

Comments on Regulations Enabling Elections for Certain Transactions Under Section 336(e)

AMERICAN BAR ASSOCIATION SECTION OF TAXATION*

Abstract

These Comments, submitted on behalf of the American Bar Association Section of Taxation, discuss regulations that implement an election under section 336(e) to treat a target as if it sold its assets in a taxable sale when the target stock is sold or distributed. The regulations represent a significant step in the evolution of the corporate income tax law, allowing some transactions to be structured more simply and without unwarranted tax. The simplification arises because, unlike for a section 338 election, the target stock does not have to be acquired in large part by a corporate purchaser.

If a section 336(e) election is made, the target is deemed to sell its assets in a taxable sale and generally to liquidate. The election may be made for many sales or distributions of an affiliated interest in target stock, including importantly when the target is an S corporation that intends to retain that status.

Our Comments begin with an overview of our recommendations. We next survey the tax consequences of section 336(e) elections. We finally describe in some detail how the regulations may be simplified, clarified, and otherwise improved. Note that our Comments do not revisit the major policy calls made in the regulations.

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I. Summary of Recommendations

The Comments address the regulations that enable the election under section 336(e)¹ for certain sales and distributions of stock. Proposed regulations on this subject were issued on August 25, 2008 (the “Proposed Regulations”).² Final regulations were adopted on May 15, 2013 (the “Final Regulations”).³ The 2014–2015 Priority Guidance Plan lists as a priority project, “[r]egulations under [section] 336(e) to revise the treatment of certain stock dispositions as asset sales.”⁴

We commend Treasury and the Service for the detailed consideration of issues in the regulations, especially their responsiveness to comments on the

¹References to a “section” are to a section of the Internal Revenue Code of 1986 (the Code), as amended, unless otherwise indicated.

²Regulations Enabling Elections for Certain Transactions Under Section 336(e), 73 Fed. Reg. 49,965 (2008).

³T.D. 9619, 2013-24 I.R.B. 1212.

⁴Department of the Treasury, *2014-2015 Priority Guidance Plan, Third Quarter Update*, Apr. 28, 2015, http://www.irs.gov/pub/irs-utl/2014-2015_pgp_3rd_quarter_update.pdf.

Proposed Regulations. We believe that, as the tax practitioner and business communities become familiar with the regulations, the election will become increasingly useful and will simplify many business transactions.

The purpose of the Comments is not to revisit basic policy judgments reflected in the regulations, such as the use of the section 338(h)(10) regulations (including the consistency rules) as the model for the section 336(e) election regime and the disallowance of certain losses on stock distributions. Nor is our purpose to address possible future regulations to make the election available in transactions involving foreign corporations.

Rather, the purpose of the Comments is to identify aspects of the regulations that limit the usefulness of the election, have unintended or uncertain consequences or complicate transactions, and to recommend guidance to solve such problems. Our purpose is to make the section 336(e) election regime as user-friendly as possible without introducing abuse or administrative difficulties.

We make the following major recommendations:

1. Under the regulations, if a person transfers target stock to a related person, the transfer is not treated as a disposition included in a qualified stock disposition (QSD).

- a. This related-person rule raises some practical difficulties due primarily to attribution between partners and partnerships. For purposes of determining whether a seller of target stock and a partnership that purchases such stock are related persons, attribution of stock ownership between the partnership and its partners should be limited to partners with a 50%-or-greater partnership interest, or in any event a much larger interest than the 5% interest provided in the regulations.

- b. To avoid a trap for the unwary and to limit potential gain duplication, a taxable intercompany distribution of C corporation target stock by a subsidiary to its parent should qualify as a disposition of the stock, if the distribution is part of a series of related transactions that includes a distribution of the target stock by the parent to shareholders that are not related persons to the distributing subsidiary.

2. The Final Regulations allow QSDs to include sales and distributions of target stock over a period as long as 12 months. Although these “creeping QSDs” offer some advantages, in our view, the complications created by these QSDs more than offset their advantages. Although detailed rules could be adopted to resolve these issues, we believe such refinements would not be worth the effort and added complexity. Thus, we recommend simplified rules.

- a. For S corporation targets, QSDs should be limited to situations in which one or more dispositions of target stock comprising the QSD occur on a single day.

- b. For C corporation targets, QSDs generally should require that at the beginning of the disposition date, the target is a member of the selling affiliated group (whether or not consolidated). We also propose a binding contract exception to this general rule.

