsewhere under subchapter C, cross-border transactions may require modifications in some cases.

A. U.S. Seller – Foreign Target.

In general, in a transaction to which Section 336(e) does not apply, gain on the sale of the stock of a Foreign Target is taxed to the U.S. Seller that is a United States shareholder[124] under Section 1248 as a deemed dividend, but only to the extent of the U.S. Seller's share of the Foreign Target's earnings and profits accumulated while Foreign Target was a controlled foreign corporation ("CFC") of U.S. Seller.[125] U.S. Seller is entitled to a deemed foreign tax credit with respect to the deemed dividend included under Section 1248.[126]

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[123] Prior Report, Summary of Recommendations.

[124] Section 1248(a)(2).

[125] Section 1248(a).

Except as discussed below with respect to adopting certain Section 338 principles and FIRPTA, the application of Section 336(e) would be relatively straightforward in this context. If U.S. Seller sells, exchanges or distributes the stock of Old Foreign Target and a Section 336(e) election is made, Old Foreign Target will be deemed to sell all of its assets to New Foreign Target. Old Foreign Target will not be subject to taxation in the U.S. on the gain on the deemed sale of assets except to the extent the assets are used in a U.S. trade or business[127] or are U.S. real property interests.[128] If the gain on the deemed sale of assets is Subpart F income, U.S. Seller will generally include that gain as income under regular Subpart F rules.[129]

The deemed liquidation of Old Foreign Target would be an inbound liquidation for purposes of Section 367(b) and U.S. Seller would be required to include in its income as a deemed dividend the "all earnings and profits amount" of Old Foreign Target.[130] The all earnings and profits amount would include earnings and profits attributable to the deemed sale of assets,[131] but not to the extent already included in the U.S. Seller's income as Subpart F

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[126] Treas. Reg. § 1.1248-1(d).

[127] Section 864(c)(2)(A).

[128] Section 897(a)(1).

[129] Section 951(a).

[130] Treas. Reg. § 1.367(b)-3(b)(3)(i). Unlike prior law under the temporary regulations (Temp. Treas. Reg. § 7.367(b)-3) where the domestic corporation had a choice to include the all earnings and profits amount with different consequences that flowed from whether such amount was included, the final regulations do not permit a choice and require the inclusion of this amount. See Prior Report, Part V.D.1.a

[131] Treas. Reg. § 1.367(b)-2(d).

income.[132] As discussed below, under Section 338(h)(16) principles, the earnings and profits arising from the deemed asset sale would likely be U.S. source for foreign tax credit purposes. In these circumstances, the all earnings and profits amount may exceed the gain on the deemed sale.[133] The U.S. Seller would be entitled to a deemed-paid foreign tax credit under Section 902 to the extent the requirements of 902 are satisfied,[134] subject to the application of Section 338(h)(16) principles, which, as discussed below, we believe should apply under Section 336(e) in essentially the same way they apply under Section 338.

1. Application of Section 338(h)(16) Principles.

Section 338(h)(16) provides that, except as provided in regulations, Section 338 does not apply for purposes of determining the source or character of any item for purposes of Sections 901-908, but only to the extent that the gain from a deemed asset sale is not already

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[132] Treas. Reg. § 1.367(b)-2(d)(ii) (excluding from the all earnings and profits amount, amounts described in Section 1248(d)).

[133] See Treas. Reg. § 1.367(b)-3(b)(3)(ii), ex. 2. Other consequences of an inbound Section 332 liquidation would also apply. The natural consequences of a deemed liquidation should apply under Section 367(b) and the regulations that limit the carryover of tax attributes from the liquidated Old Foreign Target that would otherwise carry over pursuant to Section 381. First, excess foreign taxes under Section 904(c) allowable to Old Foreign Target under Section 906 carry over to U.S. Seller, but U.S. Seller is not permitted to succeed to any other foreign taxes paid or incurred by Old Foreign Target. Treas. Reg. § 1.367(b)-3(d). Second, net operating loss or capital loss carryovers of Old Foreign Target only carry over to U.S. Seller to the extent the carryovers were effectively connected with the conduct of a trade or business in the United States. Treas. Reg. § 1.367(b)-3(e). Finally, earnings and profits of Old Foreign Target that are not included in income of U.S. Seller as a deemed dividend are eligible to carry over to U.S. Seller only to the extent such earnings and profits are effectively connected with the conduct of a trade or business in the United States. Treas. Reg. § 1.367(b)-3(f). (Earnings and profits attributable to a permanent establishment in the United States may also carry over.) All other earnings and profits do not carry over and are eliminated.

[134] Treas. Reg. § 1.367(b)-3(b)(3)(i), § 1.367(b)-2(e), and § 1.367(b)-3(b)(3)(ii), exs. 1 & 2.

includible in gross income as a dividend under Section 1248 (determined without regard to the deemed asset sale by a foreign corporation). Section 338(h)(16) is intended to prevent the additional earnings and profits generated from a foreign corporation's deemed asset sale from increasing a Section 1248 deemed dividend, which, after the application of the look through rule in Section 904(d), would result in foreign source general limitation earnings that could be offset by indirect foreign tax credits from the deemed sale or other excess foreign tax credits.

The law relating to Section 338(h)(16) has generally not changed since our Prior Report.[135] The statute continues to apply without any regulatory overlay. Section 338(h)(16) is not without problems or complexity (and indeed one could debate whether it is truly appropriate as a policy matter given that the opposite result could be achieved in an actual asset sale or using a "check and sell" approach) but it seems to us that if Section 338(h)(16) is to apply in the Section 338 context, it must apply equally to Section 336(e) elections (with any exceptions or improvements to Section 338(h)(16) that may be made in further legislation, regulations or rulings). Congress clearly intended for similar Section 338(h)(16) principles to apply to Section 336(e) elections,[136] and there is no justification for making a distinction between Section 338 and Section 336(e) in this context. Moreover, any difference between Section 338 and Section

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[135] With the exception of a very small number of IRS interpretations of this provision. See Priv. Ltr. Rul. 8938036 (June 27, 1989), CCA 200103031 (Oct. 18, 2000).

[136] H. Rep. 100-795, 100th Cong., 2d Sess. 314-315. ("To the extent that any regulations prescribed under section 336(e) extend the principles of section 338 to a sale of stock in a foreign corporation, the committee anticipates that those regulations will not affect inappropriately the determination of source and of a taxpayer's foreign tax credit limitation . . . . The committee intends that regulations ensure that the objectives of the Act's foreign tax credit limitation changes are preserved.").

336(e) might give taxpayers an incentive to plan into Section 336(e) transactions.[137] The Proposed Regulations provide that Section 338(h)(16) principles should apply to Section 336(e) elections where the issue arises in their existing scope (i.e., where U.S. Target has a foreign branch),[138] and Section 338 principles are generally incorporated by reference.[139] Until final regulations are promulgated under Section 338(h)(16), we believe this approach is sufficient in the context of Section 336(e) elections involving foreign sellers and targets to address these concerns and to create parity between Section 338 elections and Section 336 elections, as Congress intended. In the context of a Section 336(e) election with respect to a foreign target corporation by a U.S. seller, we would expect that this would mean that any resulting earnings and profits would be U.S. source for foreign tax credit purposes, and in the context of a foreign seller of a foreign target, that the earnings and profits would be foreign source in the passive basket.

