Turning Off Relatedness

by Jasper L. Cummings, Jr.

Jasper L. Cummings, Jr.

Jasper L. Cummings, Jr., is of counsel with Alston & Bird LLP in Raleigh, North Carolina.

In this article, Cummings examines a recent letter ruling that allowed a group to amortize an intangible that it bought from itself with a section 336(e) election, and he questions the choices of Treasury that led to this ruling result.

Table of Contents

I. Huh? Huh! Or Huh . . .

A. A Startling Example

Vocal inflection can change the meaning of "huh." It can express incredulity or surprise. But when tax experts (think of Davis Polk & Wardwell LLP partner David Schnabel) on the lecture circuit say "huh" about a new regulation or other guidance, it has another meaning: "I see something I can use in a way that the IRS likely didn't consider." The speaker can be confident because he knows the IRS turns square corners; when it turns a corner and confronts an unexpected result, it usually says "Our recipe made that cake, so it must be a good cake."

This article examines several rules that apply step transaction analysis to determine if two persons are related. For purposes of these rules, being related usually is a bad thing. But frequently the result that looks bad for most taxpayers can look good to some taxpayers. The most infamous example is *Kimbell-Diamond*.[1] Another is *Helmer*.[2] More to the point here is the busted section 351 exchange.[3] Mostly taxpayers want tax-free incorporations, but not when a taxable incorporation can put appreciated property into a corporation that gets a basis step-up and can be made to pay the incorporator for the tax benefits.

Today *Kimbell-Diamond* lives on in section 338, which can't apply to a stock purchase from a related person. But when is relatedness measured? That is the same issue that is central to the busted section 351 exchange, which depends on breaking control "immediately after" by a subsequent sale of the stock received in the

[1] *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951) (stock of corporation owning qualified replacement property was acquired in order to obtain corporation's assets by liquidation; held transaction was in substance acquisition of assets, whose basis was therefore reduced — an IRS win); in all later cases the asset basis was increased to the buyer's stock purchase price.

[2] *Helmer v. Commissioner*, T.C. Memo. 1975-160. *See* CC-2003-020; Jasper L. Cummings, Jr., "*Klamath* and 'Economic Substance,'" *Tax Notes*, Feb. 26, 2007, p. 871.

[3] This is an exchange that appears to qualify for section 351 nonrecognition treatment "immediately after" the exchange but does not because of the special definition of the term "immediately after" for purposes of section 351(a).

exchange with the new corporation. Tax professionals have learned to say "huh" about such rules requiring a relationship or lack of relationship. They reason that "if the first step is between related persons but one of them becomes unrelated, maybe the first step was not between related persons."

That is how we got intentionally busted 351 exchanges, and more recently a way for intercompany property sales to qualify for section 168(k) bonus depreciation. In fact, we have (quickly) becomes so used to such bookend integration rules that we overlook how odd the result is. A transaction that really was between related parties becomes not so when they become unrelated.

This article is meant to (re)sensitize readers (perhaps also Treasury, although it does not readily take advice) to how odd it is; to question whether it should be; and suggest some surprising uses of the technique. Consider this example.

Example 1: P owns S1 and S2; S1 owns S3; and they file consolidated returns. S1 exchanges an unincorporated business as well as the stock of S3 with Newco for all its stock and sells Newco to S2 for cash equal to its value. P sells S1 to an unrelated buyer, which liquidates S1 and takes the cash. Section 351 should not apply to the exchange with Newco because S1 did not control Newco immediately after the exchange because of the stock sale of S1 out of P's group.[4] S2 has made a qualified stock purchase (QSP) of Newco stock, and a section 338 (or 336(e)?) election is made for both Newco and S3. Newco claims section 197 amortization for the intangibles acquired in its incorporation and section 168(k) bonus depreciation for the tangible property acquired from S1 because they aren't related after the sale of S1 stock out of the group.

Putting aside the income taxation of the seller side of these exchanges, this example shows how the integrated separation of S1 from S2 may allow a suite of three potentially favorable tax results: (1) busting the section 351 exchange with Newco, (2) S2 can affect a QSP of Newco and S3, and (3) Newco can claim both section 197 and 168(k) amortization and bonus depreciation.

In Example 1, by separating the seller from the stock buyer the consolidated group in effect created basis benefits for itself. That happened in part in LTR 202120005 (involved section 197 but not section 168(k)). But readers may be more familiar with the reverse situation in which the buyer corporation is disaffiliated, so that the basis increase can be enjoyed outside the group. That is the more typical method of busting a section 351 exchange and providing bonus depreciation to the buyer of a corporation out of a group following an intragroup sale of assets qualifying for bonus depreciation.

Because those results depend on parties being unrelated, let's start with the policy poles of related person definitions. Evidently, these have never been well differentiated, and it is unclear whether Treasury thought about the range of possibilities in making up some rules for relatedness. And it is likely Treasury signed off on LTR 202120005, even though it literally did not have to.

B. Policy Poles

1. Testing relatedness.

Assume that Congress or Treasury wants to write a rule that provides a defined result for related-party transactions. It has at least four options for timing the measurement of relatedness of two participants in the transaction:

1. at the time of the transaction, but without regard to its effects on relatedness;
2. immediately after the transaction, which necessarily takes the transaction's effects into account (indeed, this seems like the logical meaning of "immediately after");
3. after the transaction, but disregarding a transitory status created by the transaction; or
4. after the transaction, but disregarding a preexisting status that transitorily continues, and instead determining the status at the later end point of an integrated series of transactions.