3. To more closely align with the section 338 consistency rules:
 - a. The regulations should state explicitly that neither the consistency rule nor its “principles” apply to an S corporation target in a QSD or to a disposition of stock of a C corporation target by an S corporation.
 - b. The stock ownership threshold for asset purchasers subject to the consistency rule should be changed to a 25% threshold or in any event to a much higher threshold than in the current 5% rule.
 - c. To determine whether the consistency rule’s stock ownership threshold is met, attribution of stock ownership between a partnership and its partners should be limited to partners with a 50%-or-greater partnership interest (or in any event a much larger interest than in the current rule).
4. In a taxable distribution of stock subject to a section 336(e) election, losses on deemed sales of assets are disallowed to the extent of the net loss, if any, recognized by the target. Assuming that this rule is retained, it can be revised to be fairer and more administrable.
 - a. In a stock distribution, if section 336(e) elections are made for the target and its subsidiaries, any net loss should be computed by aggregating the gains and losses of the target and its electing subsidiaries.
 - b. The rule should not apply to a QSD that includes one or more distributions of target stock in complete liquidation of the target’s parent corporation.
 - c. The fraction that determines the proportion of loss disallowed should be revised to include all target stock sold during the disposition period, regardless of whether the stock is included in the QSD as recently disposed stock, and regardless of whether the sale takes place before, on, or after the disposition date.
5. If target stock is sold in a QSD, no section 336(e) election is made, and the target liquidates or merges as part of the same plan, it is unclear whether the *Kimbell-Diamond* doctrine (or step-transaction doctrine) applies to create a deemed purchase of the target assets. The regulations should make clear that neither doctrine applies, because their application not only is unnecessary following the repeal of the *General Utilities* doctrine but would also compromise the integrity of the section 336(e) election.
6. If a member of a consolidated group disposes of target stock in a QSD, including a section 355(d) or (e) distribution, the target stock has an excess loss account (ELA), and a section 336(e) election is made, the regulations should make clear that the ELA is not be triggered, because the target will recognize all of its gain or loss.
7. To make the regulations more administrable for S corporations and their shareholders and to answer some important questions, the regulations should provide the following:
 - a. For S corporation targets, the regulations should state clearly the date on which shareholder status is determined, in order to identify the shareholders who must join in a section 336(e) election agreement

and (if the QSD does not arise from dispositions occurring on a single day) the shareholders to whom gain or loss on the deemed asset sale is allocated.

b. If an S corporation distributes the stock of a qualified subchapter S subsidiary (QSub) and either section 311 or section 355(d) or (e) applies, the distribution should be treated as a “sale” of the QSub stock by the S corporation under section 1361(b)(3)(C)(ii). Thus, the S corporation should be deemed to distribute the QSub assets rather than stock.

c. An S corporation’s shareholders must join in a written agreement to make a section 336(e) election for the corporation. The regulations should clarify whether the requirement for a written agreement is satisfied by either:

i. An agreement to which the target is a party, and in which the shareholder agrees to a section 336(e) election for any QSD, either under specified conditions or as the target determines; or

ii. An agreement entered into on behalf of a shareholder by the target or any other person under a power of attorney granted to such person to make a section 336(e) election.

8. The adjusted grossed up basis (AGUB) is the aggregate basis of the target’s assets following a section 336(e) election. Its computation is more complicated than it needs to be and is sometimes uncertain. In relevant part, the regulations should make clear that the AGUB computation is a collective computation, should explicitly set out that computation, and should provide an example in the regulations that involves the computation.

9. Under the section 338 regulations, the definition of nonrecently purchased stock and the gain recognition agreement work in tandem to prevent the elimination of corporate-level gain. In contrast, under the Final Regulations, the definition of nonrecently disposed stock and the gain recognition election often work together to duplicate gain but not to prevent its elimination. In addition, while a section 338 election may allow selective loss recognition, a section 336(e) election should not. To address those points:

a. Nonrecently disposed stock should be limited to stock that is not recently disposed stock and that is owned by a corporate purchaser affiliated with the target after the QSD; and

b. If nonrecently disposed stock is limited as we recommend, the gain recognition election should be required and a holder of nonrecently disposed stock should recognize loss as well as gain.

Note that the Appendix to the Comments lays out these and other recommendations, as well as a suggested priority to implement the regulations.

II. Background

If a parent corporation sells or distributes stock of a corporate subsidiary, or if shareholders sell the stock of an S corporation, the parties may be subject

to multiple levels of tax on a single economic gain. Before the section 336(e) regulations were adopted, tax-planning techniques were available to avoid this multiple tax in some situations. Both practical business considerations and technical tax rules have limited this planning, however, and these limitations were not always consistent with tax policy.

At the time the *General Utilities* doctrine was repealed in 1986, Congress recognized this problem and enacted section 336(e) to authorize regulations that would permit taxpayers to avoid multiple levels of corporate taxation in appropriate cases.⁵ In our view, the regulations substantially accomplish the purpose of section 336(e) in the contexts to which they are addressed.