There are numerous problems of application and arguably incorrect applications of Section 338(h)(16) in the Section 338 context that have been discussed at length by other

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[137] See Fuller, supra n.7 ("As the situation stands, taxpayers can make a § 336(e) election without concerns regarding the limitations of § 338(h)(16). Section 338(h)(16)'s application to §336(e) is not self executing. This could present (and may already have provided) interesting planning opportunities for U.S. sellers.").

[138] Prop. Treas. Reg. § 1.336-2(g)(3)(i) ("The principles of section 338(h)(16) apply to section 336(e) elections for target corporations with foreign operations to ensure that the source and foreign tax credit limitation are properly determined.") .

[139] Prop. Treas. Reg. § 1.336-1(a).

commentators.[140] If any future regulations address these concerns, they should do so for both Section 338 and Section 336(e).

B. Foreign Seller – U.S. Target.

We believe that there are three general circumstances where a Foreign Seller of a U.S. Target may wish to make a Section 336(e) election: first, where the U.S. Target is a U.S. real property holding company (USRPHC) and the Foreign Seller wishes to take advantage of the "FIRPTA purge" rule discussed below; second where the U.S. Target has a loss in its assets and the loss may result in a carryback that could give rise to a tax refund; and third, where the Foreign Seller is a CFC, as the deemed sale of assets by U.S. Target would not give rise to Subpart F income for direct or indirect U.S. shareholders of Foreign Seller, where the sale of the stock of U.S. Target would give rise to Subpart F income. These circumstances are generally not abusive and we see no reason why the final regulations if expanded to foreign corporations should prevent any Section 336(e) election with respect to the sale of stock of a U.S. Target by a Foreign Seller.

The consequences of a Foreign Seller selling the stock of a U.S. Target in a transaction for which a Section 336(e) election is made are generally straightforward. The election should generally have the same consequences as when a U.S. Seller sells U.S. Target and they make a Section 336(e) election. Old Target would be deemed to have sold all of its assets to New Target, and Old Target would liquidate under Section 332, distributing the sales

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[140] See e.g. See Kimberly S. Blanchard, Cross-Border Acquisition Patterns Implicating Section 338: Recommendations for Reform, 843 PLI/Tax 607, 638-639 (Oct-Dec 2008); Thomas W. Avent, Jr. & John F. Simon, Section 338(g) Elections: Opportunities and Hidden Hazards, 18 J. Int. Tax'n, Number 2 (February 2007); Chudy, Early-Hubelbank & Reddy, 788-2nd T.M., Stock Purchases Treated as Asset Acquisitions — Section 338, VII.D.2.e.

proceeds to Foreign Seller. Although Section 367(e)(2) generally makes a Section 332 liquidation taxable when a U.S. subsidiary liquidates into a foreign parent, in these circumstances that rule would not result in any additional gain or loss because U.S. Old Target would have recognized the gain or loss in the assets on the deemed sale pursuant to the Section 336(e) election.

As a result of the deemed liquidation of U.S. Old Target into Foreign Seller resulting from the Section 336(e) election, Foreign Seller succeeds to the earnings and profits of U.S. Old Target under section 381.[141] The earnings and profits represent income that U.S. Old Target will generally have paid tax upon when earned. To avoid double taxation of the earnings and profits, we believe that these carried over earnings and profits should be treated as "post-1986 undistributed U.S. earnings" within the meaning of Section 245(a). This would allow U.S. shareholders of Foreign Seller to claim a dividends received deduction when Foreign Seller later distributes the earnings and profits attributable to U.S. Old Target. The flip side may be that if the foreign corporation pays dividends to foreign shareholders, the dividend may be subject to U.S. withholding tax.[142]

1. FIRPTA Purge.

It may be beneficial for a Foreign Seller to make a Section 336(e) election with respect to the sale or exchange of the stock of a USRPHC. Section 897(c)(1)(B) generally provides that an interest in a U.S. company is not a United States real property interest (USRPI)

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[141] Treas. Reg. § 1.367(e)-2(b)(3)(ii).

[142] Such dividends could be U.S. source dividends under Section 861(a)(2)(C) subject to withholding. Because these earnings were not subject to branch profits tax, Section 884(e)(3)(A) does not apply.

if on the date of the disposition of the stock of that company it (i) holds no USRPI and (ii) all of the USRPI were disposed of in transactions in which the full amount of gain (if any) was recognized.[143] The deemed sale from U.S. Old Target to U.S. New Target should qualify as a transaction in which gain is recognized for purposes of the FIRPTA purge rules, resulting in the stock of Old Target ceasing to be a USRPI when it is deemed to liquidate (except in the unusual circumstance where consideration includes one or more USRPIs).[144] Thus, the sale or exchange of stock in U.S. Target would not have any FIRPTA implications. This result is appropriate because all of the built-in gain in the USRPI held by U.S. Target would be recognized on the deemed sale. In this context, it would be important, as discussed below, that U.S. Target either sign the Section 336(e) election form after the acquisition or for Foreign Seller to notify purchasers. U.S. Target would be liable for tax on what, in effect, otherwise would have been Seller's FIRPTA stock gain and any other gain on U.S. Target's deemed sale of assets, and so purchasers should be aware that Seller and U.S. Target are making a Section 336(e) election. Section 1445 withholding issues are discussed below in Part VIII.E.ii.

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[143] See Treas. Reg. § 1.897-2(f)(2).

[144] Even in this case, there may be no tax due under Section 897, albeit for a different reason. Under Temp. Reg. § 1.897-5T(b)(3)(iv)(A), a foreign corporation that meets the stock ownership requirements of Section 332(b) with respect to stock in a domestic corporation that is a United States real property interest (other than a foreign corporation electing domestic status under Section 897(i)) does not recognize any gain under Section 897(e)(1) upon receipt of property in a section 332(a) liquidation. In this case the relevant exception to withholding is Treas. Reg. § 1.1445-2(d)(2).

2. CFC Issues.

In the absence of a Section 336(e) election, the sale by a Foreign Seller that is a CFC of the stock of U.S. Target would result in Subpart F income[145] that would pass through to direct or indirect U.S. shareholders.[146] If a Section 336(e) election applies with respect to the sale, there will generally be no gain (and thus no Subpart F income) at the Foreign Seller level. This result is appropriate because U.S. Target recognizes the full gain on the deemed sale of its assets, so a U.S. tax has been paid. The U.S. shareholders will eventually pay tax, but only on an actual shareholder level realization or other future event.[147] In the case of a U.S. shareholder that is a corporation, this tax may be mitigated by a dividends received deduction under Section 245.