If the transaction itself cannot affect the relationship, relations that exist before the transaction will also exist at the time of the transaction and after it, such as a sale of loss

[4]There is no direct authority for this conclusion, but it follows from the letter ruling discussed. Reg. section 1.1502-34 shouldn't apply.

property between related family members (for purposes of section 267). That is category (1).

In contrast, section 267(a)(1) turns off the loss disallowance rule for a corporation's distribution of loss property in its own complete liquidation because the transaction itself ends the relationship between the parties. Similarly, section 302(b)(3) makes sale treatment for a redemption depend on the redemption causing termination of the shareholder's interest. These two examples use the second category of relatedness.

Arguably, and some may disagree, the definition of a consolidated intercompany transaction is also in the second category above: It means to capture the effect on the relationship that the transaction itself may cause.[5] It isn't concerned with transitoriness but with whether the transaction at issue affects the relationship of the parties (the membership in the group). Reg. section 1.1502-13(b)(1)(i) states:

> An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction.

The principal commentator states: "It is also unclear the extent to which a larger plan or arrangement to change a corporation's status as a member is taken into account under the immediately after requirement."[6] The treatise assumes that the base case is the member ceasing to be a member "in the transaction." It cites numerous private rulings in which the IRS declined to take account of subsequent related steps that removed a member from the group. And it cited somewhat fewer conflicting rulings. It acknowledges a few authorities ignoring transitory member status, but that isn't the same as ignoring member status that continues through the transaction at issue.

The principal goal of that definition should be the practical one of not initiating the potentially complex matching rules for intercompany transactions if the transaction itself renders the parties unrelated. So the second category of relatedness should be the correct interpretation for purposes of that definition. But people may think otherwise thanks to the insidious infiltration of all-purpose step transaction thinking into the testing of relatedness, for no good policy reason.

2. Immediately after plus.

The fun comes in transactions that themselves (1) can affect the relationship, but (2) can have an immediately after status that is transitory because a later integrated step will undo it. Practitioners may immediately think of these classic examples:

- *Gregory*;[7]
- *Minnesota Tea*[8] and *American Bantam Car*;[9] and
- *Zenz*.[10]

These three archetypal treatments of integrated transactions either should or have come to stand for these three general principles:

- 1A. *Gregory*: Properly stands for an interpretation of a business purpose into the definition of a reorganization, which by itself allowed the Court to deny the benefit of nonrecognition, without having to rely on resequencing the steps to produce recognition.[11]
- 1B. *Minnesota Tea*: Similar to *Gregory* in that it protected access to a nonrecognition reorganization, but it resequenced the distribution of the reorganization boot to shareholders who paid the creditors into a payment of the creditors by the corporation, which caused it to be taxed on the boot. The decision ignored the transitorily created status of the shareholders as recipients of the boot.
- 2. *American Bantam Car*: Although corporations rarely seek to make affirmative use of *Minnesota Tea*, busting section 351s has come to be useful to taxpayers; the IRS

[5] A section 332 liquidation of a subsidiary is an intercompany transaction, which is consistent with the interpretation here, because the parent shareholder is its successor, and "member" includes section 381 successors for this purpose. Reg. section 1.1502-13(j)(2).

[6] 1 *Taxation of Corps Filing Consolidated Returns*, para. 31.04, at n.187 (2011).

[7] *Gregory v. Helvering*, 293 U.S. 465 (1935).

[8] *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938).

[9] *American Bantam Car Co. v. Commissioner*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

[10] *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954).

[11] *See* Cummings, *The Supreme Court's Federal Tax Jurisprudence* 92 (2016).

has agreed that taxpayers can use the loose interpretation of "immediately after," which originated in opinions like *American Bantam Car*, to deny nonrecognition to taxpayers that wanted it. This, too, generally is an example of ignoring a transitorily created status of control.[12]

- 3. *Zenz*: This case applied the fourth category of relatedness: Fern Zenz may have appeared to continue to be related to the corporation that redeemed her stock, but at the end of the steps was not related.

3. Policy choices.

This article focuses on the policy choice to use the fourth category of step translation relatedness. That category doesn't just take account of the effect of the transaction on the relationship, and it doesn't ignore a transitorily created status. Rather, it ignores a transitory continuation of a preexisting status while waiting for the other shoe to drop and the relationship to be ended by some later event.

Use of the fourth category has become all too "natural." No one — not taxpayers or the IRS or Treasury or courts — should assume that the *Zenz* approach is standard. Rather, the standard approach to measuring relatedness should be the second category above: Wait just long enough to see whether the single transaction at issue affects the relationship. That approach can be interpreted from the words and context of "immediately after."

Of course, going further to ignore a transitorily created status — the third category — is always an argument the IRS can make, based on some sort of statutory purpose to limit some tax benefit and the general suspicion of transitory status. But taxpayers know they can't count on doing so without a ruling.

The more difficult issue is when the IRS and Treasury should create a positive rule embracing the *Zenz* approach (category (4) relatedness) for the purpose of benefitting taxpayers without getting a ruling. There are two primary instances of regulations using category (4). The first one, the 1999 section 338 regulation, was adopted without any useful explanation.