A. *Sale of Subsidiary Stock*

In the case of a sale of subsidiary stock by a parent corporation, taxable gain on the subsidiary stock is taxed to the seller, but the subsidiary's assets retain any built-in gains. The result is two levels of corporate tax on a single economic gain.⁶

To avoid the multiple taxes on one economic gain, sellers and purchasers often try to structure their transactions as target asset sales. If a "longhand" asset sale is impractical, the parties may achieve the tax treatment of an asset sale with a corporate transaction such as a forward cash merger⁷ or a transaction involving conversion of the target to an entity classified as a disregarded entity or a partnership before the sale of its equity interests.⁸

In some instances, even these transactional structures are not viable. The terms of leases, contracts or licenses may prohibit asset transfers, even by merger, without the consent of another party. Or, the terms of financing may prohibit assumption of the target's liabilities by another party without the lender's consent. Even state law conversion statutes that permit a corporation to be "continued" as an LLC, which can be a disregarded entity, may require novation of contracts. In such cases, consents that are required to use these structures may be subject to burdensome conditions, or they may not be forthcoming at all.

In these instances, the only practical way to sell the target's business is by selling the target stock. In such cases, a stock sale generally would not prevent duplication of corporate level taxation, except in the limited circumstances in which a corporation may be converted to a disregarded entity without change in form, such as a QSub. A section 338(h)(10) election may be made for a sale and purchase of the target stock, if the sale constitutes a "qualified stock purchase," or "QSP." That is, the stock sale must meet these requirements:

⁵Tax Reform Act of 1986, Pub. L. No. 99-514, § 336(e), 100 Stat. 2085, 2270-71.

⁶In these Comments, the corporation whose stock is sold is referred to as the "target." For convenience, this term also refers to a subsidiary corporation whose stock is distributed to shareholders of its parent corporation. Similarly, references to a "seller" and a "purchaser" of target stock may also refer to a distributing corporation and a distributee shareholder, respectively.

⁷Rev. Rul. 69-6, 1969-1 C.B. 104.

⁸Reg. § 301.7701-2(c).

- The target must be either a subsidiary member in a section 1504(a) affiliated group (that is owned directly or indirectly by a corporate common parent) or an S corporation immediately before the acquisition date (that is, the first day on which there is a QSP of the target).
- A single corporation or affiliated group must purchase, within a “12-month acquisition period,” target stock meeting the requirements of section 1504(a)(2), that is, 80% or more by both vote and value, excluding certain preferred stock (the >80% target stock).
- The purchaser may not be a “related person” (defined below) to the seller.

Pursuant to a section 338(h)(10) election, for federal income tax purposes the stock sale is recast and treated as consisting of three steps, all occurring on the acquisition date:

- The formation of a hypothetical new corporation (the new target) by the corporate purchaser of the target stock.
- The sale of the target’s assets to the new target in exchange for an amount based on the consideration actually paid for the target stock and deemed assumption of the target’s liabilities by the new target.
- The distribution by the target of the sale proceeds (that is, the consideration actually paid for the stock) adjusted for any assets distributed by the target corporation before the sale as a part of the same transaction and liabilities of the target corporation that are assumed by or otherwise borne by the target’s stockholder(s), generally in a liquidation of the target.

If a section 338(h)(10) election is made, and the target has subsidiaries, an election may be made for each first-tier subsidiary. The same treatment applies to lower-tier subsidiaries.

If there is a QSP, and no election is made under section 338(h)(10) (or section 338(g)), a complex series of “consistency rules” may eliminate any increase in the basis of assets sold by the target to the corporate purchaser of the target stock or its affiliates during a designated time period.⁹

If there is no single corporate purchaser of the >80% target stock (for example, in a public offering of target stock), there is no QSP, and a section 338(h)(10) election is not available. Treasury and the Service have been commendably flexible in allowing section 338(h)(10) elections where

⁹Other transactions with the same results are also subject to the consistency requirement, set forth in Regulation section 1.338-8. The time period in which asset sales are subject to a consistency requirement (the consistency period) is generally the period beginning one year before the 12-month acquisition period begins and ending one year after the acquisition date, but the consistency period can be extended to include certain planned transactions. I.R.C. § 338(h)(4).

intermediate steps have been necessary to produce a QSP,¹⁰ but the complexity of these steps can be a barrier.¹¹ Moreover, the flexibility has not extended to allowing the election where no corporate purchaser of the >80% target stock continues to exist after the acquisition.¹²

The principal breakthrough in the section 336(e) regulations is to eliminate the requirement of a corporate purchaser of the >80% target stock. A section 336(e) election is available if a domestic corporation or S corporation shareholders sell the >80% target stock to any purchaser or purchasers (which could include one or more individuals and/or corporate or noncorporate entities), so long as the >80% target stock is sold or distributed within 12-months (the 12-month disposition period), in one or more taxable transactions, and the purchasers are not related persons to a seller. Such a sale or distribution of target stock is referred to as a “disposition” of the stock, and such a transaction or series of transactions is a “qualified stock disposition” or “QSD.”