C. Foreign Seller – Foreign Target.

In a circumstance where a Foreign Seller disposes of the stock of a Foreign Target in a sale or exchange, current law likely permits a result similar to what a Section 336(e) election would permit.[148] Except in cases where the Foreign Target is a per se corporation,[149] or where an entity classification election is not otherwise available,[150] Foreign Seller can "check the box" to

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[145] Section 954(c)(1)(B)(i). Of course, this will not be the first subpart F event as the stock will be U.S. property within the meaning of Section 956, which may make this scenario a rare one.

[146] Section 951(a).

[147] E.g., a dividend or a transaction that gives rise to subpart F income or an investment in U.S. property under Section 956.

[148] Dover Corp. v. Commissioner, 122 T.C. 324 (2004). We note that the IRS has not acquiesced in Dover, but also has not appealed.

[149] Treas. Reg. § 301.7701-2(b)(8).

[150] E.g., where an entity classification election has been made within five years and other relief is not available.

treat Foreign Target as a disregarded entity.[151] When Foreign Seller elects to treat Foreign Target as a disregarded entity, Foreign Target is deemed to distribute all of its assets and liabilities to Foreign Seller in liquidation.[152] The assets owned by Foreign Target will be treated as a division of Foreign Seller. Foreign Seller can then effectively accomplish an asset sale for U.S. tax purposes by selling the stock of Foreign Target. In Dover Corp. v. Commissioner,[153] the Tax Court confirmed the desired subpart F results of this structure. The Dover result, however, is unavailable where a check-the-box election is not available and a formal liquidation of Foreign Target is unwieldy, although at least temporarily a Section 338(g) election may achieve a similar result[154] for per se corporations and other foreign corporations that are ineligible to check the box because they have elected corporate status in the five years before the sale.

The results of a Section 336(e) election, are generally similar to those of a Dover transaction although the ordering is slightly different (i.e., in the Section 336(e) election context, foreign target is deemed to sell assets and liquidate into foreign parent; in a Dover transaction, foreign target is deemed to liquidate first and then foreign parent is deemed to sell the assets). Section 336(e) elections, by contrast, can be made available for target corporations that are not

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[151] The check and sell approach is also available where Foreign Target has multiple owners. There the Foreign Sellers can check to treat Foreign Target as a partnership, with similar results.

[152] Treas. Reg. § 301.7701-3(g)(1)(iii).

[153] 122 T.C. 324 (2004).

[154] See David R. Sicular, W(h)ither Subpart F, Doc. 2007-8611, 115 Tax Notes 349, 375, 2007 TNT 79-37 (Apr. 23, 2007) (exploring whether Section 338(g), Section 954(c)(6), and Section 964(e) can effectively prevent the sale of a CFC engaged in a trade or business from generating Subpart F income, and thus achieving results similar to that available under the check and sell approach where the CFC is a per se corporation, at least until the sunset of Section 954(c)(6)).

eligible for the check the box rules without disrupting the general application of the latter rules.[155] A Section 336(e) election in this context would permit taxpayers to accomplish these results for per se corporations and corporations that cannot otherwise check the box to be disregarded entities. We believe that there is no reason to distinguish between corporations that can elect to be disregarded and corporations that for various reasons cannot, and, accordingly, Section 336(e) elections should be available for foreign target corporations in addition to the check and sell approach.

If a Section 336(e) election is made with respect to a Foreign Seller's disposition of the stock of Foreign Target, Foreign Target generally will not be subject to U.S. tax on the deemed asset sale (except with respect to assets that are used in a U.S. trade or business or are

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[155] This relief may be complicated by another aspect of the Section 336(e) Proposed Regulations – the rule that Section 338 trumps Section 336(e). That is, if a stock sale is a qualified stock purchase for Section 338 purposes, it cannot be a qualified stock disposition for Section 336 purposes. Prop. Reg. § 1.336-1(b)(v). After the sunset of Section 954(c)(6), a Section 338(g) election will not replicate the Dover result (because the Section 964(e) deemed dividend will be Subpart F income). This may make the Dover result unavailable for transactions that involve a qualified stock purchase of a foreign target that cannot check the box. In this setting, achieving the result in the text may require elaborate structuring to avoid having a transaction constitute a qualified stock purchase. For example, foreign buyers may be willing to set up a corporation owned 99%/1% by different entities in the buyer group and then to check the box to treat that corporation as a partnership. The sale of stock to that local-law corporation would not then be a qualified stock purchase under Section 338, and thus could qualify under Section 336(e), as proposed. It would be preferable, we think, where there is a foreign seller and foreign target, to modify the overlap rule to permit taxpayers to choose whether to elect under Section 338 or Section 336(e) or to provide that Section 336(e) trumps Section 338. In this limited context, we do not believe that this will permit the opportunity for abuse and will prevent unnecessary structuring to plan out of Section 338.

U.S. real property interests). In general, Foreign Target will not be taxable on the distribution of the proceeds of the deemed sale in the deemed liquidation to Foreign Seller.[156]

D. Distributions involving Foreign Corporations.

We do not see any special issues in the international context relating to distributions where a Section 336(e) election is made with respect to the target corporation.[157]

E. Miscellaneous Issues Involving Foreign Corporations.

1. Section 954(c)(1)(B).

The Preamble specifically requests comments on the characterization of the gain on the deemed asset disposition under Section 954(c)(1)(B). We are not entirely sure what the concern is. We believe that the deemed asset disposition under Section 336(e) should be treated just like an actual asset disposition; the income on the deemed asset sale should be characterized in the same way it would have been on an actual asset sale followed by a liquidation. We would not distinguish between an actual and a deemed transaction for purposes of the characterization of income under Section 954(c)(1)(B). If an actual asset disposition would not have given rise to Subpart F income, then a deemed asset disposition should not give rise to Subpart F income. Even if the IRS's arguments in Dover were adopted, they would not apply under Section 336(e) where the CFC itself is treated as selling its own historic business assets.

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[156] Treas. Reg. § 1.367(e)-2(c).

[157] We note that in the cross-border context there are special rules not applicable in the wholly-domestic context that may make an otherwise qualifying Section 355 distribution taxable in whole or in part to the distributing corporation. See e.g., Treas, Reg. §§ 1.367(e)-1 and 1.367(b)-5. As a general matter, we would expect that Section 336(e) would apply in these areas in accordance with the principles discussed elsewhere in this report.

2. Application of Sections 897 and 1445.

The Preamble also requests comments regarding how the withholding tax provisions of Section 1445 should apply to the deemed asset disposition (if relevant). We believe that there are several issues worthy of discussion including how the underlying substantive rules of Section 897 apply in this context. We note, too, that most (if not all) of these issues are also present in the Section 338 context and should be addressed there as well.

Section 1445 generally requires a transferee of a U.S. real property interest to withhold 10% of the amount realized from a foreign transferor. The purpose of Section 1445 withholding is to provide an extra level of comfort that FIRPTA tax will in fact be paid by the foreign party that owes the tax. It also has the additional effect of collecting at least a portion of that tax somewhat earlier than it might otherwise have been paid.[158] Section 336(e) elections in the international context, like Section 338, will raise a number of issues under Section 1445.

a. Foreign Target.

The first, and most obvious issue, is that if a Section 336(e) election is made with respect to a Foreign Target that owns a United States real property interest ("USRPI"), Foreign Target will be deemed to sell the USRPI and the buyer will be required to withhold 10% of the purchase price. In this context, Section 1445 withholding is a bit anomalous. First, the party seemingly required to withhold (New Target) is the same entity as the seller (Old Target) from whose proceeds withholding is required.[159] Second, New Target has no actual sale proceeds,

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[158] Treas. Reg. § 1.1445-1(c).

[159] In the proposed sale-to-self model the unrelated third party would have the initial withholding obligation, and Old Target would have a reciprocal obligation on the repurchase.
(footnote continued)

only the assets it is deemed to purchase. Third, Target, which is the withholding agent, also has the underlying liability under Section 897 so it will be required to withhold its own tax.[160] Of course, all of the oddities already exist in the context of Section 338(g) elections (where there is no particular guidance), and the third also exists in other areas by express statutory provision (Section 1445(e)(2)). Presumably, as under Section 338(g), in effect the Target is required to pay its FIRPTA tax in installments – 10% of gross value upon the deemed sale (and, as noted below, this payment will tend to be delinquent, as the election will often be made much later than the resulting deemed sale is deemed to occur[161]) and the balance when it files its return for the deemed sale. With respect to all of the options discussed below, any regulations should permit the withholding certificate procedure to apply generally to any withholding obligations imposed in this context to help prevent a situation where withholding based on 10% of the amount realized is excessive.[162]

Perhaps this state of affairs (which has apparently existed under Section 338 for some time) is satisfactory. If not (and if the government feels additional collection methods are needed), there is a range of options available to ensure that the IRS receives appropriate payments of FIRPTA tax. Any solution will need to deal with the anomalies noted above that arise from the differences between the real world (where cash moves) and the deemed asset sale

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This would be very messy and could result in double withholding – yet another reason to refrain from adopting the sale-to-self method in the Section 355 context.

[160] Prop. Treas. Reg. § 1.336-2(b)(ii). (New Target remains liable for the tax liabilities of Old Target, including the tax liability for the deemed disposition tax consequences).

[161] Under Treasury Regulation Section 1.1445-1(c)(1), Section 1445 withholding is generally required to be remitted within 20 days of the sale or exchange, which under Section 336(e) would be deemed to have occurred on the disposition date.

[162] See Treas. Reg. §§ 1.1445-3, 1.1445-6.

resulting from a Section 336(e) election: (1) the actual cash payments (which are normally where withholding occurs) are being made between seller and purchasers based on the sale of stock of Foreign Target and not, of course, on the deemed asset sale between Old Foreign Target and New Foreign Target (because it is not actually occurring in the real world where cash is changing hands)[163] and (2) given the fact that the Section 336(e) election may not be filed until long after the date of the transaction, the parties may not know at the time of the closing (when the cash is actually paid) that they will ultimately decide to make the election. Whether or not any changes are made to Section 1445 to account for Section 338 or 336(e), the timing of payment issue should be addressed.

We believe that if the government wishes to add additional safeguards, the best alternative is to require the seller of target stock (whether U.S. or foreign) to remit to the IRS a portion of the proceeds received from the purchaser (whether U.S. or foreign) when the Seller files the Section 336(e) election form (or perhaps within 20 days thereafter).[164] Such a system might work as follows. The Section 336(e) election would require an electing Seller with respect

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[163] Or in the sale-to-self model, between Old Target and unrelated third party, and then unrelated third party and Old Target.

[164] Other options might include requiring Foreign Target to pay the 10% of amount realized on the deemed sale of a USRPI when the Section 336(e) election is filed with the IRS (or within 20 days after thereafter). This option would solve the timing problem for Foreign Target, but would not do much for the IRS – Foreign Target (in its capacity as New Target) probably has this obligation under current law already because New Target is deemed to have purchased USRPI from Old Target. In addition, there is no reason to assume that Foreign Target would have sufficient cash to make the payment at that time. It also is problematic to impose the obligation on purchaser – while this is the normal Section 1445 system where purchaser is buying stock of a U.S. corporation, that is not the transaction in this case and, for the reasons discussed elsewhere in this report, it is not practical to involve purchaser in matters related to Section 336(e) (as there could be thousands of purchasers). Indeed, in this case, there may be no statutory authority to do so.

to a Foreign Target to pay in connection with the filing of a Section 336(e) election the amount of withholding that Foreign Target would owe if it sold all of its assets on the disposition date for their fair market value. This amount will generally be 10% of the fair market value of the USRPIs on that date unless a lower amount is permissible pursuant to the Section 1445 regulations (including the withholding certificate rules, which we would propose to make available to Seller to the same extent they would be available to Target).[165]

For administrative ease, we would then suggest treating the withholding tax as if paid by the FIRPTA taxpayer (Target in this case), which means that it would be credited against Target's tax liability.[166] The Target will still be obligated to file a tax return, which would report gain or loss on the sale of the USRPI, and Target would be required to make up any shortfall if the Seller's remittance was not sufficient to cover the FIRPTA tax. Target would also be entitled to receive any refund to the extent that Seller's remittance was in excess of the FIRPTA tax.[167] If the parties wish to have a different arrangement, it can be negotiated in connection with any

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[165] See Treas. Reg. §§ 1.1445-3, 1.1445-6.

[166] See Treas. Reg. § 1.1445-1(f)(1) ("The withholding of tax under section 1445(a) does not excuse a foreign person that disposes of a U.S. real property interest from filing a U.S. tax return with respect to the income arising from the disposition. Form 1040NR, 1041, or 1120F, as appropriate, must be filed, and any tax due must be paid, by the filing deadline generally applicable to such person. (The return may be filed by such later date as is provided in an extension granted by the IRS.) Any tax withheld under section 1445(a) shall be credited against the amount of income tax as computed in such return.")

[167] See Treas. Reg. § 1.1445-1(f)(2) ("If the amount withheld under section 1445(a) constitutes less than the full amount of the transferor's U.S. tax liability for that taxable year, then a payment of estimated tax may be required to be made pursuant to section 6154 or 6654 prior to the filing of the income tax return for that year. Alternatively, if the amount withheld under section 1445(a) exceeds the transferor's maximum tax liability with respect to the disposition (as determined by the IRS), then the transferor may seek an early refund of the excess pursuant to §1.1445-3(g), or a normal refund upon the filing of a tax return.").

other negotiation relating to making of the election (and, of course, absent a contractual agreement, Seller cannot be forced to make the election). [168]

We have considered whether the failure of Seller to remit the amounts due should invalidate the election. On balance we believe that this is harsh – at most invalidity should result only if the parties did not make a good faith attempt to comply with this remittance requirement, and even this may be come difficult to administer. We would not adopt such an invalidity rule, and believe it may be sufficient to require that Seller pay appropriate interest and penalties on underpayment.[169]

While we acknowledge that this proposal imposes some burdens on Seller, we believe that they are a fair price to pay for the election, and should not generally come as a surprise to a Seller (presumably Seller will generally know if its subsidiary owns USRPIs). Our only real hesitation with respect to this proposal is whether it might raise problems for Seller under foreign tax law. While presumably under U.S. tax law principles, any withholding should be considered a capital contribution to Target or a selling expense, resulting in appropriate tax treatment assuming Seller negotiates for the purchase price to be appropriately adjusted (and recall, again, that this cannot be imposed on Seller involuntarily). It is at least conceivable, however, that foreign tax law in a particularly jurisdiction might view the transaction differently.

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[168] Seller and purchaser, in the purchase contract, or in an amendment thereto (if they decide to make a Section 336(e) election after the closing) could negotiate provisions that would require the purchaser to pay over to seller any refunds or other tax benefits received or realized by Target in excess of the actual FIRPTA tax liability and any price adjustments as necessary to take into account the Seller's obligation.

[169] See Treas. Reg. § 1.1445-1(e) (providing that where transferee fails to withhold, it is liable for the tax and subject to interest and penalties).

A second objection might be that the parties may not want to, in effect, increase Target's capitalization. Our only response to this is that the parties can create an appropriate arrangement contractually – or forego the Section 336(e) election.

The foregoing mechanic would generally apply to sales and exchanges, as well as distributions with respect to which Section 336(e) elections are made.

b. Foreign Seller – U.S. Target.

A second set of Section 1445 issues arises in a very different fact pattern – a Foreign Seller of stock of a corporation that is a USRPHC. As discussed above, by making the Section 336(e) election the FIRPTA taint will be purged and the Seller will not owe any tax under Section 897. The Section 1445 rules contemplate that if stock of a U.S. corporation has ceased to be a USRPI by reason of the purge rule the seller can obtain a certificate from the target to that effect under Treasury Regulation Section 1.897-2(h)(1) and avoid Section 1445 withholding.[170] The question is whether that relief should be available in the context of the purge rule applying solely by reason of a Section 336(e) regulation which, of course, cannot be made before the disposition occurs. We believe that it is appropriate to grant relief in this area, but only where it is certain that the Section 336(e) election will be made. We would propose the following regime. First, Seller would notify purchaser that it intends to file an election under Section 336(e) and request that purchaser not remit the Section 1445 withholding that might otherwise be due to the IRS. The purchaser would then withhold under Section 1445, and would be permitted, but not required, to retain (and not to remit to the IRS) the withheld amounts for a

[170] Treas. Reg. § 1.1445-2(c)(3).

certain period (say, as short as 30 days to as long 8 1/2 months).[171] If the purchaser agrees to do this and if Seller then provides proof of filing of the Section 336(e) election within that period, purchaser would release the withholding amount to Seller. If not, purchaser would pay the funds over to the government and the Seller's recourse would be to apply for a refund when it files a return (or pay any additional tax owed), just as it would in the absence of a Section 336(e) election.[172] Similar rules would apply for Section 1445(e)(2) withholding by the Foreign Seller itself.

3. Application of Treas. Reg. § 1.338-9(d).

Treasury Regulation Section 1.338-9(d) provides that if a Section 338 election is made for a domestic or foreign target, and the target's taxable year under foreign law does not close at the end of the acquisition date, foreign income taxes attributable to the foreign taxable income earned by the target during the taxable year are allocated to Old Target and New Target under the principles of Treasury Regulation Section 1.1502-76(b). Treasury Regulation Section 1.1502-76(b)(2)(iv) generally provides that federal, state, local, and foreign taxes are allocated on the basis of the items or activities to which the taxes related.[173] If 40% of the foreign income is allocated to Old Target, then 40% of the foreign taxes related to the foreign income will also be allocated to Old Target, with the remainder allocated to New Target. We believe that the

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[171] Indeed, if the election form were executed and filed on the closing date, the regulations could permit the parties to avoid withholding altogether.

[172] Treas. Reg. § 1.1445-1(f)(2).

[173] See TD 8515, 1994-1 CB 89, 90 ("The final regulations require foreign income taxes to be allocated in proportion to foreign taxable income.").

same approach should be followed under Section 336(e) and we agree with the incorporation of these principles into the Proposed Regulations.[174]

4. 367 Earnings and Profits Rules.

The Preamble requests comments as to whether special earnings and profits rules are necessary in the event that the Section 336(e) election is extended to cross-border transactions, and specifically refers to the rules of Proposed Regulation Section 1.367(b)-8. Our answer to that question depends in large part on whether our suggestion described above relating to the model under Section 336(e) for transactions described in Sections 355(d) and (e) is adopted.

The proposed 1.367(b)-8 regulations adopt a complex overlay to the general rules of Section 312(h) and Treasury Regulation Section 1.312-10 to deal with the far more complex role that earnings and profits play in the cross border area, relating to foreign tax credits, source of income, protection of taxation under Section 1248 and previously taxed income, among other things. Section 336(e) elections add several additional issues – first, the ongoing impact of the principles of Section 338(h)(16) on the earnings and profits generated by the election (if they end up in a foreign corporation), and second, whether any additional special rules should be added to address in the Section 336(e) context the several earnings and profits issues that Proposed Regulation Section 1.367(b)-8 addresses.

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[174] Prop. Reg. § 1.336-2(g)(3)(ii) ("If a section 336(e) election is made for target and target's taxable year under foreign law (if any) does not close at the end of the disposition date, foreign income taxes attributable to the foreign taxable income earned by the target during such foreign taxable year are allocated to old target and new target under the principles of §1.1502-76(b).").

Turning to the first issue (principles of Section 338(h)(16)), the regulations would need to address source and any other relevant characteristic of deemed sale and historic earnings and profits to the extent that as a result of the election (and any other adjustments) the earnings and profits end up as earnings and profits of a foreign corporation. Under the principles of Section 338(h)(16), presumably the enhanced earnings would be treated as having a U.S. source for purposes of applying the foreign tax credit rules to a subsequent distribution or deemed distribution to U.S. shareholders of Target. The Section 1.367(b)-8 regulations would simply add this to the list of earnings and profits characteristics to be tracked. We note that there should be no impact on any foreign shareholders of New Target, since Section 338(h)(16) does not by its terms treat any enhanced earnings as from U.S. sources for any purpose other than foreign tax credits.

A second issue arises in the Section 355(d) or (e) context, particularly if the final regulations adopt the basic model (which includes a deemed liquidation of Old Target), as we propose above for such transactions. Under Section 312(h), there would then need to be an allocation of Seller's earnings and profits to New Target, and this allocation would now include all of the earnings and profits of Old Target, both historic as well as those generated by the deemed sale on the Section 336(e) election. The choice of which earnings and profits are allocated to New Target could make a significant difference, particularly where Target is foreign and those historic earnings and profits have associated foreign taxes. In order to avoid inappropriate loss of potential foreign tax credits, we recommend that earnings allocated from Seller to New Target come first from historic (pre-Section 336(e) election) earnings and profits

of Old Target and then from other earnings and profits.[175] To the extent that earnings and profits of Old Target are reallocated to New Target, we believe that those earnings and profits should be excluded from any income inclusion to Seller of the all earnings and profits amount under Treasury Regulation Section 1.367(b)-3 resulting from the Section 336(e) election

IX. Making the Election.

A. Target Should be a Party to the Election.

The Proposed Regulations provide that the Seller makes a unilateral Section 336(e) election by attaching a prescribed statement to its timely filed federal tax return for the year in which the disposition occurred.[176] We believe that this approach should be modified to require that Target also be a party to the election. The reason is simple – as under Section 338(h)(10), both parties are affected by the election and therefore both parties should be part of the process.[177] This is particularly true in the affiliated, non-consolidated context. The tax situation of Target can be adversely affected when Seller makes a Section 336(e) election in several ways:

> (1) where Seller and Target are members of an affiliated, but non-consolidated group, Target alone will be liable for any tax attributable to the deemed sale of assets; if the IRS and Treasury accept our suggestion to expand the regulations to

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[175] This could either be a cross-section, as contemplated by Prop. Reg. Section 1.367(b)-8(b)(2) or, if believed more appropriate, could come next from the enhanced earnings and profits of Old Target.

[176] Prop. Reg. § 1.336-2(h).

[177] While it is true that a Target is not required to join the filing of a Section 338 election, its owners do, which is a good practical proxy. We reached a similar conclusion in our Prior Report: "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." Part V.C.

foreign corporations, the number of circumstances where Seller and Target are members of an affiliated, but non-consolidated group will expand;[178]

(2) even where Target and Seller are members of a consolidated group, Target remains jointly liable for the taxes on the deemed asset sale;[179] and

(3) in both cases, the election may result in a step down in the basis of Target's assets, with a corresponding reduction in depreciation and amortization deductions going forward.[180]

In light of the foregoing, we believe that Target should be a party to the Section 336(e) election. We acknowledge, however, that the case for requiring Target to be a party to the Section 336(e) election is strongest in the cases where Target bears the tax on the deemed asset sale (e.g., a domestic non-consolidated target, a foreign target owning a USRPI or a U.S. trade or business or an S corporation with asset gain subject to Section 1374). In situations where Target would not expect to bear any tax liability (for example where Parent and Target file a consolidated return, and perhaps also S corporations not subject to section 1374[181] and certain foreign Targets), we would not object to the adoption of a different rule as the goal of protecting purchasers is less pronounced.[182]

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[178] In addition, there may be significant timing issues – as discussed below, under the proposed rules, the making of an election can create an overdue Old Target deemed sale tax return.

[179] Prop. Reg. § 1.336-2(b)(1)(ii) ("[N]ew target remains liable for the tax liabilities of old target (including the tax liability for the deemed disposition tax consequences.").

[180] Additional considerations will arise if our recommendation with respect to S Corporations is adopted.

[181] As discussed in Part VII. For S corporations we would require the consent of all S corporation shareholders

[182] We note, however, that states may ultimately follow the Section 336(e) election, in which case, even if Seller and Target are members of a consolidated group for federal income tax purposes, Target may bear a separate state-level tax.

We note, too, that Congress appears to have contemplated joint elections. The amendment to Section 336(e) in the Technical and Miscellaneous Revenue Act of 1988, and the legislative history accompanying that amendment, makes it clear that Congress did not intend to require an election made only by Seller. As originally enacted Section 336(e) provided that "such corporation [clearly referring to seller] may elect." The amendment replaced the quoted words with "an election may be made."[183] "This [change] clarifi[ed] that Congress did not intend to require the election to be made unilaterally by the selling or distributing corporation."[184]

Requiring Target to be a party does not provide as much protection to purchasers as would be available if the purchasers were required to join in the election. We believe, however, that requiring the purchasers to join in the election would be administratively burdensome and unworkable, particularly where the purchasers may be widespread and may purchase at different times (or simply passively acquire shares in a distribution). Moreover, in settings where there are a limited number of purchasers and it would be practical for the purchasers to sign a joint election, it is equally practical for Target to do so.

This leaves the question of when Target may sign the election. While it would provide the greatest protection to purchasers if Target were only able to sign the form post-disposition (when it is no longer controlled by Seller), on balance, we favor a regime that permits Target to sign the form prior to the disposition date, with an additional requirement that Seller give appropriate pre-disposition notice to purchasers. We reach this view because requiring a post-disposition signature from Target may conflict with other legitimate goals the parties may

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[183] P.L. 100-647, § 1006(e)(3).

[184] S. Rep. No. 445, 100th Cong., 2d Sess. 59 (Aug. 3, 1988).

have.[185] For example, in Section 338(h)(10) transactions, for example, it is customary for the buyer or seller (depending on which party benefits from the election) to require that the other party deliver a signed Form 8023 at the closing, particularly in cases where the buyer has priced the transaction taking into account the basis step-up provided by the election or the seller is counting on an ordinary loss. This can, of course, be addressed by a contract that requires seller to join in the Section 338(h)(10) election, but buyers and sellers often prefer not to be in a situation where it is necessary to rely on specific enforcement of a sale contract or to sue for money damages if the other party fails to execute the election form. Similarly, in the Section 336(e) context, there may be circumstances where seller and purchaser may wish to have a signed election before closing. Indeed, in many cases, the purchaser will be the party that has the bigger stake in having the Section 336(e) election made, and will want to ensure that the seller has signed prior to closing. Requiring a post-disposition signature from Target does not readily accommodate this objective.

B. Sales or Exchanges.

Under our proposal, in a sale or exchange transaction, Seller and Target would both be required to join in the Section 336(e) election, but Target could sign before or after the closing. If Target signs after the closing, it will be under the control of purchasers, and so the Target and purchasers will be protected. If Target signs before the closing, it will be Seller that directs Target to execute the election form, but the requirement for Target's signature will still

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[185] We acknowledge that our Prior Report at least appears to have reached a different conclusion as to the timing of Target's signature – it would have required a signature from New Target (i.e., post-disposition): "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." Prior Report, Part V.C. After years of experience with Section 338(h)(10) elections, our views have evolved.

provide some practical protection. The election is an affirmative act that Seller may have a contractual or common law duty to disclose, particularly if it is material, even if the relevant agreement does not expressly mention Section 336(e). To further protect purchasers, we would also suggest that the regulations require Seller to notify purchasers that it has caused Target to make the election within a reasonable period, and, at least in cases where Target would bear the tax, before closing.[186] As a practical matter, this may require the Sellers to provide notice before signing or at least to confer with the purchasers if the election is made after signing, but before closing, because many purchase agreements will contain a covenant that Target not make a material tax election between signing and closing without the purchaser's consent.[187] So long as purchasers have knowledge that a Section 336(e) election will be made, they can take the tax consequences of such election into account when negotiating and pricing the transaction, at least if they have this knowledge before the signing. Target's ability to sign the Section 336(e) election before the closing will also give Seller the comfort that it will not have to rely on contractual provisions that Target will sign after closing to ensure that the election is filed effectively.

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[186] The election would continue to be valid, however, even if Seller fails to provide the notice, but the failure should carry with it meaningful penalties for failure to do required information reporting. The Seller may also be subject to non-tax contractual or common law liability to the extent purchasers and Target are damaged as a result of the election. We acknowledge that a pre-signing notification requirement is somewhat in tension with the notification rules for Section 338(g) elections involving foreign targets

[187] If the transaction is an IPO, presumably the fact of the election would be disclosed in the offering materials.

C. Distributions.

We believe that the same rules should apply to a Section 336(e) election that relates to the distribution of Target stock – Seller and Target should both be required to join in the election.[188] Again, requiring multiple and widespread distributees to join in the election would also be administratively burdensome and unworkable. As in the sale or exchange model, Target could sign before or after the distribution. If Target signed before the distribution, Seller would be required to notify the distributees before the distribution as discussed below.

We note that the Preamble suggests that, in the distribution context, the distributees' interests will generally be protected because of the distributing corporation's fiduciary duties to shareholders.[189] Fiduciary duties may not protect the distributees, however. If the election is beneficial to Seller, it will benefit the Seller's shareholders and this may satisfy any fiduciary duties even if it is not beneficial to Target. The Seller may have to weigh its duties to its shareholders and the future Target shareholders, particularly in cases where there is a pro rata distribution and Seller shareholders will continue to be Seller shareholders but will become Target shareholders as well. It is possible that the Section 336(e) election could be good for the Seller, but bad for the Target; fiduciary duties will not help in a zero sum game. After the

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[188] Our Prior Report would have permitted a unilateral election by Seller in this setting, but would only have permitted Seller to make the election before the distribution of Target stock. Prior Report, Part V.C. For the reasons discussed in the text, we believe that the system we now propose better protects the interests of all parties. In addition, of course, having the same rule for sales, exchanges and distributions will be simpler than the bifurcated proposal in our Prior Report.

[189] See Preamble, pg. 49,970. ("The IRS and Treasury Department believe that in a distribution of target stock, it would be impractical to require each distribute who generally will hold relatively small percentages of the target stock, to join in the election. *Further, the distributees' interests should generally be protected because of the distributing corporations fiduciary responsibilities to its shareholders.*").

disposition, fiduciary duties will not help at all - if the election is beneficial to the Seller, it may no longer owe a fiduciary duty to Target shareholders.[190]

One benefit of a joint election is that it may tend to lead to adequate disclosure to distributees. In the public company context, the disclosure in the SEC documents should be sufficient to protect the Seller's shareholders, particularly in an exchange offer, tender offer or similar context where shareholders must take some action and the seller could be liable for a material omission. In the private company context, shareholders may have to rely on negotiated agreements. For that reason, we recommend that the final regulations provide that in the case of a distribution, the Seller should be required to give notice to distributees before the distribution that it *may* cause Target to make the election.[191] This would put distributees on notice of the possibility of a Section 336(e) election. The notice would be protective in circumstances where shareholders are required to take some action before or in connection with the distribution, but only informative where shareholders are not required to take such action. The notice requirement could be satisfied by (i) disclosure in publicly-filed documents, (ii) in the private

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[190] For elections made after the disposition, as discussed below, the proposed rule of requiring Target to sign the election would avoid the problem that Seller's fiduciary duties do not protect Target shareholders – Target's signature and consent would be required on the election form and it *will* have an interest in protecting itself. After the distribution, Target will have an independent board with fiduciary duties only to Target shareholders, making disclosure less important in terms of protecting the interests of Target and its shareholders.

[191] If Seller discloses the possibility of a Section 336(e) election to its shareholders before the distribution, but does not take any steps to cause Target to sign the Section 336(e) election form before the distribution (or to agree to sign after the distribution), Target and Target shareholders will be protected against a unilateral Seller election after the fact because Target will have to consent to the election. If Seller discloses this possibility and then either causes Target to sign before the distribution or causes Target to agree to sign after the distribution, we believe that the notice before the distribution of the possibility that a Section 336(e) election will be made is sufficient.

company context, notices to shareholders mailed to addresses on the seller's books and records, or (iii) any other reasonable method (e.g., the method for informing shareholders of the time and place for shareholder votes). If Seller complies with the foregoing requirements, the notice would be valid, even if not all shareholders receive actual notice. Again, failure to give the notice would be treated as an information reporting failure. It would not invalidate the election. In cases where Target signs after the disposition, Seller would not be required to give notice because, as discussed above, Target's board will be capable of sufficiently protecting Target shareholders.

D. Manner and Timing.

If the New Target is a party to the election, we believe that the election should follow similar mechanics for the election under Section 338(g) and (h)(10), where the election is filed on a separate 336(e) election form on or before the fifteenth day of the ninth month after the acquisition date,[192] rather than being filed with the Seller's tax return for the year in which the election is made.[193] The rule that the Section 336(e) election be filed with Seller's tax return for the year in which the sale occurred presents potential timing problems that should be addressed whether or not the final regulations adopt our suggestion that Target should be a party to the election. In those circumstances, Seller will be required to file its tax return for the year in which the transaction occurred within nine months and fifteen days after the end of that year (assuming it files for an extension). Depending on when the transaction occurred within the year, the due date for Seller's tax return could be more than twenty months after the transaction. The taxable

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[192] Treas. Reg. §§ 1.338-2(d), 1.338(h)(10)-1(c)(3).

[193] Prop. Reg. § 1.336-2(h).

year of Old Target, however, will generally close as of the date of the transaction, and Old Target would then be required to file its final tax return within nine months and fifteen days of the transaction (assuming it files for an extension). Accordingly, under the proposed rule, there could be many circumstances where Old Target is required to file a tax return without knowing at the time of filing whether a Section 336(e) election will be made.[194] Requiring the Section 336(e) election form to be filed within nine months and fifteen days of the transaction, as we have proposed (as in the Section 338 context) will generally prevent Target from being required to file a tax return without knowing that a later Section 336(e) election will be made.

Finally, if the IRS and Treasury determine to expand the Section 336(e) election to sales of S Corporations, we believe that all S Corporation non-selling shareholders (and all S corporation selling shareholders) should be required to consent to the election.[195] This is consistent with the requirement under Section 338(h)(10) that non-selling S Corporation shareholders consent to the election.[196]

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[194] Moreover, there will often be state and local tax consequences to the Section 336(e) election and the closing of Old Target's taxable year. Even where Seller and Old Target are part of a consolidated group for federal income tax purposes and old target itself would not file a tax return for the short taxable year for federal income tax purposes, Old Target may still have a state law filing obligation and its state tax return may be due before Seller is required to file a federal tax return on which it could make a section 336(e) election.

[195] See Part VII.

[196] See Treas. Reg. § 1.338(h)(10)-1(c)(3).

X. Calculation of Aggregate Deemed Asset Disposition Price (ADADP) and Adjusted Grossed Up Basis (AGUB).

The Proposed Regulations calculate the grossed-up amount realized on the sale, exchange or distribution of Target stock by (i) adding (x) the amount realized on the sale or exchange of recently disposed stock, but not taking into account selling costs, plus (y) the fair market value of recently disposed stock distributed, determined as of the date of each distribution, (ii) dividing the sum of (x) and (y) by the percentage of Target stock by value (for this purpose, including stock described in Section 1504(a)(4)) attributable to the recently disposed stock, as determined on the disposition, and (iii) subtracting the selling costs incurred in connection with the sale or exchange that reduce Seller's amount realized.[197]

We believe that this methodology, which is the same as in Section 338, should be revised in two respects. First, the intent of the formula, if there are multiple dispositions at fluctuating values, is to create a blended value. If Section 1504(a)(4) stock is involved, the formula may not get to an appropriate result because the calculation of the grossed-up amount realized in effect assumes that the value of Section 1504(a)(4) stock fluctuates with the common, and we do not believe that is generally the case. Second, the selling costs should also be grossed up. Failing to gross up the selling costs results in ADADP that likely exceeds the amount that would have been realized had Seller disposed of all Target stock. As a practical matter, the actual selling costs for each separate block of stock may fluctuate, but we believe it is more accurate and appropriate to use a grossed-up selling expense based on the actual selling expenses for the blocks of stock sold subject to the gross-up than to assume the selling costs are zero with respect to the stock deemed sold. A similar approach should also be applied to capitalized

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[197] Prop. Treas. Reg. § 1.336-3(c)(1).

acquisition costs in calculating adjusted grossed up basis (AGUB). In the context of AGUB, this will result in the purchasing corporation's basis in each share of purchased stock equaling the average price of the purchased stock. In its discussion of the proposed amendments to Treasury Regulation Section 1.338-5, the Preamble seems to endorse this goal.[198]

> We use the example in Treasury Regulation Section 1.336-3(c)(2) to illustrate.
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> Example 19. Target has two classes of stock outstanding, voting common stock and preferred stock described in section 1504(a)(4). Seller owns all 100 shares of each class of stock. On March 1 of Year 1, Seller sells 10 shares of Target voting common stock to A for $75. On April 1 of Year 2, Seller distributes 15 shares of voting common stock with a fair market value of $120 to B. On May 1 of Year 2, Seller distributes 10 shares of voting common stock with a fair market value of $110 to C. On July 1 of Year 2, Seller sells 55 shares of Target voting common stock to D for $550. On July 1 of Year 2, the fair market value of all the Target voting common stock is $1,000 ($10 per share) and the fair market value of the preferred stock is $600. Seller incurs $20 of selling costs with respect to the sale to A and $60 of selling costs with respect to the sale to D. The grossed-up amount realized on the sale, exchange, or distribution of recently disposed stock of Target corporation is calculated as follows: The sum of the amount realized on the sale or exchange of recently disposed stock sold or exchanged (without regard to selling costs) and the fair market value of the recently disposed stock distributed is $780 ($120 + $110 + $550) (the 10 shares sold to A on March 1 of Year 1 is not recently disposed stock because it was not disposed of during the 12-month disposition period). The percentage of Target stock by value on the disposition date attributable to recently disposed stock equals 50% ($800/ ($1,000 + $600). The grossed-up amount realized equals $1,500 (($780/.50) - $60 selling costs).

Under our proposed approach, the outcome would differ.

> First, the gross-up would take into account only the value of the common. The value of the 1504(a) preferred would be added *after* the gross-up.[199] The amount

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[198] Preamble at 49,970.

[199] We would propose to value the Section 1504(a) stock (1) if it is not publicly traded, at its face amount, unless the dividend is less than the applicable federal rate, in which case we would apply the OID rules (Section 1274), and (2) if it is publicly traded, at its market value on the disposition date.

realized on the recently disposed stock would be the same, $780. The gross-up percentage, however, would be .80, represented by the value of the disposed of stock on the disposition date ($800) divided by the value of the common stock on the disposition date ($1000). Applying the gross-up percentage to the amount realized results in $975. The value of the Section 1504(a) stock ($600) would then be added to the grossed-up amount on the sale of the common ($975) to result in a sale price of $1575.

Second, the selling costs would be grossed up assuming that Seller incurred the same selling costs with respect to each block of stock deemed sold in calculating the ADADP based on value (including the 1504(a) preferred stock) and excluding the actual selling costs incurred in the disposition of non recently disposed stock. Thus, on these facts the grossed-up selling costs would be $171.82 ($60/$550 * $1575).

Accordingly, after adjusting for the fact that 1504(a) preferred stock does not fluctuate in value with common and grossing-up the selling costs, the ADADP in this example would be $1403.18 ($1575-$171.82).

To change the facts slightly, assume that Seller sold the stock to C rather than distributing it, and incurred $25 of selling costs in doing so, but that all other facts in the example are the same. On those facts, the grossed-up selling costs would be $202.84 ($85 (total selling costs)/$660 (fair market value of stock with respect to which selling costs were incurred) * $1575), and the total ADADP would be $1372.16 ($1575-$202.84).

We believe that these two adjustments will result in more accurate determinations of ADADP across the majority of cases. If the IRS and Treasury make these changes to the Section 336(e) regulations, we would also recommend that corresponding changes be made to the Section 338 regulations, which currently use analogous rules to the Proposed Regulations.[200]

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[200] Treas. Reg. § 1.338-4(c)(1) and (2).

XI. Other Miscellaneous Issues

A. Gain Recognition Elections.

The Proposed Regulations provide for deemed gain recognition in certain contexts where a single purchaser acquires 80% or more of Target's stock in a Section 336(e) disposition and also holds non-recently disposed stock.[201] This rule is similar to an analogous rule under Section 338(h)(10).[202] We are not sure why either of these rules should exist as exceptions to the general rule in each area, and believe that no such exception is required. Thus, we would eliminate the gain recognition rule in both Section 336(e) and Section 338(h)(10). If this suggestion is not adopted, we would retain the rule under Section 336(e) for consistency with Section 338(h)(10).

B. Pre-Liquidation Distributions

It should be made clear that, in the case of a Section 336(e) election, like a Section 338(h)(10) election, Target assets distributed from Target to Seller prior to and in connection with the transaction may be treated as distributed pursuant to the plan of liquidation that is deemed to occur as a result of the election.[203]

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[201] Prop. Reg. § 1.336-4(c)(2).

[202] Treas. Reg. § 1.338(h)(10)-1(d)(1).

[203] Treas. Reg. 1.338(h)(10)-1(e), example 2.