The more recent one for bonus depreciation was justified with very aggressive arguments, basically referring to congressional intent to goose the economy. Second, Treasury said the taxpayer could have gotten the result it wanted by rearranging the steps, so why force it to do so? But, as usual, no one noticed that the Supreme Court has rejected that theory as a ground for ruling for a taxpayer that didn't follow the rules.[13] Therefore, it also seems to be a shaky ground.[14]

Justifications of the fourth category also may mention transitoriness, but Treasury fails to distinguish between a transitorily created status (category (3)) and a transitory continuance of status. Finally, economic realities may be cited as justification for the fourth category of relatedness, but there are usually several ways to look at the economics. For example, Zenz didn't own any stock after it was all over, but the trial court (which was reversed) had cited a different economic reality to find a dividend: that Zenz got the precise amount of the corporation's earnings and profits. So economic realities can be ambiguous.

4. *Zenz*: Not a universal model.

The iconic *Zenz* case is the prototype for the fourth category of relatedness but shouldn't be viewed as creating a universal principle. Zenz wanted to sell all the stock of her corporation, but the buyer didn't want it to come with earnings and profits. So they agreed that she would sell part of the stock to the buyer and then the corporation would redeem the rest for an amount equal to the retained earnings. Today we would say the redemption clearly should be treated as a sale because section 302(b)(3) says so. But that subsection didn't then exist. Instead, the statute allowed a redemption to be taxed as a sale only if not essentially equivalent to a dividend. The regulation supplied the interpretation that a

[12] Of course, sometimes preexisting controlling shareholders contribute more property to their corporation and the transaction will be subject to the "immediately after" gloss of *American Bantam Car*, but that is not the context in which the relatedness test was created; rather, it was created in the transitorily created status context.

[13] Cummings, *The Supreme Court's Federal Tax Jurisprudence*, Ch. VI.E.1.d (2016).

[14] For example, it took a highly engineered ruling to reach that result in the famous Rev. Rul. 2003-51, 2003-1 C.B. 938. *See* Cummings, "Rev. Rul. 2003-51: A New Gloss on the Step Transaction Doctrine?" *Tax Notes*, Dec. 22, 2003, p. 1473.

redemption ending the shareholder's ownership should not be essentially equivalent to a dividend.[15]

The district court focused on the purpose of Zenz and her stock buyer that she extract the corporate earnings through the redemption; it thought that that proved the redemption was essentially equivalent to a dividend. It bolstered that theory by imputing more bad motives to Zenz: She really intended to take a dividend first and sell her stock second but reversed the steps, making the redemption look like a termination of ownership. The circuit reversed, stating:

> The District Court's findings were premised upon the view that taxpayer employed a circuitous approach in an attempt to avoid the tax consequences which would have attended the outright distribution of the surplus to the taxpayer by the declaration of a taxable dividend. The rationale of the District Court is dedicated to piercing the external manifestations of the taxpayer's transactions in order to establish a subterfuge or sham.

So the circuit rejected the subjective approach to what a dividend looks like and found that a redemption that terminated stock ownership in form wasn't a dividend. If that were the end of the *Zenz* story you would wonder why we remember it. But 21 years later, in a 1975 revenue ruling, the IRS claimed that the circuit had held that the ordering of the steps didn't matter, and that "effect be given to the overall result."[16] It reasoned: "Making the immediately before and the immediately after computations in this manner properly reflects the extent to which the shareholder involved in each situation actually reduces his stock holdings as a result of the whole transaction."

But of course, the circuit opinion didn't say the ordering didn't matter; it said the form controlled because after the redemption Zenz owned no stock and it did not matter that subjectively she was trying to bleed out the corporate earnings. Rather, the IRS wanted the order of steps not to matter because it had an administrative problem with taxpayers that ordered the steps the other way, which would be most typical: Redeem first, sell the rest of the stock second. There was no reasoned basis for Rev. Rul. 75-447, 1975-2 C.B. 113, which effectively adopted the category (4) relatedness test, without knowing there were several categories to choose from.

The takeaway from a full understanding of how we got to the *Zenz* principle is that the IRS made it up and fibbed about following the circuit ruling. Like many other taxpayer-favorable rules, the IRS figured: "Who will complain? If they want a dividend, they can take a dividend; if they want a redemption sale, they can take a redemption and then sell the rest of their shares." That may be a good solution to a specific transactional problem, but it isn't a template for a universal adoption of the fourth category of relatedness.

II. Recent Letter Ruling

A. Facts

In LTR 202120005 Parent owns S1, which owns S2 and S3. S2 owns T1 and S3 owns T2. Parent wants to have S1 sell S2 and S3, but without T1 and T2, which may be called "unwanted assets." S2 will distribute T1 to S1, and S1 and S2 will "jointly file an election under section 336(e) with respect to the distribution." S3 will distribute T2 to S1, and S1 and S3 will "jointly file an election under section 336(e) with respect to the distribution." Then S1 will sell S2 and S3 to an unrelated buyer for cash. T1 and T2 own trademarks and trade names. All corporations are members of a consolidated group.

The IRS ruled that each section 301 distribution of the stock of T1 and T2 was a qualified stock disposition (QSD) for which a section 336(e) election could be made. It presumably relied on the fact that S2 and S3 became unrelated to S1 when S1 sold S2 and S3,

[15] 26 C.F.R. 29.115-9, at 424. ("On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend.")

[16] Rev. Rul. 75-447, 1975-2 C.B. 113. *See also* Rev. Rul. 84-114, 1984-2 C.B. 90.

because a QSD cannot occur between related parties.