A sale of target stock to a related person does not qualify as a disposition of target stock, eligible to be counted toward the >80% target stock requirement for a QSD. Thus, it is critical to determine whether a purchaser is a related person. The definition of “related person” in the section 336(e) regulations is similar but not identical to the same concept for section 338 purposes.¹³ In both sets of rules, the relevant relationship is the relationship between the seller and the purchaser of the target stock, and the relationship is determined after the transaction or series of related transactions. The relationship between the target and the seller or between the target and the purchaser is not relevant. In an intended QSD, there can be numerous purchasers, and the definition of “related person” takes into account constructive as well as actual stock ownership. Thus, it may be difficult, if not practically impossible, to determine whether a possible purchaser is a related person to the seller.

In a sale of subsidiary stock, the consequences of a section 336(e) election are similar to those of a section 338(h)(10) election. For federal tax purposes, the stock sale is disregarded, and the transaction is treated as:

- A sale of the target’s assets to the new target in exchange for the consideration based on the amount actually paid for the target’s stock and an assumption of the target’s liabilities by the new target.

¹⁰ See, e.g., Reg. §§ 1.338(h)(10)-1(c)(2), -1(e), Exs. (11)–(13), 1.338-3(b)(3)(iv), Ex. (1); P.L.R. 2004-27-011 (Oct. 6, 2003); P.L.R. 2011-26-003 (Apr. 4, 2011); P.L.R. 2011-45-007 (Aug. 8, 2011); P.L.R. 2012-03-004 (Oct. 19, 2011); P.L.R. 2012-13-013 (Dec. 29, 2011); P.L.R. 2012-16-026 (Jan. 12, 2012); P.L.R. 2012-28-011 (Apr. 6, 2012).

¹¹ As an example, to execute a public offering with a “busted” section 351 exchange, like the one described in Regulation section 1.338-3(b)(3)(iv), Ex. (1), steps are necessary to prevent the same persons from acquiring target stock both from the selling parent and from the target itself as a part of an integrated transaction.

¹² Reg. § 1.338(h)(10)-1(c)(2), Ex. (14).

¹³ Compare Reg. § 1.338-2(c)(13), with I.R.C. § 338(h)(3)(A)(iii) and Reg. § 1.336-1(b)(12).

- A distribution by the target of the proceeds of the deemed asset sale and an assumption of any remaining liabilities by the parent, generally in a liquidation of the target.

These transactions are deemed to occur on the first day on which enough target stock has been disposed of so that a QSD has occurred (the disposition date). The treatment of the target's subsidiaries is also the same as under section 338(h)(10). A separate election can be made as to each such subsidiary, down the chain.

If there is a QSD of the stock of a subsidiary, and no section 336(e) election is made, the "principles" of the consistency rules apply and may eliminate any increase in the basis of assets sold by the target to a purchaser or distributee of 5%-or-more of the target stock in the QSD or a related person (a 5% purchaser). In this respect, the section 336(e) regulations conform to the section 338(h)(10) model, but they apply the consistency requirement to a much broader class of asset purchasers, and they impose the requirement on stock distributions as well as sales.

B. *Sale of S Corporation Stock*

A sale of stock of an S corporation does not result in two levels of *corporate* taxation. However, a sale of the stock of an S corporation that terminates the S status of the target exposes income arising during the period of S status to corporate level tax. This occurs because the shareholders of a target S corporation are taxed on their gain from the stock sale, but the basis of the target's assets is not increased to reflect that gain.¹⁴ If the S status of the target corporation terminates after a QSD, but before recognition of the unrecognized gain, the result is to expose unrecognized corporate level gain to corporate level tax.

Even if the S status of the target continues after a QSD the failure to adjust the inside basis of the assets of the target to match the stock purchase price can produce inappropriate timing and-or character mismatches for the purchasing stockholder. These mismatches result from the pass-through of "non-economic" taxable income from the S corporation to the purchaser due to post-acquisition recognition by the target of unrealized corporate-level appreciation that had been reflected in the stock purchase price. The resulting basis increase in the stock caused by this non-economic income may produce later capital loss for the stockholder, but this loss often cannot be offset by the

¹⁴Even with application of sections 338(h)(10) and 336(e), the treatment of S corporations is less favorable than the treatment of partnerships, because section 754 elections can produce inside basis adjustments on any sale of an interest in a partnership, rather than only in transactions that satisfy the $\geq 80\%$ stock requirement for a QSP or a QSD. See I.R.C. § 754; Reg. § 1.754-1(b).

non-economic pass-through income, due to limitations on capital loss carrybacks and on offsets of ordinary income with capital losses.¹⁵

A section 338(h)(10) election could avoid these problems, but, as with any such election, it is available only if one corporation (or affiliated group) purchases the >80% target stock. The section 336(e) regulations create an alternative structure, subject to the same >80% stock ownership change threshold but without requiring a corporate purchaser.

If the section 336(e) election is made for a stock sale, the treatment of the transaction is the same as for a section 338(h)(10) election. The stock sale is disregarded by the seller, and the transaction is treated as:

- A sale of the target's assets to the new target (including assumption of the target's liabilities by the new target), and
- A distribution by the target to its shareholders of the sale proceeds, generally in a section 331 liquidation, all on the disposition date.

Before adoption of the section 336(e) regulations, the same planning techniques that were available to corporate parents selling subsidiary stock were available to S corporations participating in transactions where a section 338(h)(10) election was unavailable or impractical—for example, “longhand” asset sales, forward cash mergers and transactions involving a conversion of the target corporation to an entity classified as a disregarded or pass-through entity in a nontaxable transaction before a sale of interests in the target entity. For S corporations, these planning techniques are supplemented by the ability to treat a wholly owned corporate subsidiary as a disregarded entity through a QSub election.¹⁶

It is generally possible to achieve the same result as a section 336(e) election using an alternative structure. For example, immediately before the sale, through a preliminary section 368(a)(1)(F) reorganization, an S corporation target may become a QSub or a disregarded single-member LLC under a newly-formed holding company that becomes the tax successor to the S

¹⁵For instance, if an individual purchases 100% of the stock of an S corporation target and immediately converts the target to an LLC classified as a disregarded entity or partnership, the gain recognized by the target on its deemed distribution of assets in liquidation will increase the purchaser's stock basis, and the liquidation will result in the purchaser's simultaneous recognition of capital loss on the purchased stock. This immediate liquidation solution is imperfect, however, in that tax costs may be incurred because of the characterization of the pass-through gain as ordinary income, which cannot be offset by the capital loss on the stock. Such ordinary income characterization may arise from the character of the assets (e.g., cash method accounts receivable and depreciation recapture) or from the application of section 1239, an application that may likely occur because of the closely held nature of many S corporations. I.R.C. § 1239(a).

¹⁶I.R.C. § 1361(b)(3). This structure avoids many practical non-tax problems that may arise upon a conversion of a target corporation to a sole member LLC under state law (e.g., need for contract novation on government contracts). Similar flexibility is available for a wholly owned subsidiary of a REIT, under section 856(i)(2).

corporation.¹⁷ The holding company can then sell the disregarded entity. In many cases, for business reasons, these alternative structures are commonly used even in cases where a section 338(h)(10) sale could be done. It seems likely that the complexities and restrictions involved in a section 336(e) election (particularly the exclusion of related person transactions) will cause S corporations to favor these alternative structures over section 336(e) elections.

C. *Distribution of Target Stock by C Corporation*

Multiple taxation of a single economic gain can also occur if a corporation distributes stock of a subsidiary to shareholders, and the distribution does not qualify for tax-free treatment under section 355 (including section 355(d) or (e)). In such a case, the distributing corporation is taxed on its built-in gain in the target stock, and there is no increase in the basis of the target's assets. By contrast, if the target distributes its assets, either "longhand" or deemed, the same taxable gain would be recognized to the distributing parent, but an increase in the target's asset basis would result.¹⁸

The problem is that a distribution may be intended to qualify under section 355, which applies only to stock distributions. Before adoption of the section 336(e) regulations, there was no regulatory authority to allow a stock distribution that did not qualify for tax-free treatment to generate an asset basis increase.

Under the section 336(e) regulations, if a distribution of target stock is taxable (that is, not qualifying under section 355), it can be a QSD or part of a QSD, and the distributing parent may make a section 336(e) election. Taxable distributions and sales of target stock may be combined to reach the >80% target stock threshold for the section 336(e) election. Again, the >80% target stock must be distributed and—or sold during a 12-month disposition period, and the distributees or purchasers must not be related persons to the distributing corporation.

Under the same principles that apply to stock sales, the related-person relationship is between the distributing corporation and the distributee shareholder, determined after the distribution or series of related transactions. Thus, a distribution of target stock within an affiliated corporate group, by a lower tier distributing corporation (S) to its immediate parent (P), cannot constitute a QSD even if that distribution is a prelude to a further distribution of the >80% target stock by P to its public shareholders. Because S and P continue to be related persons, the distribution by S to P cannot constitute a QSD.

If a distribution of target stock to unrelated shareholders is intended to qualify as tax-free under section 355, the distributing parent may make a protective section 336(e) election, to prevent multiple taxation in case the

¹⁷Reg. § 1.368-1(b); see Rev. Rul. 2008-18, 2008-1 C.B. 674.

¹⁸Such a transaction is described in *Pope & Talbot Inc. v. Commissioner*, 104 T.C. 574 (1995), *aff'd*, 162 F.3d 1236 (9th Cir. 1999).

distribution does not so qualify. We believe such protective elections will be common in spin-offs and will constitute the vast majority of section 336(e) elections for stock distributions.¹⁹

Generally, if a section 336(e) election (protective or otherwise) is made for a taxable stock distribution, the tax recast and effect of the distribution is similar but not identical to the treatment of a stock sale with a section 336(e) election. Like a stock sale, the distribution is treated as a sale of the target's assets to the new target, an assumption of the target's liabilities by the new target and a distribution by the target, generally in liquidation, all on the disposition date. The distributing corporation is treated as purchasing the stock of the new target for its fair market value (with no gain or loss recognized to any party) and then distributing the stock to its shareholders without gain or loss recognition. The treatment of the target's subsidiaries is the same as in a stock sale.

Special rules apply if the stock distribution is taxable only to the distributing corporation under section 355(d) or (e) and a section 336(e) election is made. Then, the transaction is treated as a sale by the target of its assets not to a new target but to itself, again on the disposition date, and the target is not deemed to liquidate. The purpose of this "sale-to-self" rule is to have the target's attributes remain with the target and not be transferred to the distributing parent (or disappear entirely if the distributing parent did not hold section 1504(a) control of the target).

Whether or not special rules apply in one important respect, the consequences of a stock distribution with a section 336(e) election can be highly unfavorable: If net loss is recognized to the target on its deemed asset sale, that net loss is permanently disallowed, but the basis of the assets in the new target's hands is still stepped down to reflect the loss. If the QSD consists entirely of stock distributions, all the net loss is disallowed. If the QSD includes both sales and distributions, the portion of the net loss that is attributable to the distributed stock is disallowed. Because the target and each of its subsidiaries is subject to a separate election, net loss disallowance applies separately to each corporation for which the election is made, and net loss is computed separately for each corporation.

If a stock distribution constitutes a QSD or part of a QSD, and no section 336(e) election is made, the "principles" of the consistency rules may eliminate step-up in the basis of any assets that the target sells to distributees of 5%-or-more of the target stock in the QSD.

¹⁹ However, in one recent transaction where a section 336(e) election was made, a spin-off was intended to be taxable to the distributing corporation under section 355(e). Robert Wilens, *HEI to Engage in a 'Bad' Morris Trust Transaction (Section 311—Tax on Distributions)*, 2015 TAX NOTES TODAY 14-8 (Jan. 22, 2015).

D. *Distribution of Target Stock by S Corporation*

Stock distributions by S corporations can trigger adverse tax consequences that are not addressed by any available alternative structure. In cases in which it is not practical as a business matter to convert a lower tier QSub into an LLC, and cases involving intended section 355 distributions, the ability to make an actual or protective election under section 336(e) is a welcome improvement in the law.

A section 355 spin-off must take the form of a stock distribution. Thus, the distributing S corporation is locked into a form that, on disqualification, will result in gain recognition without basis increase in the transferred assets. We note, however, that the innovation of protective section 336(e) elections in this context may often not be available for S corporation spin-offs because the shareholders may be related parties to the distributing S corporation, and thus the distributions would not be dispositions counting toward a QSD.

E. *Background Conclusions*

The section 336(e) regulations constitute a significant step forward in the evolution of the corporate income tax law. The regulations allow many transactions to go forward without disproportionate tax burden or undue complexity of form. They also mitigate the risk of a spin-off failing to qualify for tax-free treatment. Understandably, the regulations are complex. In most situations, however, we believe that, after becoming familiar with the regulations, taxpayers and their advisers will find them manageable.

Nevertheless, our study of the regulations and early experience with them has revealed areas in which the regulations could be simplified, clarified, and improved without revisiting major policy determinations.

III. Analysis

A. *Related Person*

The distinguishing features of section 336(e) are its extension of the deemed asset sale regime to sales of stock to noncorporate purchasers and to certain taxable distributions of stock. In both situations, the broad prohibition against related party transfers severely limits the practical application of the section 336(e) regime. In our view, however, the perceived abuse targeted by these rules can be prevented by a far narrower prohibition, and it may be that no prohibition at all is necessary.

1. *General*

A number of valid approaches might be considered to address the difficulties created by current related-person rules. For example, a good argument can be made that the related-person prohibition duplicates other requirements for a section 336(e) election and thus can be abandoned altogether. However, we appreciate that Treasury and the Service have reviewed numerous comments and considered many alternatives, and decided to retain the related-person

prohibition but modified the attribution test with a 5% threshold for triggering attribution between partners and partnerships.²⁰ The preamble to the Final Regulations makes it clear that Treasury and the Service did not necessarily consider this change to be a permanent solution, and that they would “continue to study whether related-party transactions should qualify for a section 336(e) election.”²¹

In our experience, many of the practical difficulties raised by the related person rules are due to attribution between partners and partnerships. Accordingly, we acknowledge that the majority of such issues can be addressed by the decision to add an attribution threshold. We submit, however, that a 5% threshold is far too low and should be increased significantly. For reasons outlined below, we believe that for purposes of section 336(e), the threshold should be increased to 50%.

The statutory rules prohibiting related-person transactions under section 338 and the regulations prohibiting related-person transactions under section 336(e) appear similar. In practice, however, they are very different. Under section 338, the related-person exclusion only applies to stock if the seller’s ownership of the target stock is attributed to the purchaser (using the section 318 attribution rules as modified for section 338).²² One important difference, however, is that section 338 requires a single corporate purchaser. Accordingly, the section 318 attribution rules operate very differently: section 318 comes with a built-in threshold that requires at least 50% ownership before attribution can occur between a corporation and its shareholder.

In contrast, the related person exclusion under section 336(e) applies in any case where the stock of the purchaser could be attributed to the seller or vice versa (using the section 318 attribution rules as modified for section 336(e)).²³ As noted above, fundamental to the idea of section 336(e) is its extension of the asset purchase regime to individual and partnership purchasers. Although for this purpose section 318 operates similarly in its application to corporations and individual shareholders (imposing a 50% attribution threshold), the practical application of the rules to partnerships yields very different results. Accordingly, even with a 5% attribution threshold, a partnership purchaser is left at a significant disadvantage.

Example III.A.-1—Relatedness Created by Overlapping Partners

Parent owns all the stock of Target. Partnership X owns all of the stock of Parent. Individual A holds a 5% limited partnership interest in X and in Partnership Y. Except for A’s overlapping 5% ownership, X and Y are unrelated. Parent sells the Target stock to Y.

²⁰ See T.D. 9619, 2013-23 I.R.B. 1218. Such comments were requested in the preamble to the Proposed Regulation section 336(e). Prop. Reg. §§ 1.336-1 to -5, 73 Fed. Reg. 49,965 (2008).

²¹ Prop. Reg. §§ 1.336-1 to -5, 73 Fed. Reg. 49,965 (2008).

²² I.R.C. § 338(h)(3)(A)(iii).

²³ See § 338(h)(3)(A)(iii); Reg. § 1.336-1(a)(2)(b)(12).

Parent (seller) and Y (purchaser) are related persons, because stock owned by Parent would be attributed to X (section 318(a)(2)(C)), and then from X to A (section 318(a)(2)(A), as modified to provide a 5% threshold). Thereafter, such stock would be attributed from A to Y (section 318(a)(3)(A) as modified to provide a 5% threshold). The section 336(e) election is not available because Parent's sale of the Target stock to Y is not a QSD.²⁴

Example III.A.-2—Relatedness Created by Downward Partner Attribution

Parent owns all of the stock of Target. Parent also owns a 5% interest in Partnership X. X purchases Target stock from Parent.

Parent (seller) and Partnership X (purchaser) are related persons, because stock owned by Parent would be attributed to X (section 318(a)(3)(A) as modified to provide a 5% threshold). The section 336(e) election is not available because Parent's sale of the Target stock to X is not a QSD.

Example III.A.-3—Relatedness Created in a Rollover Transaction

Target, an S corporation, is owned by four individuals. Individual A owns a 25% interest in Target. All the Target shareholders sell their stock to Partnership Y. As part of the transaction, A is required to purchase a 5% interest in Y.

A (seller) and Y (purchaser) are related persons, because, after A purchases a 5% interest in Y, stock owned by A would be attributed to Y (section 318(a)(3)(A) as modified to provide a 5% threshold). The section 336(e) election is not available because the sale of Target stock is not a QSD.

The foregoing are examples of legitimate transactions that can arise in practice. In addition, where partnerships are private equity or other investment vehicles, confidentiality agreements commonly prevent the parties from knowing whether individual cross-ownership even exists.

While section 338 itself contains a prohibition on related-person sales, there is no such statutory prohibition in section 336. In our view, it is difficult to identify the rule's utility in preventing potential taxpayer abuse. Consistent with the statute, the legislative history of section 336(e) does not suggest that

²⁴The Final Regulations already contemplate that a sale may qualify as a QSD, even though it is blocked as a QSP by the section 338 related-person rule, as the following variation of Example I-1 illustrates. Suppose that (1) Y owns all the stock of corporation Q, (2) Partnerships X and Y have only one partner in common, Fred, (3) Fred owns less than a 5% interest in each partnership, and (4) Parent sells the Target stock to Q rather than Y. That sale would be a QSD but not a QSP. The sale would not be a QSP, because Parent and Q would be related persons: Stock owned by Parent would be attributed through X, Fred and Y to Q. I.R.C. §§ 338(h)(3)(A)(iii) (defining related persons), 318(a)(2)(A), (C), 318(a)(3)(A), (C). However, the sale would be a QSD, because the 5% rule would block attribution through Fred.

a related person prohibition should be imposed. In this regard, the legislative history provides as follows:

The conferees intend that the regulations under this elective procedure will account for appropriate principles that underlie the liquidation-reincorporation doctrine. For example, to the extent that regulations make available an election to treat a stock transfer of controlled corporation stock to persons related to such corporation within the meaning of section 368(c)(2), it may be appropriate to provide special rules for such corporation's section 381(c) tax attributes so that net operating losses may not be used to offset liquidation gains, earnings and profits may not be manipulated, or accounting methods may not be changed.²⁵

We note that actual acquisitive D reorganizations and section 304 overlap transactions are and should be excluded from the definition of "disposition" in the final section 336(e) regulations. Regulation sections 1.336-1(a)(2)(b)(5)(A) and (B) define a "disposition" (the prerequisite for a QSD) to exclude any sale, exchange or distribution of stock that meets one of the following requirements: (1) The basis of the stock in the hands of the purchaser is determined in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom the stock is acquired or under section 1014(a) (relating to property acquired from a decedent); (2) section 351, 354, 355, or 356 applies; or (3) it is a transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized in the transaction (except for transactions governed by section 355(d) and (e)).²⁶

A related-person rule is not necessary to prevent a transaction qualifying as an acquisitive D reorganization or a section 304 transaction from being treated as such (and thus ineligible for the section 336(e) election). In fact, under the existing related-person rules, a transaction may avoid application of the related-party rules (because the seller does not meet the value threshold for attribution) but nevertheless be subject to section 304 (for example, in a situation where the seller owns 50% or more of the vote of the purchaser). We believe that the existing definition of "disposition" in the Final Regulations disqualifies such a transaction as a QSD without a related-person rule.

The remaining concern addressed in the legislative history would appear to involve situations where the deemed asset transaction (as recast under section 336(e)) would qualify as an acquisitive reorganization that provides the seller

²⁵H.R. REP. NO. 99-841, at 204 (1986) (Conf. Rep.). The Tax Reform Act of 1984 amended section 368(c)(2) to provide that "control" for purposes of sections 354(b) and 368(a)(1)(D) is to be determined under section 304(c). Pub. L. No. 98-369, § 54, 98 Stat. 494, 570 (1984). The Tax Reform Act of 1986 (the 1986 Tax Act) moved this definition to section 368(a)(2)(H) but did not make a substantive change. Pub. L. No. 99-514, § 361, 100 Stat. 2085, 2806 (1986).

²⁶The related-party rule is found in the third prong of the definition, found in Regulation section 1.336-1(a)(2)(b)(5)(C), which provides that a "disposition" excludes a sale, exchange, or disposition to a related person.

with section 304(c) control (for example, an acquisitive D reorganization). In our view, the best way to prevent such a transaction from qualifying as a QSD would be an explicit rule addressing this situation.

Finally, we find it difficult to identify more generalized concerns and note that section 336(e), without a related-person rule, generally would not allow truly related parties to achieve a result that they could not accomplish by other means. After all, in the sale context, section 336(e) simply allows parties to replicate the result that they could have achieved by actually transferring assets. Even where an asset transfer presents business obstacles, related parties can often replicate the result by engaging in a preliminary F reorganization that places the historic target as a disregarded limited liability company under a new corporate successor to the target and having the successor transfer the interests in the disregarded entity.

Because there appears to be little if any abuse potential that is actually prevented by the related-person rule and because the related-person rule in practical application prevents many legitimate transactions (and where it does not, can create a trap for the unwary), we urge Treasury and the Service to consider a significant modification of the rule, particularly as applied to partnerships and partners. As explained, we believe that the rule can be eliminated altogether. However, if it is determined that a related-person rule should be retained, even for the time being, we believe most of the difficulty created by the rule can be addressed by increasing the threshold that triggers attribution between partners and partnerships to 50%.

We find a 50% threshold appealing for both practical and theoretical reasons. In practice, many private equity funds have overlapping ownership in the 20% to 30% range. We believe it would be most helpful to set the attribution threshold beyond the upper end of this range. From a theoretical standpoint, we think that the 50% test helps square the section 336(e) related-person rules with the rules applied in section 338 transactions. We realize that there may be some situations where a transaction that fails to qualify as a QSP (and thus section 338 eligibility) solely because of the related-party rules could qualify as a QSD (and thus be eligible for the section 336(e) election). In fact, such situations are possible under the existing section 336(e) regulations because of the introduction of the 5% threshold for partnership attribution. While we do not see the need, we note that preventing this result should be a simple matter addressed by adding a sentence to the regulations.

We also believe that a 50% test has some appeal because it tracks the section 304(c) control test referenced in the section 336(e) legislative history. Again, we believe that other requirements in the Final Regulations foreclose most (if not all) of the potential abuse identified in the legislative history. Nevertheless, to the extent the related-party rules are intended to serve as a backstop to these provisions, we believe that applying a 50% attribution threshold across the board is appropriate.

2. *Related Person in Series of Transactions*

The related-person rules in the regulations under both section 338 and section 336(e) focus on the relationship between the seller and the purchaser of the target stock—not between the seller and the target.²⁷ At the same time, related-person status is determined immediately after a purported QSP or QSD and any series of related transactions (if any). The results can be counterintuitive:

Example III.A.-4—Relatedness Between Seller and Purchaser

Background. