
CHAPTER 8

TAXABLE CORPORATE ACQUISITIONS

A. INTRODUCTION

There are many ways to structure a corporate acquisition. In the preceding chapter, we previewed one method: a sale by the target corporation¹ of all its assets followed by a distribution of the proceeds of sale to the shareholders in complete liquidation of the target.² An alternative is a sale by the shareholders of their stock in the target corporation. In either case, the business can be acquired in exchange for cash, notes, stock or bonds of the acquiring corporation, other property, or any combination of consideration. In an asset acquisition, the acquiring corporation may purchase the assets directly, drop them down to a controlled subsidiary or cause a subsidiary to make the acquisition. In a stock acquisition, the target may stay alive as a subsidiary of the acquiring corporation or liquidate. Variations abound on these basic formats.

Although we quickly will turn our attention to the tax consequences of corporate acquisitions, it may be useful at the outset to consider a few nontax factors that may influence the form of a transaction. Stock acquisitions are usually simpler to execute than asset acquisitions. To sell its assets, the target must prepare conveyance documents for many different items of property, give notice to creditors in compliance with local bulk sales laws, and incur sales or other local transfer taxes. In a stock acquisition, however, it is unnecessary to transfer any of the target's assets; instead, the acquiring corporation simply buys the target's stock directly from the T shareholders. A stock purchase thus may be desirable (or even essential) if the target holds certain nonassignable assets, such as a favorable lease or employment contract, or has valuable rights under state law that might be jeopardized if the corporation were dissolved. On the other hand, a stock acquisition may expose the buyer to liabilities of the target that may be unknown or contingent at the time of the transaction. This threat normally can be

¹ In discussing acquisitions in this and later chapters, the acquired corporation generally will be called the "target," or "T," and the corporate purchaser will be called the "acquiring corporation," or "P." By using the term "target," we do not necessarily mean to suggest that the acquisition is a hostile takeover.

² A target corporation that sells all or most of its assets usually will liquidate and distribute the proceeds to its shareholders. Alternatively, T could stay alive as an investment company after the sale. If T is closely held, staying alive likely would cause it to be classified as a personal holding company. For the perils of personal holding company status, see Chapter 14D, *infra*. For the possibility of a sale of assets by a C corporation followed by a conversion to S corporation status, see Chapter 15F, *infra*.

minimized by warranties and indemnity provisions in the stock purchase agreement. But some buyers still prefer to avoid the risk altogether by buying the assets and not assuming any burdens that might be connected with the corporate entity. The presence of unwanted assets, the unwillingness of minority shareholders of the target to sell their stock, and the requirements of regulatory agencies and local corporate and securities law are additional nontax factors that may influence the choice of form.

The principal tax issues raised on a corporate acquisition are best introduced by revisiting the simple example from the preceding chapter. Recall that A is the sole shareholder of Target Corporation ("T") and has a \$100,000 basis in her T stock. T's only asset is a parcel of undeveloped land ("Gainacre") with a fair market value of \$400,000 and a zero adjusted basis. Purchaser, Inc. ("P") wishes to acquire the land for \$400,000 cash. Consider three simple methods of structuring the acquisition:

- (1) *Liquidation of T Followed by Shareholder Sale of Assets.* T distributes Gainacre to A in complete liquidation and then A sells Gainacre to P for \$400,000.
- (2) *Sale of T Assets Followed by Liquidation.* T sells Gainacre to P for \$400,000 and then liquidates, distributing the after-tax proceeds of sale to A.
- (3) *Sale of T Stock.* A sells her T stock to P for \$400,000 and P either keeps T alive as a wholly owned subsidiary or causes T to liquidate and distribute Gainacre to P.

Under any of these methods, one would expect A to recognize gain equal to the difference between her amount realized on the liquidation or sale of stock and the \$100,000 adjusted basis in her T stock. In addition, T has \$400,000 of corporate-level gain inherent in Gainacre. Should that gain also be recognized and, if so, should P (directly or indirectly through its ownership of T stock) take Gainacre with a \$400,000 fair market value basis? If T does recognize gain, who bears the economic burden of the corporate-level tax? Alternatively, can the transaction be structured so that T's gain is deferred through a zero transferred basis in the land? Or, perish the thought, might T's gain be permanently forgiven, with P (or T, if it is still alive), taking Gainacre with a \$400,000 cost basis? To what extent do (or should) the answers to these questions depend on the form of the transaction? And how are they affected if the seller is not an individual but a corporation that owns 100 percent of the T stock?

The after-tax economic outcome of these transactions may differ radically depending on the structure selected by the parties. The remainder of this chapter fills in the details, first considering asset acquisitions and then stock acquisitions.

B. ASSET ACQUISITIONS

1. TAX CONSEQUENCES TO THE PARTIES

A taxable asset acquisition occurs when a purchaser ("P"), which may be an individual or a business entity such as a corporation or partnership, acquires the assets of a target corporation ("T") in exchange for cash, notes, other property, or a mix of such consideration, and the acquisition does not qualify as a tax-free reorganization under Section 368.³ Following the sale of its assets, T normally liquidates and distributes the sales proceeds to its shareholders, but the shareholders may choose to keep T alive and cause it to reinvest the proceeds. Under the corporate laws of most states, an asset acquisition also may be accomplished more efficiently by a cash merger of T into P (or a subsidiary of P). On the merger, T's shareholders receive cash or notes (or a combination) from P, and T's assets and liabilities automatically transfer to P (or its subsidiary). The Service views such a "cash merger" as if T sold its assets to P and then completely liquidated.⁴

To illustrate the tax consequences of the most basic asset acquisition methods, return again to the example of A, the sole shareholder (stock basis—\$100,000) of T, whose only asset is appreciated Gainacre (basis—zero; fair market value—\$400,000). Assume that C corporations are taxed at a flat 20 percent rate, and individuals are taxed at 40 percent on their ordinary income and 20 percent on long-term capital gains.⁵

Liquidation of T Followed by Shareholder Sale of T Assets. If T distributes Gainacre to A in complete liquidation, it recognizes \$400,000 gain under Section 336(a) and incurs a tax liability of \$80,000 ($20\% \times \$400,000$). A bears the economic burden of the tax and is obligated to pay it because T has no assets after it liquidates. A recognizes \$220,000 gain on the liquidation (\$400,000 distribution less \$80,000 corporate-level tax less \$100,000 basis in T stock) and incurs a shareholder-level capital gains tax of \$44,000 ($20\% \times \$220,000$). A takes Gainacre with a \$400,000 basis under Section 334(a) and recognizes no further gain on a sale of Gainacre to P for its fair market value. When the smoke clears, the total corporate and shareholder-level tax on the liquidation and sale is \$124,000, leaving A with \$276,000. P takes Gainacre with a \$400,000 cost basis and, if P is a corporation, it does not succeed to the tax attributes (e.g., earnings and profits, net operating losses, etc.) of T.

Sale of T Assets Followed by Liquidation. The result is identical if T sells Gainacre to P and then liquidates. T recognizes \$400,000 gain on the sale, pays a corporate-level tax of \$80,000, distributes the \$320,000 net proceeds to A in complete liquidation, and A again recognizes

³ See Chapter 9B, *infra*.

⁴ Rev. Rul. 69-6, 1969-1 C.B. 104.

⁵ These assumptions approximate the income tax rates in effect as this edition went to press in 2019 and ignore the impact of the 3.8 percent tax on net investment income and any state taxes.

\$220,000 gain under Section 331(a) and incurs \$44,000 of tax on the long-term capital gain. P takes Gainacre with a \$400,000 cost basis and does not succeed to any of T's tax attributes.

Sale of T Assets Not Followed by Liquidation. If T does not liquidate after selling Gainacre to P, T once again recognizes \$400,000 gain and incurs \$80,000 in corporate-level tax, but A does not recognize gain if T retains and reinvests the \$320,000 net proceeds. Keeping T alive defers and may permanently eliminate any tax at the shareholder level. For example, if A holds the T stock until her death, A's heirs will take a stepped-up basis in the stock under Section 1014 and then may liquidate the corporation without paying a shareholder-level tax. This "no liquidation" strategy may have some appeal if A is elderly and her estate is on the verge of obtaining a stepped-up basis in the T stock, but it is rarely desirable if the liquidation will be postponed for many years. First, the double tax on corporate earnings must be navigated if A wants access to T's earnings.⁶ Moreover, if T no longer conducts an ongoing business, it likely will be classified as a "personal holding company."⁷ As such, it will be required to distribute its net investment income annually to A or face a penalty tax equal to 20 percent of any undistributed income.⁸ In many situations, keeping T alive may be more expensive than liquidating, although not as expensive as it was before the top tax rate on qualified dividends was reduced to 20 percent.

Conversion to S Corporation. If T chooses to stay alive, it could avoid some of the problems just described by becoming an S corporation. For example, T's income would pass through to its shareholders and be subject to only one level of tax, albeit at slightly higher marginal rates for some high-income individual shareholders. But as an S corporation, T would face other obstacles. To name just two, an S corporation that was once a C corporation may lose its S status or be subject to a special corporate-level tax if it has Subchapter C earnings and profits and significant passive investment income.⁹

2. ALLOCATION OF PURCHASE PRICE

Code: § 1060. Skim § 197.

Regulations: §§ 1.1338–6(a), (b), (c)(1); 1.1060–1(a)(1).

Background. The parties to an asset acquisition typically negotiate and agree upon a purchase price based on the value of the target corporation as a going concern. For tax purposes, however, a sale of the assets of a going business for a lump sum is treated as a sale of each

⁶ Dividends received by T, however, would qualify for the 50 percent dividends received deduction under Section 243(a), and corporate-level *regular* tax could be avoided altogether by investing the sales proceeds in tax-exempt municipal bonds.

⁷ See §§ 541 et seq. and Chapter 14C, *infra*.

⁸ I.R.C. § 541.

⁹ See I.R.C. §§ 1362(d)(3); 1375; Chapter 15C and 15F, *infra*.

individual asset rather than of a single capital asset.¹⁰ This fragmentation approach requires the parties to allocate the purchase price among the various tangible and intangible assets that have been sold. The allocation is used to determine the amount and character of the seller's gain or loss, and the buyer's cost basis in each asset for purposes of computing depreciation and amortization deductions and gain or loss on a subsequent disposition.

The parties historically had adverse interests when it came to allocating the purchase price among the assets. Buyers wished to allocate as much as possible to inventory, depreciable property and amortizable intangibles with the shortest recovery periods, and they resisted allocations to land and nondepreciable goodwill. Sellers, by contrast, benefitted by allocating a larger portion of the purchase price to assets yielding a capital gain and less to ordinary income assets. If the seller is a C corporation, these conflicts diminished with the elimination of a corporate capital gains rate preference. But buyers are still motivated to allocate basis to assets that provide depreciation or amortization deductions over the shortest possible recovery period, including the ability (through 2022) to deduct 100 percent of the cost of certain qualified property under Section 168(k), and corporate sellers with unused capital losses still prefer capital gains over ordinary income.

The parties may include a negotiated purchase price allocation in their written agreement. Because buyers and sellers historically had adverse interests, negotiated allocations usually were respected by the Service. Indeed, the Service and some courts generally did not permit a party to take a tax reporting position inconsistent with an agreed allocation unless the contract was unenforceable because of mistake, undue influence, fraud or duress.¹¹ More often than not, however, agreements of sale do not contain any purchase price allocation, allowing the parties to go their separate ways and possibly "whipsaw" the government in the process by taking inconsistent positions. A typical controversy involved the tension between a covenant not to compete and goodwill. Amounts paid by the buyer that are attributable to a covenant by the seller not to compete with the buyer for a stated period of time result in ordinary income to the seller and, before enactment of Section 197, the payments were amortizable by the buyer over the life of the covenant. Payments for goodwill, on the other hand, could not be depreciated or amortized by the buyer before Section 197 was added to the Code, and gain on the sale of goodwill was capital gain to the seller. Thus, sellers preferred allocations to goodwill, while buyers, craving deductions, preferred allocations to a covenant not to compete.

¹⁰ Williams v. McGowan, 152 F.2d 570 (2d Cir.1945).

¹¹ Commissioner v. Danielson, 378 F.2d 771 (3d Cir.1967), cert. denied, 389 U.S. 858, 88 S.Ct. 94 (1967). Other courts, using a more lenient standard, permitted a party to override a contractual allocation by a showing of "strong proof" that the agreement should not be respected. See, e.g., Ullman v. Commissioner, 264 F.2d 305 (2d Cir.1959).

Even without a covenant not to compete, some of the most contentious allocation controversies have involved the amount properly attributable to goodwill and the going concern value of an acquired business. The allocation is critical to a buyer who pays a premium—i.e., an amount that exceeds the fair market value of the target's identifiable tangible and intangible assets. At one time, the Service permitted the “proportionate” method of allocation, under which the value of each acquired asset (including intangibles such as goodwill) was determined, and then the aggregate purchase price was allocated in proportion to the relative fair market value of each asset. The proportionate method often had the effect of shifting any premium paid for the business toward depreciable and amortizable assets and away from nondepreciable goodwill. The future tax benefits that resulted from this buyer-friendly allocation method were a stimulus to the corporate takeover mania of the 1980s.

Under another valuation approach, known as the residual method, each tangible and intangible asset (excluding goodwill and going concern value) is valued first. If the overall price paid for the business exceeds the aggregate fair market value of these assets, the excess (“residue”) is allocated to goodwill and going concern value. The impact of the residual method is to allocate more of the total purchase price to goodwill and going concern value as compared to the proportionate method. In the case of a “bargain purchase,” where the price paid for the business is less than the fair market value of T’s assets, nothing is allocated to goodwill and the amount allocated to the identifiable assets (other than cash, cash equivalents and marketable securities) is proportionately reduced.

Congress first moved to regulate purchase price allocations in connection with stock purchases that are treated as asset acquisitions under Section 338 by directing the Treasury to prescribe regulations governing allocation of basis among the target’s assets.¹² Not unexpectedly, the regulations mandated use of the residual method. Eventually, Congress extended this approach to asset acquisitions by enacting Section 1060, which includes reporting requirements to protect the Service from being whipsawed. Congress took another step toward certainty with the enactment of Section 197, which requires the cost of most acquired intangible assets, including a covenant not to compete, to be amortized over 15 years. Because a buyer’s ability to amortize intangible assets and the timing of that amortization affects the economic stakes of a purchase price allocation, an overview of Section 197 is useful before turning to the specific requirements of Section 1060.

Amortization of Intangibles: Section 197. Section 197 permits taxpayers to amortize many intangible assets ratably over a 15-year period, regardless of their actual “useful life” or recovery period under prior law. Amortizable “Section 197 intangibles” include information

¹² I.R.C. § 338(b)(5). See Section C2 of this chapter, *infra*.

bases, customer and subscription lists, patient files, know-how, licenses, franchises, trade names and, notably, goodwill, going concern value and covenants not to compete entered into in connection with an acquisition of all or a substantial part of a trade or business.¹³ Some of these assets, such as goodwill and going concern value, were not amortizable at all under prior law, while others were being written off over periods considerably shorter than 15 years. Amortization under Section 197 is available, however, only for acquired intangibles; it is generally not permitted for assets that are created by the taxpayer.¹⁴

Section 197 puts to rest many of the most contested tax issues in the area of business acquisitions. Litigated disputes abounded under prior law, including one case in which the Supreme Court held that “customer-based” intangibles (primarily subscriber lists) acquired by a publisher on the purchase of a newspaper were amortizable if they had an ascertainable value and a determinable useful life.¹⁵ Rejecting the Service’s argument that such intangibles were “nondepreciable per se,” the Court concluded that eligibility for amortization turned on whether the asset was capable of being valued and whether that value diminished over time.¹⁶ The Court’s approach, and the factual controversies that it necessarily engendered, are now largely moot with the enactment of Section 197.

Allocation of Purchase Price: Section 1060. The ability of the parties to make strategical purchase price allocations has been reduced with the enactment of Section 197 and the Section 1060 basis allocation rules. Section 1060 applies to any “applicable asset acquisition,” defined as any transfer (direct or indirect) of assets which constitute a “trade or business” in the hands of either the buyer or the seller, and the purchaser’s basis in the purchased assets is determined wholly by reference to the consideration paid for the assets.¹⁷ This broad definition goes well beyond the typical corporate asset acquisition, extending to sales of sole proprietorships and partnership interests.

Section 1060 requires the buyer and seller to allocate the total consideration received or paid for a business among the various transferred assets using the residual method previewed above.¹⁸ For this purpose, “consideration received” is the seller’s aggregate amount realized from the sale of its assets determined under general tax principles, and “consideration paid” is the buyer’s aggregate cost of purchasing the assets that is properly taken into account in determining basis.¹⁹ Thus, liabilities assumed by the buyer or to which the transferred

¹³ I.R.C. § 197(c)(1), (d).

¹⁴ I.R.C. § 197(c)(2).

¹⁵ Newark Morning Ledger Co. v. United States, 507 U.S. 546, 113 S.Ct. 1670 (1993).

¹⁶ Id. at 565–570, 113 S.Ct. at 1680–83.

¹⁷ I.R.C. § 1060(c); Reg. § 1.1060–1(b)(1).

¹⁸ Reg. § 1.1060–1(a)(1).

¹⁹ Reg. § 1.1060–1(c)(1).

property is subject generally are included in total consideration. Aggregate consideration is then allocated among the assets using a refined version of the residual method that places all “acquisition date assets” into one of seven classes and allocates the consideration among those classes in priority order.²⁰ In general, the amount allocated to an asset (except for the last “residual” category) may not exceed its fair market value.²¹ Specifically, total consideration is first reduced by cash and cash equivalents (known as “Class I acquisition date assets”) transferred by the seller.²² The remaining consideration is then allocated first to highly liquid assets such as actively traded personal property (e.g., marketable securities), foreign currencies, and certificates of deposit (Class II assets) in proportion to their fair market values, then to accounts receivable, mortgages, and credit card receivables (Class III), then to inventory and other dealer-type property (Class IV), then to all assets other than those in the other classes (Class V—a broad category that includes most tangible assets, such as equipment and real estate), and finally to all Section 197 intangibles except goodwill and going concern value (Class VI). Any remaining consideration, such as in acquisitions where the purchase price includes a “premium” that exceeds the liquidation value of the tangible and intangible assets acquired, is allocated to Class VII, a category limited to goodwill and going concern value.²³

Effect of Agreement Between the Parties. As first enacted, Section 1060 did not address the question of whether the parties to a transaction should be bound by any written agreement they reach regarding allocation of the purchase price. Concerned that taxpayers might continue to take reporting positions that were inconsistent with their agreements, Congress amended Section 1060 to provide that a written agreement governing the allocation of consideration in an applicable asset acquisition shall be binding on both parties unless the Treasury determines that the allocation (or fair market value) is not appropriate.²⁴ The regulations provide that a party may refute an agreed allocation or valuation only by proving that the agreement was unenforceable due to mistake, undue influence, fraud or duress.²⁵ This is the standard long advanced by the Service and applied by the Third Circuit in the *Danielson* case.²⁶ In holding the parties to their agreement, however, Congress made it clear that it did not intend to restrict the Service’s

²⁰ Reg. § 1.1060–1(c)(2). The Section 1060 regulations incorporate by reference the residual method used under Reg. § 1.338–6 for certain stock acquisitions that are treated as asset acquisitions under Section 338. Id.

²¹ Reg. § 1.338–6(c)(1).

²² Reg. § 1.338–6(b)(1). In the unusual case where the total consideration to be allocated is less than the amount of Class I assets, then the purchaser must immediately recognize ordinary income to that extent. Id.

²³ Reg. § 1.338–6(b)(2).

²⁴ I.R.C. § 1060(a), last sentence.

²⁵ Reg. § 1.1060–1(c)(4).

²⁶ Commissioner v. Danielson, *supra* note 11.

ability to challenge the taxpayers' allocation to any asset by any appropriate appraisal method, particularly where there is a lack of adverse tax interests between the parties.²⁷ For example, an allocation that departs from the mandated residual method will not be respected even if it is part of a negotiated agreement and it would be reasonable for the Service to make an independent showing of the value of goodwill in order to challenge the taxpayer's valuation of other assets.²⁸

Reporting Requirements. The parties to an applicable asset acquisition must attach a statement (Form 8594) to their tax returns, reporting information concerning the amount of the total sales price and how it was allocated among the various asset classes.²⁹ The purchaser also must report any collateral agreements related to an acquisition, such as covenants not to compete, employment agreements, licenses, leases and the like.³⁰

C. STOCK ACQUISITIONS

1. BACKGROUND

In a taxable stock acquisition, the purchaser ("P") buys the stock of a target corporation ("T") from T's shareholders for cash or a combination of cash, notes and other consideration. A taxable stock acquisition may be structured as a reverse triangular merger, in which P forms a wholly owned transitory subsidiary ("S"), and S merges into T under state law, with T's shareholders receiving cash and debt obligations of P. When the dust settles, T is a wholly owned subsidiary of P.

Acquisitions of public companies are almost always stock acquisitions. They are sometimes launched when P begins acquiring T stock in the open market.³¹ The next step may be a cash tender offer to T's shareholders or a friendly merger negotiated with T's management. If P succeeds in acquiring control of T, the final step is usually a "back-end" merger where recalcitrant minority shareholders are squeezed out of the picture, sometimes for the same price originally offered to tendering shareholders or perhaps on less attractive terms.³²

²⁷ H.R. Rep. No. 101-964, 101st Cong., 2d Sess. 1096 (1990). See Reg. § 1.1060-1(c)(4).

²⁸ See generally Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess. 355-360 (1987).

²⁹ I.R.C. § 1060(b). See Reg. § 1.1060-1(e).

³⁰ Reg. § 1.1060-1(e).

³¹ P may purchase up to five percent of T's stock without any requirement for public disclosure under the federal securities laws. Securities Exchange Act of 1934, § 13(d), 15 U.S.C.A. § 78m(d) (1981).

³² Squeeze outs are facilitated by the modern corporate laws of Delaware and other states where many public companies are incorporated. See, e.g., Del. Corp. Law § 251.

Whether the transaction is structured as a direct stock purchase or a reverse triangular cash merger,³³ T's shareholders recognize gain or loss on the sale of their stock, measured by the difference between their amount realized and stock basis, and P takes a cost basis in the T stock it acquires. T shareholders who receive notes generally may report their gain on the installment method if the T stock is not publicly traded.³⁴ The more difficult conceptual questions relate to the tax consequences to T and the impact of a stock acquisition on the basis of T's assets and T's other tax attributes. Should a stock acquisition be treated as if it were a taxable asset acquisition coupled with a liquidation of T, or should the form of the transaction control? Should the parties be permitted to select which treatment they would prefer?

Not surprisingly, Congress has exhibited considerable hyperactivity in answering these questions. The *Kimbell-Diamond* case, which follows, is the best place to begin describing the evolution of the current tax treatment of stock acquisitions.

Kimbell-Diamond Milling Co. v. Commissioner

United States Tax Court, 1950.

14 T.C. 74.

■ BLACK, JUDGE.

[In August, 1942, taxpayer's milling plant was destroyed by fire and two months later the taxpayer collected insurance as a reimbursement for its loss. It then purchased for approximately \$210,000 cash all the stock of Whaley Mill & Elevator Co. in order to use Whaley's plant and equipment to replace its own destroyed facilities. The purchase price consisted of \$120,000 of insurance proceeds and \$90,000 of additional funds. The taxpayer's sole intention in purchasing Whaley's stock was to acquire the assets of the company through a prompt liquidation.

Taxpayer liquidated Whaley three days after acquiring the stock. In a prior proceeding, reported at 10 T.C. 7, the Tax Court held that the acquisition of Whaley came within the 1939 Code predecessor of § 1033 so that the taxpayer's gain on the involuntary conversion was not recognized. Since the taxpayer's acquisition of the Whaley stock qualified under § 1033, its basis was \$110,000 (the sum of the \$20,000 adjusted basis of the destroyed assets and the \$90,000 of additional funds that were paid in addition to the insurance proceeds). The assets of Whaley acquired by the taxpayer in the liquidation had an adjusted basis to

³³ A reverse triangular cash merger is treated for tax purposes as if P purchased T stock directly from the shareholders. Transitory "S" is disregarded. See Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 79-273, 1979-2 C.B. 125.

³⁴ I.R.C. § 453(k)(2). Installment sales of very large blocks of stock may be affected by Section 453A, which imposes what amounts to an annual interest charge on a seller's tax liability that has been deferred by the installment method. In general, this provision applies only if the face amount of the seller's installment receivables during the taxable year exceed \$5 million.

Whaley of more than \$300,000; the depreciable assets represented about \$140,000 of this total.

The central dispute in the case was over the taxpayer's basis for depreciation in the assets acquired in the Whaley liquidation. After addressing a procedural issue, the Court proceeded to discuss the merits. Note that this case arose under the 1939 Code, which did not contain former § 334(b)(2) or present § 338. Ed.]

* * *

OPINION

Having decided the issue of *res judicata* against petitioner, we must now determine the question of petitioner's basis in Whaley's assets on the merits. Petitioner argues that the acquisition of Whaley's assets and the subsequent liquidation of Whaley brings petitioner within the provisions of [the predecessor of § 332] and, therefore, by reason of [the predecessor of § 334(b)(1)], petitioner's basis in these assets is the same as the basis in Whaley's hands. In so contending, petitioner asks that we treat the acquisition of Whaley's stock and the subsequent liquidation of Whaley as separate transactions. It is well settled that the incidence of taxation depends upon the substance of a transaction. *Commissioner v. Court Holding Co.*, 324 U.S. 331. It is inescapable from petitioner's minutes set out above and from the "Agreement and Program of Complete Liquidation" entered into between petitioner and Whaley, that the only intention petitioner ever had was to acquire Whaley's assets.

We think that this proceeding is governed by the principles of *Commissioner v. Ashland Oil & Refining Co.*, 99 Fed. (2d) 588, certiorari denied, 306 U.S. 661. In that case the stock was retained for almost a year before liquidation. Ruling on the question of whether the stock or the assets of the corporation were purchased, the court stated:

The question remains, however, whether if the entire transaction, whatever its form, was essentially in intent, purpose and result, a purchase by Swiss of property, its several steps may be treated separately and each be given an effect for tax purposes as though each constituted a distinct transaction. * * * And without regard to whether the result is imposition or relief from taxation, the courts have recognized that where the essential nature of a transaction is the acquisition of property, it will be viewed as a whole, and closely related steps will not be separated either at the instance of the taxpayer or the taxing authority. *Prairie Oil & Gas Co. v. Motter*, 10 Cir., 66 F.2d 309; *Tulsa Tribune Co. v. Commissioner*, 10 Cir., 58 F.2d 937, 940; *Ahles Realty Corp. v. Commissioner*, 2 Cir., 71 F.2d 150; *Helvering v. Security Savings Bank*, 4 Cir., 72 F.2d 874. * * *

See also *Koppers Coal Co.*, 6 T.C. 1209 and cases there cited.

We hold that the purchase of Whaley's stock and its subsequent liquidation must be considered as one transaction, namely, the purchase

of Whaley's assets which was petitioner's sole intention. This was not a reorganization within section 112(b)(6), and petitioner's basis in these assets, both depreciable and nondepreciable, is, therefore, its cost, or \$110,721.74 (\$18,921.90, the basis of petitioner's assets destroyed by fire, plus \$91,799.84, the amount expended over the insurance proceeds). Since petitioner does not controvert respondent's allocation of cost to the individual assets acquired from Whaley, both depreciable and nondepreciable, respondent's allocation is sustained.

* * *

NOTE

If the stock purchase and subsequent liquidation of the target-subsidiary in *Kimbell-Diamond* had been treated as separate transactions, the buyer would have taken a (higher) transferred basis in the target's assets under Section 334(b)(1). The court looked to the buyer's intent, however, in holding that the stock purchase was merely a transitory step in a transaction that was properly characterized as a purchase of assets. Under this application of the step transaction doctrine, the liquidation was disregarded, and the buyer took a cost basis in the assets.

In the 1954 Code, Congress replaced the elusive intent standard of *Kimbell-Diamond* with a more objective test.³⁵ If a corporation purchased a controlling (80 percent or more) stock interest in the target corporation and then liquidated the target within a specific period of time, the acquiring corporation was treated as if it had purchased the target's assets. In general, the acquiring corporation took a cost basis in the assets equal to what it paid for the stock rather than the usual transferred basis that results from the liquidation of a controlled subsidiary. Although more "objective" than *Kimbell-Diamond*, the 1954 Code rules were laden with timetables, control and "purchase" requirements and a host of adjustments for cash distributions, liabilities assumed and transactions occurring after the acquisition but prior to the liquidation. Additional problems were created by the requirement that the buyer liquidate the newly acquired target in order to secure a *Kimbell-Diamond* cost basis in the target's assets.³⁶

Congress responded to these deficiencies by enacting Section 338, which refines the *Kimbell-Diamond* concept by allowing the acquiring corporation to elect to treat certain stock purchases as asset purchases. Unlike *Kimbell-Diamond* and the prior statutory scheme, Section 338 does not require a corporate buyer of stock to liquidate the target to get a cost basis in its assets. This is convenient when the buyer wishes to keep the target alive as a subsidiary. Under current law, a corporation that acquires control (i.e., at least 80 percent) of a target corporation in a transaction that is taxable to the selling shareholders is thus presented with four basic choices. It may: (1) not make the Section 338 election and keep T alive, leaving T's bases in its

³⁵ I.R.C. § 334(b)(2) (pre-1982).

³⁶ For historians and masochists, see Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 11.45 (5th ed. 1987).

assets and other tax attributes unaffected; (2) not elect under Section 338, liquidate T tax-free under Section 332 and inherit its asset bases and other tax attributes;³⁷ (3) make the Section 338 election and treat the transaction as an asset acquisition under which “new T” takes a cost basis in its assets and is purged of all of its prior tax attributes; or (4) make the election and then liquidate T, inheriting the cost basis in the assets but not any of “old T’s” tax attributes.³⁸

Before proceeding further, it is important to keep in mind that *Kimbell-Diamond* and Section 338 originated long ago in the *General Utilities* era, when liquidating distributions and sales generally did not trigger a corporate-level tax. The principal question then confronting a corporate buyer of stock was whether to take a cost basis or a transferred basis in the target’s assets. If T’s assets were appreciated, a well advised corporate buyer would make the Section 338 election in order to obtain a stepped-up cost basis in the target’s assets at little or no corporate-level tax cost. The stakes are vastly different under current law, where liquidating sales and distributions generally are taxable events. If a stock purchase is treated as an asset acquisition, the target must recognize gain or loss, and one of the parties (buyer or seller, or both) must bear the economic burden of the corporate tax imposed on any gain. Accordingly, the Section 338 election is undesirable in virtually all cases where the target’s assets are appreciated because it rarely makes economic sense to elect to pay tax currently in order to step up the basis of assets and avoid tax later. Section 338 nonetheless survives in the 1986 Code, along with reams of intricate regulations, and it remains an attractive option in a few situations that are discussed below.

2. OPERATION OF SECTION 338

Code: §§ 338(a), (b) (omit (b)(3)), (d), (e)(1), (2)(A) & (D), (g), (h)(1), (2), (3)(A), (4)(A), (5), (6)(A), (9), (11).

Regulations: §§ 1.338–4(a), (b)(1) & (2), (c), (d)(1), (e), –5(a), (b)(1) & (2), (c), (d)(1), (e)(1)–(3).

Overview of Section 338. Section 338 is a complex statutory mechanism that seeks to equate for tax purposes the purchase of an 80 percent or more interest in the stock of the target corporation with a purchase of the target’s assets. In general, the goals are to: (1) ensure that the target and its shareholders bear the same tax burden on a sale of the target’s stock that they would have incurred on a sale of its assets followed by a complete liquidation; (2) provide the buyer with a cost basis in the assets of the target; and (3) terminate the tax attributes of the target and start afresh, without regard to whether or not the target is actually liquidated.

³⁷ Note that the tax treatment of this method is contrary to *Kimbell-Diamond*, which would have treated a stock purchase followed by a prompt intended liquidation of the target as an asset acquisition, giving P a cost basis in T’s assets rather than a transferred basis and, under current law, causing T to recognize gain or loss on the sale.

³⁸ T or P’s ability to utilize T’s net operating losses in the first two situations may be limited. See I.R.C. §§ 269(b); 382; and Chapter 12, *infra*.

To achieve these goals, Section 338 provides that if a purchasing corporation (“P”) purchases 80 percent or more of the stock of a target corporation (“T”) within 12 months or less, it may elect to treat T as having sold all of its assets for their fair market value in a single transaction.³⁹ T must recognize gain or loss on the hypothetical asset sale, after which it returns as a virgin corporation (“new T”) with a cost basis in its assets and none of its former tax attributes.⁴⁰ If T is liquidated, this cost basis simply carries over to the parent under the rules governing liquidations of a subsidiary.⁴¹

The contours of Section 338 are easier to explain than its details. The section is littered with anti-avoidance provisions, many of which are aimed at maneuvers that are beyond the scope of this book. Understanding Section 338 is eased by focusing on its fundamentals.

Qualification for Section 338. The Section 338 election is available only to a “purchasing corporation,” which is defined as “any corporation which makes a qualified purchase of stock of another corporation.”⁴² A “qualified stock purchase” is a transaction or series of transactions in which one corporation acquires by “purchase” an 80 percent controlling interest in another corporation during a 12-month “acquisition period.”⁴³ Roughly translated, all of this means that P must buy at least 80 percent of the stock of T within a 12-month period in transactions that are taxable to the selling shareholders.⁴⁴

The Election. If a corporation makes a qualified stock purchase and desires to make the Section 338 election, it must do so no later than the fifteenth day of the ninth month beginning after the month in which the “acquisition date” occurs.⁴⁵ The acquisition date is the day within the 12-month acquisition period on which the 80 percent purchase requirement is satisfied.⁴⁶ Once made, a Section 338 election is irrevocable.⁴⁷ There is no turning back, even with the Commissioner’s permission, if the results prove to be undesirable.

Effect of Election: Deemed Sale of Target Assets and Termination of Old Target’s Existence. If P makes a qualified stock purchase and follows up with a timely Section 338 election, T is treated as having sold all of its

³⁹ I.R.C. § 338(a).

⁴⁰ I.R.C. § 338(b).

⁴¹ I.R.C. §§ 332; 334(b)(1). See Chapter 7C2, *supra*.

⁴² I.R.C. § 338(d)(1).

⁴³ I.R.C. §§ 338(d)(3); 338(h)(1). The requisite stock interest is defined in Section 338(d)(3) by reference to Section 1504(a)(2), which defines “control” as possession of at least 80 percent of the total voting power and 80 percent of the total value of a corporation’s stock.

⁴⁴ “Purchase” is defined to exclude transactions that would not have resulted in the full recognition of gain or loss to the seller (i.e., reorganizations, gifts, bequests, Section 351 transfers) and acquisitions from certain “related persons” within the attribution rules of Section 318. I.R.C. § 338(h)(3).

⁴⁵ I.R.C. § 338(g)(1).

⁴⁶ I.R.C. § 338(h)(2).

⁴⁷ I.R.C. § 338(g)(3).

assets at the close of the acquisition date for their “fair market value” in a single transaction and is treated as a new corporation which purchased all of its assets as of the beginning of the day after the acquisition date.⁴⁸ As a result, T recognizes gain or loss on this hypothetical sale, just as if it actually had sold its assets.⁴⁹ For purposes of this deemed sale, Section 338 provides that T is not treated as a member of an affiliated group if it otherwise might have been.⁵⁰ Although the income realized on the deemed asset sale may not be combined with the income of P or its affiliates for tax purposes, the economic burden of the tax liability resulting from the deemed sale is indirectly borne by P, which will factor it into the price to be paid for the stock. On the day after the deemed sale, T is reincarnated. It returns as a new corporation with no earnings and profits or other tax attributes from its pre-deemed sale era and with a cost basis in the assets that it hypothetically purchased from its former self.⁵¹ If all this talk about deemed transactions seems mysterious, keep in mind that it is simply the mechanism used by the Code to equate purchases of assets and stock when a Section 338 election is made.

Aggregate Deemed Sale Price. In the hypothetical asset sale triggered by a Section 338 election, T is treated as selling its assets for their “aggregate deemed sale price” (“ADSP”).⁵² This is easy to determine if 100 percent of T’s stock is purchased in one transaction and not as easy if the stock purchases do not occur within 12 months or P does not acquire all of T’s stock. In general, ADSP is the sum: of (1) the grossed-up amount realized on the sale to P of P’s recently purchased T stock, and (2) the liabilities of old T, including tax liabilities from the deemed sale.⁵³ “Recently purchased stock” is T stock purchased by P during the 12-month acquisition period and held by P at the time of the qualified stock purchase.⁵⁴ Thus, if P purchased all of T’s stock during the 12-month acquisition period, the ADSP is the total amount realized by the selling T shareholders plus old T’s liabilities.

If P purchased less than 100 percent of T’s outstanding shares during the 12-month acquisition period, then the concept of “grossed-up” amount realized comes into play. The grossed-up amount realized is an amount equal to the amount realized on the sale to P of P’s recently purchased T stock without regard to costs of sale, divided by the

⁴⁸ I.R.C. § 338(a).

⁴⁹ See Section B1 of this chapter, *supra*.

⁵⁰ I.R.C. § 338(h)(9). This means that losses of P or any P affiliate or losses of a corporate parent or affiliate of T may not be used to shelter gains resulting from T’s deemed asset sale, but T may deduct its own net operating losses against the gains from the deemed sale. See Reg. § 1.338-1(f)(3)(iv). A “consolidated deemed sale return” may be filed, however, by all target corporations acquired by a purchasing corporation on the same acquisition date if the targets were members of the same selling consolidated group. I.R.C. § 338(h)(15). Cf. I.R.C. § 338(h)(10) and Section C3 of this chapter, *infra*.

⁵¹ I.R.C. § 338(a)(2).

⁵² Reg. § 1.338-4(a).

⁵³ Reg. § 1.338-4(b)(1), (d).

⁵⁴ I.R.C. § 338(b)(6)(A).

percentage of T stock (by value) attributable to that recently purchased stock, less any selling costs (such as brokerage commissions) incurred by the selling T shareholders in connection with their sale of recently purchased stock that reduce their amount realized.⁵⁵ The function of this complex formula in situations where P does not acquire 100 percent of T stock is to approximate the total amount that would have been realized on the sale of T stock if P had purchased all the shares at the same average price that P paid for the shares actually purchased during the acquisition period. To illustrate, if during the 12-month acquisition period P purchased 80 percent of T's outstanding stock for \$800,000, the grossed-up amount realized on the sale to P of P's recently purchased T stock would be \$800,000/.80, or \$1,000,000.

Remember that the theory underlying Section 338 is to replicate the tax consequences of an asset acquisition. If P were to purchase all of T's assets, the purchase price would reflect any T liabilities assumed or property transferred subject to liabilities as part of the transaction. Under the principles of the *Crane* case, T's amount realized in such an asset sale would include the amount of those liabilities. In a stock purchase, the amount paid by P for T's stock similarly will take into account the debts and liabilities on T's balance sheet as of the "acquisition date." To properly determine the deemed sale price of T's assets under Section 338, the ADSP is increased by liabilities of old T, including tax liabilities, that properly would be taken into account as amount realized on a disposition by T of its assets to an unrelated purchaser who assumed the liabilities or took assets subject to a liabilities of old T.⁵⁶

Determination of Asset Basis After Deemed Purchase. New T's basis in its assets has been described as a *Kimbell-Diamond* type cost basis, but the actual approach used to determine the aggregate basis and allocate it among T's assets is not quite that simple. The regulations label new T's basis as the "adjusted grossed-up basis" ("AGUB").⁵⁷ The AGUB generally is the sum of: (1) the grossed-up basis in P's recently purchased T stock, (2) P's basis in nonrecently purchased T stock (e.g., T stock owned by P before the 12-month acquisition period), and (3) liabilities of new T, including any tax liabilities triggered by the deemed sale.⁵⁸ AGUB is similar but not necessarily identical to ADSP. If P holds only recently purchased stock in T and T has no contingent liabilities, the two calculations usually produce the same result.

⁵⁵ Reg. § 1.338-4(c)(1).

⁵⁶ Reg. § 1.338-4(d)(1). General tax principles control the time that liabilities are taken into account. See Reg. § 1.338-4(d)(2). Since determination of the ADSP may depend, in part, on the tax liability triggered by the deemed sale, and old T's tax liability depends on the ADSP, the calculation is potentially circular. The regulations recognize that the determination of ADSP may require trial and error computations. Reg. § 1.338-4(e). They also include examples of a formula to resolve this mathematical teaser. To revisit high school algebra, see Reg. § 1.338-4(g) Examples.

⁵⁷ Reg. § 1.338-5(a).

⁵⁸ Reg. § 1.338-5(b)(1).

To illustrate, assume again that during the 12-month acquisition period P purchased 80 percent of T's outstanding stock for \$800,000 and assume P does not own any other T stock. In computing ADSP and AGUB, the grossed-up amount realized and the adjusted grossed-up basis are both \$1,000,000.⁵⁹ But if P owns nonrecently purchased T stock with a per-share basis different than P's basis in its recently purchased stock, the calculation of the ADSP for old T's assets and the AGUB for new T's assets will produce different results.⁶⁰ The difference is attributable to the fact that the ADSP formula treats P's nonrecently purchased stock the same as stock that is held by T shareholders other than P, while the AGUB formula uses P's actual basis in its nonrecently purchased T stock. P can make an election to recognize gain on its nonrecently purchased T stock.⁶¹ If such an election is made, the sum of the grossed-up basis in P's recently purchased T stock and P's basis in any nonrecently purchased stock will equal the ADSP.⁶² The election, however, requires P to currently recognize gain on its nonrecently purchased T stock, and so it usually is not desirable from a tax standpoint.

Allocation of Adjusted Grossed-up Basis Among Target Assets. If P makes a Section 338 election, new T's aggregate AGUB is allocated among its assets under regulations promulgated under Section 338(b)(5). These regulations utilize the same seven-class system and reporting requirements previously discussed with respect to basis allocations in asset acquisitions.⁶³

Consistency Rules. Section 338 allows a purchasing corporation to take a transferred basis in T's assets (by not making the election) or, at the cost of a tax on any gain (or deducting any loss) inherent in the target's assets, to take essentially a fair market value basis in those assets. When Section 338 was enacted, the consistency requirement was designed to ensure that P was put to a choice: it could select one or the other, but not both (or some of each) of these options. To achieve that objective, Section 338(e) was intended to prevent P from acquiring some assets from T or an affiliate of T with a cost basis and other assets with a transferred basis during a "consistency period" that begins one year before the start of the acquisition period and extends to one year after the acquisition date.⁶⁴ Under Section 338(e), if P acquired such an asset from T during the consistency period, it was deemed to make a Section

⁵⁹ For ADSP, see Reg. § 1.338-4(c); for AGUB, see Reg. § 1.338-5(b), (c).

⁶⁰ Contingent liabilities that are taken into account in determining a seller's amount realized but are not yet properly included in a purchaser's basis also may be the source of an initial disparity that usually will be corrected by later adjustments. See, e.g., Reg. § 1.338-5(b)(2)(ii).

⁶¹ I.R.C. 338(h)(3). Losses on nonrecently purchased stock are not allowed. Reg. § 1.338-5(d)(3)(iii).

⁶² See Reg. § 1.338-5(d)(3).

⁶³ See Section B2 of this chapter, *supra*; Reg. § 1.338-6.

⁶⁴ I.R.C. § 338(h)(4)(A).

338 election with respect to the purchase of T's stock, unless T sold the asset in the ordinary course of its business (e.g., a routine sale of inventory) or P took a transferred basis in the asset.⁶⁵ Section 338(f) was designed to ensure that if P makes a qualified stock purchase with respect to T and one or more affiliates (e.g., a wholly owned subsidiary) of T during any consistency period, then all such qualified stock purchases must be treated consistently under Section 338; an election with respect to the first applies to all later qualified stock purchases and if no election is made for the first purchase, none may be made for later ones.

In the final Section 338 regulations, the Treasury significantly narrowed the reach of the consistency period rules because they were designed to patrol against exploitation of the long ago repealed *General Utilities* doctrine. Under the regulations, the asset consistency rules of Section 338(e) generally apply only if P acquires an asset directly from T during the consistency period and T is a subsidiary of another corporation ("S") in a consolidated group.⁶⁶ Under the regulations, the stock consistency rules of Section 338(f) are now limited by the regulations to preventing avoidance of the asset consistency rules.⁶⁷

Understanding the limited application of the asset consistency period rules requires a very basic knowledge of the consolidated return regulations, which generally permit a parent corporation in a consolidated group to increase the basis for its stock in a subsidiary when the subsidiary recognizes a taxable gain on the sale of one of its assets.⁶⁸ The relationship of this rule to Section 338 is best illustrated by the following example provided by the Treasury where P is the purchasing corporation, T is the target and S is T's parent:⁶⁹

The proposed regulations apply the consistency rules in the context of consolidated groups to prevent acquisitions from being structured to take advantage of the investment adjustment rules. If the consistency rules did not apply in such a case, P could acquire assets from T with a stepped-up basis in the assets, and then acquire the T stock at no additional cost to the S group.

Example. S and T file a consolidated return. S has a \$100x basis in the T stock, which has a fair market value of \$200x. On January 1, 1993, T sells an asset to P and recognizes \$100x of gain. Under § 1.1502–32 [of the consolidated return regulations], S's basis in the T stock is increased from \$100x to

⁶⁵ I.R.C. § 338(e)(2)(A) and (B).

⁶⁶ Reg. § 1.338–8(a)(2). The rules are also extended to a few other limited abuse cases that are well beyond the coverage of this text. See Reg. § 1.338–8(a)(3), (4).

⁶⁷ Reg. § 1.338–8(a)(6).

⁶⁸ See Reg. § 1.1502–32 and Chapter 13, *infra*.

⁶⁹ See Preamble, Prop. Reg. §§ 1.338–4, –5 (CO–111–90), issued Jan. 14, 1992 (1992–1 C.B. 1000).

\$200x. On March 1, 1993, S sells the T stock to P for \$200x and recognizes no gain or loss.

The consistency rules of the proposed regulations apply to the transaction because T's gain on the asset sale is reflected under § 1.1502–32 in S's basis in the T stock. However, under the proposed regulations, the District Director no longer has the discretion to impose a deemed section 338 election for T. Instead, under proposed [regulation] § 1.338–4(d), P takes a carryover basis in any asset acquired from T. (This is referred to as the carryover basis rule).

Section 338 Election Coupled with Liquidation of T. If P purchases 80 percent or more of T stock, makes a Section 338 election, and then promptly liquidates T, the stock purchase and subsequent liquidation of T are accorded independent significance for tax purposes—i.e., they are not stepped together and treated as an integrated transaction. P is treated as having made a qualified stock purchase rather than a direct acquisition of assets under the *Kimbell-Diamond* doctrine.⁷⁰ On the liquidation, P recognizes no gain or loss under Section 332, and T recognizes no gain or loss on the distribution of its assets to P under Section 337. In any event, neither P nor T would have any significant realized gain or loss because at least 80 percent of the T stock would have been recently purchased, and any built-in gain on T's assets was recognized as a result of the Section 338 deemed asset sale. After the liquidation, P succeeds to T's fair market value basis in its assets.

Stock Acquisitions Without Section 338 Election. The tax consequences of an acquisition of 80 percent or more of T's stock with no Section 338 election are less complicated. T's shareholders, as always, recognize gain or loss on the sale of their stock. T becomes a subsidiary of P and retains its tax attributes, including the historic basis in its assets, earnings and profits, and the like. If P subsequently liquidates T, or T merges into P or another P subsidiary, neither P nor T recognizes gain or loss, and T's asset bases and other tax attributes carry over to the transferee.⁷¹ Significantly, the initial qualified stock purchase and subsequent liquidation of T (or merger of T into P or a P affiliate) are not treated as an integrated transaction (e.g., as a direct purchase of T's assets by P) even if all the steps were planned from the outset. If the transactions were integrated, T would recognize gain or loss on its assets, a result which is fundamentally inconsistent with P's decision not to make a Section 338 election. The extent to which T (if it stays alive) or P (if it liquidates T) may utilize T's net operating losses after the

⁷⁰ Reg. § 1.338–3(c)(1)(i). See also Rev. Rul. 90–95, 1990–2 C.B. 67 (stating that “Section 338 replaced the *Kimbell-Diamond* doctrine”).

⁷¹ Rev. Rul. 90–95, supra note 70. See also Reg. § 1.338–3(d)), discussed in Chapter 9B1e, infra.

acquisition is likely to be limited by Section 382, which is examined in a later chapter.⁷²

3. ACQUISITION OF STOCK OF A SUBSIDIARY

Section 338(h)(10) Election. The previous discussion assumed that T was not a subsidiary of another corporation. Consider, however, the situation where T is a wholly owned subsidiary of Seller, Inc. ("S"), and P wishes to acquire T. Assume that the value of T's stock (and also its underlying assets) is \$400,000; S has a \$100,000 basis in its T stock; and T has a \$100,000 aggregate basis in its assets. T could sell its assets directly to P for \$400,000 in a taxable transaction and then distribute the sales proceeds to S in a tax-free liquidation under Section 332, with the net result being \$300,000 of taxable gain to T on the asset sale. Alternatively, T could distribute the assets to S in a tax-free liquidation. S would take the assets with a \$100,000 transferred basis under Section 334(b) and recognize \$300,000 gain on a sale to P. In either case, S does not recognize gain or loss on its T stock, and P acquires the assets with a \$400,000 cost basis. If the disappearance of S's \$300,000 gain on its T stock seems inconsistent with the double tax regime, remember that no assets have yet been distributed out of corporate solution to the shareholders of S, the real people who own the enterprise. The policy is to avoid three levels of tax on what may be a single economic gain.

Now assume that for nontax reasons P must acquire T's stock. Under general tax principles, S would recognize gain or loss on the sale of its T stock and P would take the stock with a cost basis. If P makes a Section 338 election, T also is treated as having sold its assets in a taxable transaction. If P does not elect, the bases of T's assets are unchanged and any built-in gain or loss is preserved. Either way, the result is double *corporate*-level gain, with the potential of a third round of taxation when S distributes the sales proceeds to its shareholders.

Section 338(h)(10) offers relief from this potential triple tax by permitting the parties to ignore S's sale of its T stock and treat the transaction as if it were a sale of T's assets.⁷³ If a Section 338(h)(10) election is made,⁷⁴ old T is deemed to have sold its assets to an unrelated person (new T) while a member of the S consolidated group, and then to have distributed its assets (i.e., the proceeds of sale) to S and ceased to exist. In most cases, the final step of the various hypothetical transactions is treated as a tax-free liquidation of T under Sections 332

⁷² See Chapter 12, *infra*, and I.R.C. § 269(b).

⁷³ In general, before the transaction T must be a member of "the selling consolidated group." I.R.C. § 338(h)(10)(A). A "selling consolidated group" is any group of corporations which, for the taxable period which includes the transaction, includes T and files a consolidated tax return. I.R.C. § 338(h)(10)(B). A qualified seller also may be any "affiliated group" of corporations (within the meaning of Section 1504) which includes T, whether or not the group files a consolidated return. See generally Reg. § 1.338(h)(10)-1(b)(3).

⁷⁴ The election must be made jointly by the S group and P. See Reg. § 1.338(h)(10)-1(c)(2).

and 337.⁷⁵ The tax consequences of the election are: (1) S recognizes no gain or loss on the sale of its T stock; (2) S inherits T's tax attributes (e.g., earnings and profits);⁷⁶ (3) T is deemed to have sold its assets for their fair market value in a taxable transaction,⁷⁷ and any gain or loss is included on the consolidated return filed by S and its affiliates; and (4) "new T," a subsidiary of P, is treated as having acquired old T's assets for an amount equal to their adjusted grossed-up basis.⁷⁸ Two levels of corporate-level gain are thus avoided, and the tax burden of the sale remains with the seller.

Returning to the example, if the parties make a Section 338(h)(10) election, S's \$300,000 gain on the sale of its T stock is ignored, and the \$300,000 gain on the deemed sale of T's assets⁷⁹ is included on the consolidated tax return filed by S and its affiliates. P takes a \$400,000 cost basis in the T stock and "new T" takes a \$400,000 basis in its assets.

Although the Section 338(h)(10) election is generally desirable because it eliminates two levels of corporate-level gain, it has particular allure when S has a large "outside" gain on its T stock relative to minimal "inside" gain on T's assets. In that scenario, P may purchase T's stock at little or no tax cost to S if the parties make a Section 338(h)(10) election. Of course, the same result could have been achieved if S first liquidated T under Section 332 and sold the assets to P, but this method might not be feasible if P needs to keep T alive as a corporate entity for nontax reasons.

The election also is attractive when S's consolidated group has losses that can be applied to offset any gain recognized by T on the deemed sale of its assets. If Section 338 were elected without an accompanying Section 338(h)(10) election, T must file a separate one day return reporting the income from the deemed sale and it could not offset its gain with any losses from S's other operations. If a Section 338(h)(10) election is made, however, the gain on the deemed sale is reported on S's consolidated return and may be offset by losses of S and its other affiliates.

The regulations extend the availability of the Section 338(h)(10) election to two additional situations. First, they permit the election when T and S are affiliated corporations even if T is not a member of the S consolidated group if S sells stock representing at least 80 percent of the

⁷⁵ See Reg. § 1.338(h)(10)-1(d).

⁷⁶ These inherited tax attributes generally are reduced in proportion to the percentage of old T stock held by minority shareholders. Cf. Reg. § 1.381(c)(2)-1(c)(2).

⁷⁷ The deemed sale price is determined under a formula prescribed by the regulations, which refers to the actual purchase price paid by P for the T stock and is adjusted for liabilities of T. See Reg. §§ 1.338(h)(10)-1(d)(3)(i); 1.338-4.

⁷⁸ I.R.C. § 338(b). The adjusted grossed-up basis for new T's assets is determined under Reg. § 1.338-5 and is allocated among the assets under the approach discussed earlier in this chapter. Reg. § 1.338(h)(10)-1(d)(2).

⁷⁹ We have assumed for convenience that the deemed sale price equals the \$400,000 fair market value of T's assets.

voting power and value of T to P on the “acquisition date.”⁸⁰ Second, a Section 338(h)(10) election is permitted if T is an S corporation immediately before the acquisition date.⁸¹ If T is an S corporation, the gain on the deemed sale of T’s assets is reported on old T’s final S corporation return and passes through to T’s shareholders, who may make appropriate adjustments to the basis of their T stock.⁸² These adjustments will affect the gain or loss recognized by these shareholders on the deemed liquidation of old T, and no additional gain or loss is recognized on the actual stock sale. The taxation of S corporations and their shareholders is examined in Chapter 15.

4. SECTION 336(e)

Section 336(e) is a close relative of Section 338(h)(10). In some cases, it is an identical twin. Section 336(e) provides that, upon the promulgation of regulations, a corporation that owns at least 80 percent of the voting power and value of the stock of another corporation may elect to treat a sale, exchange or distribution of that subsidiary’s stock as if it were a disposition of the subsidiary’s assets. If a Section 336(e) election is made, the parent does not recognize gain or loss on the disposition of the subsidiary’s stock. The legislative history of Section 336(e) states that “principles similar to those of Section 338(h)(10)” will be used in determining the operation of the Section 336(e) election.⁸³

The overlap between Sections 336(e) and 338(h)(10) is apparent when a parent sells the stock of a controlled subsidiary to a corporate purchaser. Section 336(e) is potentially broader, however, and could apply even if the buyer were an individual or entity (such as a partnership) that is not qualified to make a Section 338 election. Moreover, Section 336(e) is not confined to sales. It potentially encompasses both liquidating and even nonliquidating distributions of the stock of a subsidiary.

Section 336(e) was an empty shell without the further details that Congress left to the Treasury to develop through regulations. In 2013, a mere 27 years after Section 336(e) was enacted, the Treasury finally issued the eagerly awaited regulations.⁸⁴ They permit a corporation with “control” of another corporation (“T”) to make an election to treat certain sales, exchanges, and distributions of T stock as taxable sales of T’s assets. The regulations also provide useful guidance on the scope of Section 336(e), its relationship to Section 338(h)(10), and the requirements for and mechanics of a Section 336(e) election.

⁸⁰ Reg. §§ 1.338(h)(10)-1(c)(1), -1(b)(3), -1(d)(4).

⁸¹ Reg. §§ 1.338(h)(10)-1(c)(1), -1(b)(4), -1(d)(4).

⁸² Reg. § 1.338(h)(10)-1(d)(5)(i).

⁸³ H.R. Rep. No. 841, 99th Cong., 2d Sess. II-204 (1986).

⁸⁴ Reg. § 1.336-1, -2.

For most purposes, the regulations utilize principles established under Section 338(h)(10) except certain familiar definitions have been modified to reflect the greater breadth of Section 336(e). For example, they use the term “disposition” rather than “acquisition” or “purchase” and “sale, exchange or distribution” instead of just “sale.” Thus, a “qualified stock purchase” under Section 338 is a “qualified stock disposition” under Section 336(e). The regulations use the term “aggregate deemed disposition price” instead of “aggregate deemed sales price” but retain the much beloved “adjusted grossed up basis.” The new term “nonrecently disposed stock” has a meaning similar to “nonrecently purchased stock” in Section 338.⁸⁵ To avoid overlap, the regulations make it clear that a transaction satisfying the definition of “qualified stock purchase” in Section 338(d)(3) is governed exclusively by Section 338 and does not qualify for a Section 336(e) election.⁸⁶

To make a Section 336(e) election, the seller⁸⁷ must own stock in a domestic C corporation meeting the requirements of Section 1504(a)(2) (generally, 80 percent of voting power and value) and must sell, exchange, or distribute (including combinations thereof) all of such stock meeting the control requirement during a 12-month disposition period. Thus, some portion of T stock may be retained by the seller or a member of the seller’s consolidated group. Any stock disposed of to a “related party” does not count for purposes of determining whether there has been a qualified stock disposition. The regulations also permit a Section 336(e) election to be made when an S corporation is the target, as long has been permitted for a Section 338(h)(10) election.⁸⁸ A Section 336(e) election will not be effective unless the seller and the target (acting as a proxy for the purchasers) enter into a written binding agreement to make the election and both the seller and target corporations attach Section 336(e) election statements to their tax returns.⁸⁹

In the case of a sale or exchange of T stock where a Section 336(e) election is made, the regulations treat Old T as if it sold all its assets to an unrelated corporation (New T) at the close of the disposition date in exchange for the aggregate deemed disposition price (generally, the amount realized on the sale of the stock, adjusted for liabilities). Old T is then treated as having completely liquidated into New T.⁹⁰ If T stock is distributed as part of a qualified stock disposition, the transaction is treated as a sale of Old T’s assets to New T, followed by a liquidation of

⁸⁵ See generally Reg. § 1.336–1(b); 1.336–3.

⁸⁶ Reg. § 1.336–1(b)(6)(ii).

⁸⁷ For this purpose, “seller” means any domestic corporation that makes a qualified stock disposition and includes both a transferor and distributor of target stock. Reg. § 1.336–1(b)(1).

⁸⁸ Reg. § 1.336–1(b)(3). See Chapter 15G1, *infra*, for more on how Section 336(e) elections are used in connection with acquisitions of S corporations.

⁸⁹ Reg. § 1.336–2(h).

⁹⁰ Reg. § 1.336–2(b)(1)(i)(A), –2(b)(1)(ii); –2(b)(1)(iii).

Old T and a deemed purchase of New T stock by the seller followed by a tax-free distribution of that stock to the seller's shareholders.⁹¹

The regulations provide limited relief from the strict limitation on the recognition of losses imposed by Section 311(a). They generally permit Old T to deduct losses realized on the deemed sale of its assets up to the realized gains triggered by a Section 336(e) election.⁹² But if the target corporation has a net loss on the deemed asset sale, that loss is permanently disallowed in proportion to the portion of the target stock that was disposed of by the seller in one or more distributions during the 12-month disposition period, whether or not the distribution was part of a qualified stock disposition.⁹³ The Section 336(e) regulations have lots of additional details, specific rules for various corporate transactions, and numerous examples. They are not light reading.

With this fascinating survey completed, the question remains—so what?—or, put differently, what value does Section 336(e) add as a planning tool? Here is the basic answer. Section 336(e) applies to *distributions* of T stock as well as sales and to a combination of sales, exchanges and distributions, and a Section 336(e) election is available even if the purchaser is not a corporation. By contrast, Section 338 does not apply to distributions or when T stock is acquired by a noncorporate purchaser. Thus, Section 336(e) is best viewed as extending the reach of the principles embodied in Section 338(h)(10) to situations where Section 338 does not specifically apply. A Section 336(e) election provides taxpayers with an additional option when planning transactions that may be structured (or deemed structured) as either a disposition of a target's assets or a sale of its stock.

D. COMPARISON OF ACQUISITION METHODS

A typical student's reaction to this chapter (or indeed the entire course up to now) might be something like this: "After considerable effort, I understand the workings of most Code sections as they are studied, but the course is becoming a conglomeration of random detail." The lament might continue with these questions about taxable corporate acquisitions: "How does it all fit together? Does it matter whether P buys T's assets or stock? What rational buyer ever would make the Section 338 election? Does substance control over form—or form over substance? When does the step transaction doctrine apply?" In short, the understandable plea is—"Give me some perspective!" This section attempts to respond by comparing taxable acquisition methods in a tax planning context, and by providing a comprehensive taxable acquisitions problem.

⁹¹ Reg. § 1.336–2(b)(1)(iv).

⁹² Reg. § 1.336–2(b)(1)(i)(B)(2)(i).

⁹³ Reg. § 1.336–2(b)(1)(i)(B)(2)(ii)–(iv).

The repeal of the *General Utilities* doctrine greatly altered the tax economics of corporate acquisitions. Prior to that time, the tax consequences of an asset purchase followed by a complete liquidation, or a stock purchase coupled with a Section 338 election, were essentially the same. T's shareholders recognized a capital gain on their investment; T did not recognize gain or loss on the actual or deemed transfer of its assets except for recapture of depreciation and a few other items; and P (or "new T") obtained a fair market value basis in T's assets. In short, taxable acquisitions involved only a single, shareholder-level tax, which could be deferred if P used installment notes as partial consideration for the purchase.

After *General Utilities* repeal, an asset acquisition is much more expensive. It requires both T and its shareholders to recognize gain unless T does not liquidate. A stock purchase coupled with a Section 338 election is no better because the deemed asset sale results in full recognition of corporate-level gain. In either case, P obtains a fair market value basis in T's assets—but at the price of an immediate corporate-level tax. Corporate-level tax is avoided, however, if P purchases T's stock and does not elect under Section 338. It is perhaps ironic that, after years of effort to equate the tax treatment of different corporate acquisition methods, we are left with an asymmetrical system under which asset acquisitions require two levels of tax with no opportunity for T to defer tax through a transferred basis, while a stock acquisition without a Section 338 election requires only a shareholder-level tax, albeit with the trade-off of a transferred basis in T's assets.⁹⁴

It follows that the preferred alternative for most taxable acquisitions is a stock purchase with no Section 338 election. It is rarely desirable to pay a front-end corporate tax on the gain inherent in T's assets in order to achieve tax savings later from the additional depreciation, amortization and other deductions that would flow from the stepped-up basis in T's assets. The two principal exceptions are: (1) where T has large net operating loss carryovers that would be available to offset the gain recognized on the deemed asset sale,⁹⁵ and (2) where T is a subsidiary of another corporation.⁹⁶

The prospect of a two-tier tax also may tilt the method of choice in corporate acquisitions more towards tax-free reorganizations, where neither T nor its shareholders currently recognize gain or loss, but tax attributes at both the corporate and shareholder levels are preserved

⁹⁴ These lingering discontinuities are discussed in Zolt, "The *General Utilities* Doctrine: Examining the Scope of Repeal," 65 Taxes 819 (1987); Yin, "A Carryover Basis Regime? A Few Words of Caution," 37 Tax Notes 415 (1987); and Lewis, "A Proposal for a Corporate Level Tax on Major Stock Sales," 37 Tax Notes 1041 (1987).

⁹⁵ These losses are available, subject after 2017 to the 80 percent of taxable income limitation, to offset the gain on T's deemed asset sale. I.R.C. § 172(a)(2). If P acquired T and did not elect under Section 338, T's NOLs would not be purged but they likely would be limited in the future under Section 382. See Chapter 12, *infra*.

⁹⁶ See I.R.C. § 338(h)(10) and Section C3 of this chapter, *supra*.

through transferred and exchanged bases. Acquisitive reorganizations are examined in Chapter 9.

Finally, these tax stakes and planning decisions may be affected by several key provisions of the Tax Cuts and Jobs Act, including: (1) the reduction of the corporate income tax rate to 21 percent; (2) the repeal of the corporate alternative minimum tax; and (3) the opportunity to deduct 100 percent of the cost of that portion of the purchase price allocated to most depreciable tangible personal property.⁹⁷ In some situations, these favorable developments may tip the scales in favor of a taxable sale of assets for cash, or a deemed asset sale resulting from a Section 338 or Section 338(h)(10) election.

PROBLEMS

1. Target Corporation ("T") is a "C" corporation. T's 1,000 shares of common stock (its only class) are owned by three unrelated individual shareholders as follows:

Shareholder	No. Shs.	Adj. Basis	F.M.V.
A	500	\$ 50,000	\$ 500,000
B	400	40,000	400,000
C	<u>100</u>	<u>140,000</u>	<u>100,000</u>
Total	1,000	\$280,000	\$1,000,000

A and B are in their late 70's and have held their T stock since the company was founded many years ago. C recently inherited her stock.

T has \$400,000 of accumulated earnings and profits and the following assets (all held long-term) and liabilities:

Assets	Adj. Basis	F.M.V.
Cash	\$200,000	\$ 200,000
Inventory	50,000	100,000
Equipment (\$100,000 § 1245 recapture)	100,000	200,000
Building (no recapture)	50,000	300,000
Securities	400,000	300,000
Goodwill	0	200,000
Total	\$800,000	\$1,300,000
Liabilities		
Bank loan		300,000
Total		\$ 300,000

⁹⁷ I.R.C. § 168(k), which through 2022 allows a business taxpayer to currently deduct rather than depreciate the cost of most forms of tangible personal property even if the original use of the property does not begin with the taxpayer. Less generous rules become applicable after 2022.

T and its shareholders are considering a sale of the business. Purchaser Corporation ("P") is interested in acquiring T. If specific computations are required by your instructor, assume (for computational convenience) that C corporations are taxed on all their income at a flat corporate rate of 20 percent and individuals are taxed at a flat 40 percent rate on ordinary income and a 20 percent rate on long-term capital gains (and ignore the 3.8 percent tax on net investment income).

What are the tax consequences of the following alternative acquisition methods to T, T's shareholders, and P?

- (a) T adopts a plan of complete liquidation, sells all of its assets (except the cash but subject to the bank loan) to P for \$800,000 cash, and distributes the after-tax proceeds to its shareholders in proportion to their stock holdings. *→ 1300k - 300k - 200k*
- (b) T adopts a plan of complete liquidation, distributes all of its assets (subject to the liability) to its shareholders in proportion to their stock holdings, and the shareholders then sell the assets (less any cash but subject to the bank loan) to P for \$800,000.
- (c) In general, how would the result in (a), above, change if P paid T \$200,000 in cash and \$600,000 in notes, with market rate interest payable annually and the entire principal payable in five years?
- (d) T sells all of its assets (except for the cash but subject to the bank loan) to P as in (a), above, except that T does not liquidate and instead invests the after-tax sales proceeds in a portfolio of publicly traded securities.
- (e) P purchases all the stock of T for \$900 per share and makes a § 338 election. (Why didn't P pay \$1,000 per share for the T stock?)
- (f) P purchases all the stock of T for cash but does not make the § 338 election. (Consider generally what P should pay for the T stock.)
- (g) Assuming P and T are indifferent to the form of the transaction except for the impact of taxes, would you recommend the acquisition method in (a) (purchase of assets), (e) (purchase of stock with § 338 election) or (f) (purchase of stock without § 338 election), above?
- (h) Would your recommendation in (g), above, change if T had \$600,000 in fully deductible net operating loss carryovers?
- (i) Assume that T is a wholly-owned subsidiary of S, Inc., and S has a \$200,000 adjusted basis in its T stock. What result if T distributes all of its assets (subject to the liability) to S in complete liquidation, and S then sells the assets to P?
- (j) Same as (i), above, except P insists that the transaction must be structured as an acquisition of T stock.

2. Should Congress enact legislation that treats taxable asset and stock acquisitions consistently for tax purposes? If so, what are its options and which would you support?

3. X Corp. owns 98 of the 100 outstanding shares of T Corp. common stock (the only class outstanding). The other two shares are owned by unrelated shareholders. T has assets with both gains and losses; assume the amount of the gains exceeds the amount of the losses. In Year 1, X engages in the following transactions. On March 1, it sells 30 shares of T stock to unrelated A for cash; on April 1, it sells 10 shares of T stock to R, a related individual; on July 1, it distributes 50 shares of T stock to X Corp.'s unrelated shareholders; and on December 1, it sells 5 shares of T stock to unrelated B. The value of T stock on July 1 is \$100 per share.

- (a) May a § 336(e) election be made and, if so, by whom?
- (b) Assuming that a § 336(e) election may be made, what are the tax consequences to all relevant parties.

E. TAX TREATMENT OF ACQUISITION EXPENSES

The expenses incurred in connection with a corporate acquisition may be substantial. Both the purchaser ("P") and the target ("T") ordinarily must pay fees to lawyers, accountants and investment bankers. P may incur additional expenses to obtain debt and equity financing, and T may be obligated to secure an opinion stating that the proposed acquisition is "fair" to T and its shareholders. In virtually all cases, the central tax question becomes whether the expenses are currently deductible, amortizable, capitalized and added to the basis of a particular tangible or intangible asset, or treated as a permanent nondepreciable capital expenditure.

The tax treatment of P's expenses are relatively settled. Costs of obtaining debt financing (such as fees for negotiating the loan and drafting loan documents, up-front commitment fees and other fees paid to the lender) generally must be amortized over the term of the loan to which the expenses relate.⁹⁸ Likewise, expenses of obtaining equity financing (e.g., to register newly issued stock, prepare offering documents, etc.) are treated as permanent capital expenditures that are neither currently deductible nor amortizable.⁹⁹ Costs attributable to the acquisition of particular T assets or T stock (e.g., legal expenses for drafting an acquisition agreement, closing costs, finder's fees) also are capital expenditures and must be added to the basis of the acquired property.¹⁰⁰ If P forms a new subsidiary to carry out the acquisition, the organizational expenses are currently deductible (up to \$5,000, but reduced as total expenses exceed \$50,000), with any excess over the

⁹⁸ Rev. Rul. 70-359, 1970-2 C.B. 103; Rev. Rul. 70-360, 1970-2 C.B. 103.

⁹⁹ Rev. Rul. 69-330, 1969-1 C.B. 51.

¹⁰⁰ If P acquires T's stock and makes a Section 338 election, these capital expenditures become part of new T's adjusted grossed-up basis and may be allocated among T's assets in accordance with the rules in Sections 338(b)(5) and 1060. See Reg. § 1.338(b)-1(g)(1).

deductible amount amortizable over 15 years if P elects to apply Section 248. In addition, P may attempt to classify certain expenses related to an acquisition as normal business expenses. Examples would include expenses related to employment agreements, executive compensation and retirement planning, tax planning, and the annual retainer paid to an investment banker that may have helped arrange the acquisition.

The tax treatment of T's expenses has been more controversial. Assume for example that the target in a friendly corporate takeover incurs legal, investment banking and other fees, including the cost of obtaining an opinion that the terms of the acquisition are fair to T and its shareholders. Are these expenses currently deductible by T as ordinary and necessary businesses expenses under Section 162 or must they be capitalized? In *INDOPCO, Inc. v. Commissioner*,¹⁰¹ the Supreme Court held that investment banking fees and other expenses incurred by a target corporation in a friendly takeover were nondeductible capital expenditures because they produced significant long-term benefits, such as the availability of the acquiring corporation's resources, the opportunity for synergy, and the benefits resulting from the target's transformation from a public company to a wholly owned subsidiary. In ruling for the government, the Court held that the creation or enhancement of a separate or distinct asset was not controlling in resolving capital expenditure classification questions. In so doing, it rejected the taxpayer's reliance on a line of appellate decisions that had interpreted the Court's opinion in *Commissioner v. Lincoln Savings & Loan Association*¹⁰² as adopting a test under which creation or enhancement of an asset is a prerequisite to capitalization. The Court clarified its earlier decision in *Lincoln Savings*, stating that the creation of a separate and distinct asset may be a sufficient reason for capitalizing an expense but not an essential prerequisite. It noted further that *Lincoln Savings* did not prohibit reliance on "future benefit" as a test for distinguishing an ordinary business expense from a capital expenditure. However, the Court conceded that an "incidental future benefit" may not require capitalization but that the taxpayer's realization of benefits beyond the year in which the expenditure was incurred is an important factor in distinguishing ordinary business expenses from capital expenditures.

Soon after it was decided, commentators began to focus on the potential ripple effect of the Supreme Court's *INDOPCO* decision—specifically whether the Court's reasoning would be imported to deny deductibility of various other expenses. The Service has calmed most of these nerves, first in a series of rulings confirming the current

¹⁰¹ 503 U.S. 79, 112 S.Ct. 1039 (1992).

¹⁰² 403 U.S. 345, 91 S.Ct. 1893 (1971).

deductibility of many expenditures¹⁰³ and more recently in extensive taxpayer-friendly regulations.¹⁰⁴

INDOPCO involved a friendly takeover. Should expenses incurred to resist a hostile takeover be treated differently? The contexts in which this issue arises include both defending against a hostile takeover by a corporate raider and arranging for a taxable acquisition by a friendly “White Knight” buyer. The cases so far indicate that the tax treatment of such expenditures may depend on the eventual outcome of the transaction. In *In re Federated Department Stores, Inc.*,¹⁰⁵ a corporate taxpayer, faced with a hostile offer, arranged a White Knight transaction and agreed to pay “break-up” fees to the White Knight if the merger fell through. Eventually, the hostile bidder was successful and the break-up fees were paid to the White Knight. A federal district court in a bankruptcy proceeding held that the fees were currently deductible under either Section 162 or Section 165 (as costs incurred in an abandoned transaction). Distinguishing *INDOPCO*, the court found that the fees were incurred to defend the business against attack and not to restructure the corporation in hopes of some future benefit.

In *A.E. Staley Manufacturing Co. v. Commissioner*,¹⁰⁶ the Tax Court considered a situation where a corporation incurred \$23 million in investment bankers’ fees and printing costs to respond to a series of hostile tender offers for its stock. The company’s board of directors declined two offers but eventually accepted a third bid. Rejecting the taxpayer’s argument that *INDOPCO* was distinguishable because the takeover in *Staley* was hostile, the Tax Court held that the fees and costs were nondeductible because they were incurred in connection with a change in the ownership of the taxpayer that “portended strategic changes *** with long-term consequences” and were capital in nature.¹⁰⁷

On appeal, the Seventh Circuit reversed and permitted the target corporation to deduct most of the expenses it incurred in resisting a hostile takeover.¹⁰⁸ The court reasoned that *INDOPCO* did not change the law with respect to costs incurred to defend a business because those expenses were to preserve the status quo, not to produce future benefits.

¹⁰³ See, e.g., Rev. Rul. 95-32, 1995-16 I.R.B. 5 (expenditures by a public utility for the implementation and operation of energy conservation and load management programs are deductible under Section 162); Rev. Rul. 94-77, 1994-2 C.B. 19 (severance payments to employees are generally deductible under Section 162); Rev. Rul. 94-38, 1994-1 C.B. 35 (costs to clean up land and treat groundwater contaminated by taxpayer are deductible under Section 162); Rev. Rul. 94-12, 1994-1 C.B. 36 (incidental repair costs are deductible under Section 162); Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising costs are generally deductible under Section 162).

¹⁰⁴ See generally Reg. § 1.263(a)-4, -5.

¹⁰⁵ 171 B.R. 603 (S.D.Ohio 1994).

¹⁰⁶ 105 T.C. 166 (1995).

¹⁰⁷ Id. at 200.

¹⁰⁸ *A.E. Staley Manufacturing Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997). See also *Santa Fe Gold Company v. Commissioner*, 132 T.C. 240 (2009) (\$165 million termination fee paid to a White Knight in an unsuccessful defense of a hostile takeover was deductible).

It concluded that most of the expenses incurred by the taxpayer in *A.E. Staley* were related to the defense of its business and corporate policy and thus were currently deductible under Section 162(a). Costs properly allocable to unsuccessful efforts to engage in an alternate transaction to prevent the acquisition, such as a financial restructuring, recapitalization, or joint venture, were held to be deductible losses under Section 165. The court also held that fees paid to evaluate the taxpayer's stock and to facilitate the eventual merger were nondeductible capital expenditures.

If either P or T incurs costs in investigating or attempting to consummate an acquisition that ultimately fails, the transactional costs generally are currently deductible as losses under Section 165.¹⁰⁹

The Service has issued lengthy regulations under Section 263 relating to the tax treatment of amounts incurred to acquire, create, or enhance various kinds of intangible assets.¹¹⁰ The regulations specify, in extraordinary detail, various categories of rights, privileges and future benefits for which capital expenditure treatment is required. Particular goals of this regulations project were to bring greater clarity to (some would say "erode" or "discard") the "significant future benefit" standard enunciated by the Supreme Court in *Indopco, Inc. v. Commissioner*, and to resurrect the more taxpayer-friendly "separate and distinct asset" approach of the Court's earlier *Lincoln Savings* decision. The effect of this new liberalized regime is to presume that outlays related to intangible assets are currently deductible unless these or subsequently issued regulations specifically require capitalization.

The regulations include specific rules on an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions such as Section 351 exchanges.¹¹¹ Costs that "facilitate" such transactions must be capitalized.¹¹² This standard is consistent with the previously discussed case law on the purchaser's acquisition expenses. Transaction costs incurred to defend against a hostile takeover are not viewed as facilitating the acquisition. As a result, they may be currently deducted rather than capitalized.¹¹³ This rule follows the Seventh Circuit's decision in *A.E. Staley*. If an initially hostile acquisition becomes friendly, the taxpayer must bifurcate the costs between those incurred to defend against the hostile takeover and those incurred to facilitate the friendly acquisition, using a "facts and circumstances" standard to draw the line.¹¹⁴ Costs incurred to thwart a hostile acquisition, such as by merging with a White Knight, must be

¹⁰⁹ Rev. Rul. 73-580, 1973-2 C.B. 86.

¹¹⁰ Reg. § 1.263(a)-4, -5, T.D. 9107, 69 Fed. Reg. 436 (Jan. 5, 2004).

¹¹¹ See Reg. § 1.263(a)-5(a). For accounting rules for debt issuance costs that must be capitalized, see Reg. § 1.446-5.

¹¹² Id. Costs that facilitate the acquisition of an intangible generally must be capitalized under Reg. § 1.263(a)-4(b)(1)(v), (e).

¹¹³ Reg. § 1.263(a)-5(l) Example 11.

¹¹⁴ Id. See also Reg. § 1.263(a)-5(l) Example 12.

capitalized even if the taxpayer's overall purpose was to defend against a hostile acquisition.¹¹⁵ But legal fees paid to seek an injunction against a hostile takeover and investment banking fees to locate a potential White Knight acquirer may be currently deducted.¹¹⁶ And there's much more, including simplifying conventions (e.g., compensation to employees are treated as amounts that do not facilitate a transaction and thus are currently deductible),¹¹⁷ de minimis exceptions (transaction costs of \$5,000 or less generally do not have to be capitalized),¹¹⁸ and timing rules.¹¹⁹

¹¹⁵ Reg. § 1.263(a)–5(l) Example 11.

¹¹⁶ Id.

¹¹⁷ Reg. § 1.263(a)–5(d)(2).

¹¹⁸ Reg. § 1.263(a)–5(d)(3).

¹¹⁹ Reg. § 1.263(a)–5(e).