The taxpayer represented that section 336(e) could apply, aside from the relationship between S1 and S2 and S3; therefore, the IRS ruled on that relationship and its termination. The taxpayer could have properly made that representation only if it believed that the distributions were not section 338 qualified stock purchases; how the taxpayer formed that belief is unclear, as discussed below.

B. Franchises

The taxpayer also represented that S2 and S3 wouldn't retain any interest as described in section 1253(b)(2) in the assets of T1 and T2, and that T1 and T2 wouldn't have any property qualifying for bonus depreciation. The IRS also ruled that section 1253(a) wouldn't apply to the deemed sales of the assets of T1 and T2. These facts tip us off that the object of the ruling request was to assure section 197 amortization for franchises owned by new T1 and new T2.

Section 1253(a) provides that "a transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name." Capital gain treatment was irrelevant unless the group had expiring capital losses; perhaps the taxpayer feared that section 1253 mandated treating the deemed sale of the franchises as licenses rather than sales (which seems unlikely).

Therefore, old target sold the franchises and new target bought them. Thus, they should be eligible for section 197 amortization, even though the ruling also said that goodwill and going concern value transferred in the deemed sale would be subject to the anti-churning rule of section 197(h) and not eligible for amortization.

You may have to look twice to convince yourself that an intangible purchased from a related seller can be eligible for section 197 amortization, except for the odd anti-churning rule applicable only to some business intangibles dating back to 1991. Of course, the old target and new target in section 336(e) land are deemed unrelated, but still the result here is a surprising creation of a new 15-year write-off of assets that never left the consolidated group.[17]

So the goal of the ruling must have been to ensure that valuable franchises owned by old T1 and old T2 were amortizable by the new T1 and new T2 based on their fair market values, with the deemed sale being taxed – to whom? (Recall that the stock sellers left the group.)

C. Tax Planning

The ruling doesn't say anything about the taxation of the old target's deemed asset sale gain. A section 336(e) deemed sale gain should be taxed to the old targets in the taxpayer's consolidated group. Also, any deemed sale losses can offset gains on the deemed asset dispositions, unlike the rule disallowing losses on section 311 distributions, which the stock distributions were, but the deemed sales were not.

So this taxpayer, foreseeing the election of Joe Biden, may have planned to accelerate gain recognition into 2020 or 2021 and refresh (or create) an amortizable basis for valuable franchises. Alternately, maybe the taxpayer group had losses in 2020 that could absorb the deemed asset sale gain, and it used those losses to create amortizable franchise basis.

But how come section 336(e) applied? Did you think either section 336(e) or 338 applied inside consolidated groups? And assuming they do, why not section 338 instead of section 336(e)? Surely the IRS Office of Chief Counsel would not have let the taxpayer make a representation that section 336(e) otherwise applied if chief counsel knew that could not be so. And why should disaffiliation of the stock sellers allow the stock seller and "buyer" to have a QSD?

First, a detour into the QSD/QSP issue.

III. Qualified Stock Disposition

A. Not a QSP

1. The origin stories.

To figure out why the section 301 distributions of T1 and T2 were not section 338 QSPs by S1 we

[17] Reg. section 1.197-2(e)(3) ("acquired by the taxpayer and persons related to the taxpayer from another person and persons related to that other person").

should refresh what we know about both regimes.[18] We know that a QSD is different from a QSP; QSDs only became available when Treasury wrote regulations defining them and allowing the section 336(e) election.[19] Both types of elections can apply to sale (or disposition) by a corporation of a controlling interest in another corporation,[20] but QSPs are stock purchases by corporate purchasers, while QSDs generally are dispositions to other types of purchasers. At least that's what we used to think before this letter ruling, in which the stock transferee was a corporation; it was a section 301 distributee of the T1 and T2 stock within the same consolidated group.

The QSP can support either a section 338(g) or (h)(10) election. In the former, the old target corporation is deemed to sell its assets and the new target is deemed to buy the assets and the stock seller still recognizes the stock sale gain (or loss). That is why section 338(g) elections take place on the buyer's watch and do not affect seller treatment (except for ancillary effects for foreign targets).[21] Foreign corporations can use section 338(g) elections. Only domestic sellers can use a section 338(h)(10) election, as a result of which the target is deemed to sell its assets and liquidate, in what is usually (but not always) a section 332 liquidation.[22]

One way to keep the two types of section 338 elections straight is to recall that they have entirely different origin stories. The section 338(g) election is the sole remnant of the *Kimbell-Diamond* transaction,[23] and isn't usually desirable domestically because someone may pay tax on both inside and outside gain as the price for a single inside asset basis step-up. In contrast, section 338(h)(10) originated in the practical fact that the seller could get the same result by liquidating the target under section 332 and selling its assets (or vice versa); the election just eliminates the hassle of liquidation and asset movement (which is not such a problem after check-the-box liquidations and conversions to limited liability company status). Observe that it took an act of Congress to employ the could-have-done-it-another-way explanation that Treasury uses to justify using the fourth category of relatedness.

2. A new type of QSD.

Most readers are familiar with section 336(e) elections principally as the workaround for section 355 distributions that become taxable to the distributing corporation, either because section 355 turned out not to apply[24] or because section 355(d) or (e) made only the distribution taxable to the distributor.[25] Treasury figured that if the distributing corporation were going to have to recognize gain and the distributed corporation were to be owned by unrelated persons (usually public shareholders) somebody ought to get the advantage of an inside basis asset step-up. The distributees in the taxable spin usually are unrelated and a QSD can occur.

So you would think that the definition of a QSD defines the distributees as other than a single corporation acquiring control; but that isn't what it says:

> A transaction satisfying the definition of a qualified stock disposition under paragraph (b)(6)(i) of this section, which also qualifies as a qualified stock purchase (as defined in section 338(d)(3)), will not be treated as a qualified stock disposition.[26]

So the distinguishing feature of a QSD is that it is not a QSP.

The regulation says that a QSD cannot be a disposition to a related person.[27] For relatedness, the principles of section 338(h)(3)(C) and reg. section 1.338-3(b)(3) shall apply.[28] Persons are

[18] For a handy chart of the differences between the types of elections, see Cummings, "Foreign M&A: The Taxable Deals," *Tax Notes Federal*, Apr. 26, 2021, p. 535.

[19] *See* Cummings, "Final Regulations on Qualified Stock Dispositions," *Tax Notes*, Aug. 19, 2013, p. 805.

[20] Although a QSP can be purchased from any type of seller.

[21] *See* Cummings, "Foreign M&A," *supra* note 18.

[22] *See* LTR 201011003 (loss on deemed liquidation in section 338(h)(10) QSP).

[23] *See* Cummings, "Another *Kimbell-Diamond* Article!" *Tax Notes*, May 12, 2014, p. 707.

[24] Reg. section 1.336-2(k), Example 3.

[25] Reg. section 1.336-2(b)(2).

[26] Reg. section 1.336-1(b)(6)(ii)(A).

[27] Reg. section 1.336-1(b)(5)(i)(C).

[28] Reg. section 1.336-1(b)(5)(iii).

related if stock in a corporation owned by one of the persons would be attributed under section 318(a) (other than section 318(a)(4)) to the other. Most importantly, the regulation says to test relatedness after the last of a series of integrated dispositions.[29] Note that regulation carefully because it is the fairly modern origin of applying the fourth category of relatedness by regulation.

The last step that breaks relationship can include a transaction with a third party such as purchasers of the stock of a newco that acquired the stock of the target from a parent corporation in a busted section 351 exchange, as illustrated by Example 1 in the regulation.[30] Indeed, the desirability of that result for aspiring sellers of basis step-ups seems to have been the reason for that rule. Even though the parent and newco clearly were related when newco acquired the target stock, that acquisition didn't become a QSP until the disaffiliation event, which made the stock buyer and seller unrelated and qualified the prior stock acquisition, which retroactively was made taxable, as a QSP.

B. Application to Recent Ruling

1. Relatedness.

In the ruling, the sale of S2 and S3 out of the consolidated group made the distributors and distributee unrelated, according to the IRS. It must have relied on the regulation defining the time for testing relatedness: "In the case of a series of transactions effected pursuant to an integrated plan to dispose of target stock, immediately after the last transaction in such series."[31] You would think that refers to cases like the busted 351 transaction illustrated in the regulation's example: The stock seller stays in place, and the stock sold passes to an unrelated person. But the magic of the ruling was to expand the quoted sentence to mean:

> In the case of a series of transactions effected pursuant to an integrated plan of the stock seller to dispose of target stock to an unrelated buyer, immediately after the last transaction in such series *that disaffiliates the seller and buyer*. [Emphasis added.]

That is a fairly bold stroke. Not only does it embrace the fourth category of relatedness, albeit with support in the regulation, but it also turns on its head the concept of disposing to an unrelated buyer by expanding it to effectively having the buyer dispose of the seller.

2. Why not a QSP?

If the transaction had been a QSP, the first issue would have been whether the group could have made a section 338(h)(10) election? Not likely. There is no published guidance or letter rulings supporting that election in such a case. LTR 201220020 allowed a section 338(h)(10) election for a sale of a target subsidiary by the common parent of a consolidated group upstream to an indirect foreign parent. The sale was followed by the foreign parent distributing to its public shareholders a lower-tier foreign sub that owned the U.S. common parent, thus disaffiliating the seller from the buyer. That ruling differed from the new ruling in that the buyer paid some consideration for the target and the sale was not within the consolidated group by distribution.

It is unlikely that section 338(h)(10) should apply to a sale between consolidated group members, even if the relationship is eliminated after the sale of the selling corporation. That election applies in these cases:

> A section 338(h)(10) election may be made for T if P acquires stock meeting the requirements of section 1504(a)(2) from a selling consolidated group ["A selling consolidated group is the consolidated group of which the consolidated target is a member on the acquisition date."], a selling affiliate ["A selling affiliate is a

[29] Reg. section 1.338-3(b)(3)(ii).

[30] Reg. section 1.338-3(b)(3)(iv), Example 1, illustrates a busted section 351 transfer of a corporation to a Newco that is disaffiliated through an initial public offering.

[31] Reg. section 1.338-3(b)(3)(ii).

> domestic corporation that owns on the acquisition date an amount of stock in a domestic target, which amount of stock is described in section 1504(a)(2), and does not join in filing a consolidated return with the target."], or . . . in a qualified stock purchase.[32]

Although the regulation doesn't say "from a different selling consolidated group," it certainly implies that meaning.

So if the distribution were a QSP, the group in the letter ruling would face the consequences of a section 338(g) election, if it were going to make one of these elections at all. S2 and S3 would have recognized section 311 gain on the stock of T1 and T2, and each of T1 and T2, as unaffiliated corporations, would report recognized deemed asset sale gain on a separate return.[33] The taxpayer wouldn't have liked that result. In contrast, under the section 336(e) election allowed by the ruling, the section 311 stock distribution gain will be ignored and the T1 and T2 deemed sale gain will be in the group.[34] That is a relatively better result.

Of course, T1 and T2, both LLCs, could have checked the box and become disregarded, and then S2 and S3 could have distributed their units to S1. Presumably, there was some reason that was undesirable; perhaps it was the difference between the treatment of the asset distribution as an intercompany transaction under reg. section 1.1502-13 versus the deemed asset sale that was not an intercompany transaction.[35]

C. Are Distribution Purchases Different?

So why not a QSP? The preamble to the 2019 reproposal of reg. section 1.168-2(k) equates the QSP and QSD in a group, but only when the target leaves the group and can be bought by unrelated noncorporate owners for which a QSP would not occur:

> Thus, section 1.168(k)-2(b)(3)(v)(D) of these proposed regulations provides a rule (Proposed Consolidated Deemed Acquisition Rule) that applies if (1) the transferee member acquires the stock of another member of the same group that holds depreciable property (target) in a qualified stock purchase or a qualified stock disposition for which a section 338 election or a section 336(e) election for a disposition described in section 1.336-2(b)(1), respectively, is made, and (2) the transferee member and target cease to be members of the consolidated group within 90 calendar days of the acquisition date (within the meaning of section 1.338-2(c)(1)) or disposition date (within the meaning of section 1.336-1(b)(8)) as part of the same series of related transactions that includes the acquisition. The Proposed Consolidated Deemed Acquisition Rule does not apply to qualified stock dispositions described in section 355(d)(2) or (e)(2) because the rules applicable to such dispositions do not treat a new target corporation as acquiring assets from an unrelated person. See section 1.336-2(b)(2).[36]

That statement clearly contemplates a way that a corporation can acquire a corporation from a corporation in a QSD. Perhaps it is thinking about a section 301 distribution of the target?

In the letter ruling, the purchaser — the parent corporation — stayed in the group. Does someone think a section 301 distribution cannot be a QSP because there is no "purchase"?

A section 301 distribution is a purchase. The regulation defines a QSP in a way that would include a section 301 distribution:

> The term purchase has the same meaning as in section 338(h)(3). Stock in a target (or target affiliate) may be considered purchased if, under general principles of tax law, the purchasing corporation is considered to own stock of the target (or target affiliate) meeting the requirements of section 1504(a)(2), notwithstanding that

[32] Reg. section 1.338(h)(10)-1(c)(1).

[33] Reg. section 1.338-10(a)(2)(i).

[34] Reg. section 1.336-2(k), Example 6.

[35] But loss disallowance shouldn't have been an issue because section 311(a) doesn't apply in consolidation.

[36] 84 F.R. 50152, 50154-50157 (Sept. 24, 2019). T.D. 9916 repeated the statement. Reg. section 1.1502-68(c)(2)(i) applies this idea.

no amount may be paid for (or allocated to) the stock.[37]

The Treasury decision adopting the regulation is consistent with it not requiring payment to affect a purchase.[38] A 1985 IRS Q&A for section 338 said that redemption of a less-than-50-percent shareholder was a QSP if the corporation recognized section 311 gain or realized but did not recognize loss, but not if the corporation did not recognize gain.[39]

IV. Category 4 Relatedness

A. First Expansion: Busted 351s

Effective March 16, 2001, Example 1 of reg. section 1.338-3 showed that a planned decontrol *of the transferee corporation* for section 351 purposes also could be a planned decontrol *of the transferee corporation* for section 338 relatedness purposes. The only fuzzy area under the regulation, assuming you had a sufficiently integrated decontrolling event, was how long you might wait to affect the decontrol. Taxpayers wanted to wait a long time if they were bleeding the stock into the market. It took one of the best tax-advised corporations in America, The General Electric Company, to talk chief counsel into a leisurely stock disposition schedule.

The GE busted section 351 event occurred in 2004.[40] But GE needed (1) to reduce its stockholding not only below 80 percent but to 50 percent, so (2) it would not be related to Genworth for section 338 purposes, so that (3) it could make a section 338(h)(10) election that allowed GE (4) to saddle Genworth with a euphemistically titled "tax receivables agreement," which (5) bled back to GE 85 percent of the Genworth tax savings from asset basis step-up, which was (6) allowed by the QSP, which was (7) allowed by the busted 351. The explanation for GE's right to claim the value of those tax benefits was "the market does not value asset basis step up." Good to know (and good that the SEC does not demand that the market be told).[41]

2004 was the date of the partial initial public offering for Genworth. GE kept a chunk of the stock and finally divested it in 2006.[42] The delayed disposition was allowed by a letter ruling — the first known busted 351/338(h)(10) letter ruling.[43]

But notice: The result of the slow-moving decontrol of the Newco was to establish that it never had been controlled by GE, either at the 80 percent section 351 level or at the 50 percent QSP level. GE acquired transitory control of Newco in the busted 351, and so the application of section 351 was turned off; likewise, application of section 338 was turned on through a category 3 relatedness test: ignoring transitorily created control.

Nevertheless, the regulation's definition is broad enough to cover a transitory continuation of a preexisting relationship, and even moving the seller out of the consolidated group,[44] the case of the recent letter ruling. It is not at all clear that Treasury knew what it was doing when it wrote that definition or that it intended to apply both the third and fourth categories of relatedness. But now the new letter ruling says it did and that the seller can leave the relationship, in contrast with the section 338 regulation example of the buyer leaving the relationship.

In the section 338 context, you would have thought that relationship might be tested "immediately after," because relationships can be lost in a QSP that is a stock redemption. Nothing in the statute indicates otherwise.[45]

Where did that section 338 regulation and that concept of timing relatedness at the end of integrated steps come from? The "after" timing

[37] Reg. section 1.338-3(b)(2).

[38] T.D. 8940.

[39] 50 F.R. 16407 (Apr. 25, 1985).

[40] Randall Stross, "Digital Domain; Google, Shmoogle. The Biggest I.P.O.'s Went Unnoticed," *The New York Times*, Aug. 29, 2004.

[41] *See* Cummings, "Tax Sharing Agreements and Related Contracts," *Tax Notes*, Sept. 22, 2014, p. 1411; Cummings, "Tax Whipsaws and the SEC," *Tax Notes*, Mar. 11, 2019, p. 1183.

[42] Elisa Martinuzzi and Carol Wolf, "GE Sells Remaining $2.8 Billion Genworth Stake (Update4)," *Bloomberg*, Feb. 27, 2006.

[43] LTR 200427011 (Involves General Electric's disposition of its Genworth insurance subsidiary. It gave GE three months to bust the section 351 exchange by disposing of enough stock not to have control "immediately after." Presumably, the sales two years later were of additional shares not required to bust the 351.).

[44] Reg. section 1.338-3(b)(3)(ii).

[45] "The stock is not acquired from a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) thereof), be attributed to the person acquiring such stock." Section 338(h)(3)(A)(iii).

rule wasn't even proposed until 1999, 15 years after section 338 was adopted.[46] The Treasury explanation of the proposal stated:

> The statute is unclear, however, as to when the relationship between the parties is tested. This rule gives effect to the statutory objective of preventing a transferor from obtaining the benefits of a section 338 election while retaining a significant interest, directly or indirectly, in the property transferred. This rule also furthers the statutory objective of affording similar tax treatment to section 338 deemed asset sales and actual asset sales. For example, under this rule, if an actual sale of assets would qualify as a reorganization under section 368(a)(1)(D) (with a carryover of basis and other attributes), taxpayers are not able to reach a different result by structuring the transaction as a stock sale and electing under section 338.

The explanation is inadequate on several grounds. First, it supposes that the section 338 election will be beneficial to the transferor, which applies only to section 338(h)(10) elections. Second, the statute is not unclear, if you understand that it was written in view of a section 338/311 stock redemption for stock of a controlled subsidiary. Third, Example 1 clearly shows that Treasury had in mind facilitating the busted 351, with an accompanying section 338(h)(10) election, which was a well-known application of ignoring a transitorily created status. But it does not explain why the integration should apply to the reverse facts as in the letter ruling. Fourth, the analogy to D reorganizations is an odd "could have done it otherwise" case to contrast.

It is most likely that Treasury decided to analogize the situation to *American Bantam Car* transitory relatedness for section 351 purposes, because in the cases it had in mind, busting 351 and attaining a QSP went together. But that does not explain category four relatedness. Treasury actually was applying the *Zenz* principle, which we have shown to have no good basis to begin with (other than administrability).

B. Second: Bonus Depreciation

Bonus depreciation cannot be claimed for used property purchased from a related person.[47] The relatedness tests incorporate sections 267, 707(b), and 1563. Except for section 267(f), there is no authority within those three sections indicating that the relationship test applies after the event being tested. However, other sections that incorporate those relationship tests frequently supply their own "immediately after" standard.[48]

Section 267(f) applies to an intercompany sale, being a sale, exchange, or other transfer of property between members of a controlled group, if it would be an intercompany transaction under the principles of reg. section 1.1502-13, determined by treating the references to a consolidated group as references to a controlled group and by disregarding whether any of the members join in filing consolidated returns. Reg. section 1.1502-13(b)(1)(i) provides that, in general, an intercompany transaction is a transaction between corporations that are members of the same consolidated group "immediately after the transaction."[49]

The primary effect of that regulation and its matching rules is to postpone the effect of some intercompany property transfers until the acquirer obtains some tax benefit from the transaction (corresponding item) or the seller or buyer or property leaves the group so that matching can no longer occur (acceleration event). If the member leaves the group in the potential intercompany transaction, there is no reason for it to be treated as an intercompany transaction. An example would be a redemption of 80 percent of a member's stock held in the group, which caused

[46] 64 F.R. 43467 (Aug. 10, 1999). Commentators did not notice the change. American Bar Association Section of Taxation, "Comments on Proposed Regulations Under Sections 338 and 1060" (Nov. 2, 1999). The New York State Bar Association Tax Section did not comment.

[47] Section 168(k)(2)(E)(ii)(II) incorporating section 179(d).

[48] For example, reg. section 1.263(a)-5(a)(2) describes a capitalization rule when expenses of an acquisition related to a business controlled after the acquisition. In that case the "after" standard makes perfectly good sense; in fact, the rule could scarcely operate otherwise.

[49] *See* Jeffrey L. Rubinger, "IRS Misses the Mark on Disallowing Loss in a Busted Section 351 Transaction," 105 *J. Tax'n* 49 (July 2006).

disaffiliation when the member becomes wholly owned by its former minority shareholder.[50]

In 2018 Treasury proposed reg. section 1.168(k)-2.[51] The explanation section discussing consolidated groups first described concerns about preventing avoidance of the related-party limitation when a group member disposed of property outside the group and another group member acquired the same property into the group. For another example, Treasury was concerned with a group acquiring property from a corporation and then acquiring the selling corporation into the group.

But the final paragraph of that discussion introduced an entirely different subject. The explanation stated, without citing any support, that when property acquisition within the group is part of a series in which the final step takes the *transferee* out of the group, relatedness will be tested after that final step. Oddly, the very next section discusses series of related transactions, and does so solely in the context of related transactions first appearing to involve an unrelated-party transaction, but a later integrated step was with a related person.

The proposed rules contained one relatedness test for consolidated groups and a general relatedness rule. Regarding consolidated groups, it focused on only one scenario: A member acquires property, and the *transferee* leaves the group; it did not address the property leaving the group or the seller leaving the group. For the transferee member leaving the group, relatedness was to be tested after the last step in the series of steps. Nothing more was required than the transaction steps be related in some undefined way.[52]

Thus, the infamous Example 21 showed a sale of depreciable property within the group, and a sale of the buyer out of the group. The steps were "integrated," but the facts did not state that the stock buyer demanded the asset sale as a precondition. The property was eligible for bonus depreciation in the buying member. The proposed regulation stated a general relatedness rule that tested relatedness at the two bookends of a series of related transactions, but only when a property transferee ceased to be a group member; obviously it was applicable only to consolidated groups.[53] The regulation didn't contain any such generally applicable relatedness test.

The affiliated and related corporation bar went nuts and made multiple comments and complaints. In 2019 Treasury reproposed the regulation.[54] It explained that commentators wondered whether the bonus depreciation would fall in the selling consolidated group, which would be the default result, and one that commentators did not like. Why Treasury didn't think of that when it wrote Example 21 is unknown, except it probably figured it had done enough good work for one day.

The 2019 preamble purported to adopt from the commentators the theory that the bonus depreciation should fall outside the group, on the transferee stock buyer's side of the deal, because that furthered Congress's stated purpose of stimulating economic activity. In other words, buyers of corporations out of consolidated groups will be happier if the stock seller can gin up for them an inside asset basis step-up (momentarily) in tangible domestic assets through the mechanism of an intercompany sale. The preamble also tried out an analogy to another rule that disregarded a transitory holding of property, but that isn't really similar because the asset buyer holds the property permanently in Example 21. The explanation clincher was that the stock buyer could have bought the member and then caused the member to buy the asset out of its former group (although that is an unwieldy transaction for sure).

Finally, the rule wound up unexpectedly in new reg. section 1.1502-68(c)(1), which is hard to find.[55] It eliminated a 90-day required linkage of the asset sale and the deconsolidation of the transferee member and requires only that they occur in a series of related transactions. It doesn't

---

[50] *See* reg. section 1.1502-13(l)(3) (stock elimination transactions as tested immediately after the transaction). *See generally* Cummings, "Intercompany Transactions Revisited," *Tax Notes Federal*, Sept. 27, 2021, p. 2157.

[51] 83 F.R. 39292, 39295-39298 (Aug. 8, 2018).

[52] Prop. reg. section 1.168(k)-2(b)(3)(iii)(B).

[53] Prop. reg. section 1.168(k)-2(b)(3)(iii)(B)(3)(*iii*).

[54] 84 F.R. 50152, 50154-50157 (Sept. 24, 2019).

[55] T.D. 9916.

define such a series. Proposed Example 21 now appears in reg. section 1.1502-68 in modified form, and it defines the requirements for a QSP or QSD in the group to be "the transferee member and the target cease to be members of the transferor member's consolidated group and cease to be related." That is consistent with the section 338 usage of category 4 relatedness. But both examples 5 and 6 of that regulation involve the buyer leaving the group.

It appears that a selling group can set up this benefit for the stock buyer without the stock buyer even being in the picture at the time the asset sale occurs. It isn't clear exactly what version of step transaction analysis that approach uses. It approximates the deferred section 1031 exchange regime.

V. Synthesis (or Guess)

The code has at least 65 "immediately after" relationship-type tests. The most normal, although not much discussed, reason to measure something immediately after a transaction is to take account of the effect of the transaction itself on the relationship being measured. Indeed, that probably was the intended meaning of section 351 when enacted.

For reasons lost in the mists of time, the IRS went further and succeeded in making courts ignore transitory control obtained in a stock exchange for purposes of taxing shareholders. Perhaps that wasn't so unexpected given the principle that nonrecognition rules like section 351 are strictly construed,[56] and the IRS is always suspicious of transitoriness.

But it is a very different thing to integrate an event that has nothing to do with the qualification of the original events under some section, for the purpose of satisfying an unrelated transferor rule. Treasury has done that in the section 338 regulation and the bonus depreciation regulation (for consolidated groups only), without explanation in the first case (and after waiting 15 years), and with a different Congress-made-us-do-it explanation in the second case.

Those two regulations aren't even close enough for government work, but they may be some of those happy rules about which no one will complain. And yet they only address the buyer becoming unrelated. By virtue of a letter ruling, we now know they also can apply when the seller becomes unrelated, this time putting the basis pop in the seller's prior group. ■

[56] Reg. section 1.1002-1: "The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule." This regulation seems to have partly disappeared, not being in RIA Checkpoint either now or as a prior regulation, probably because there is no section 1002.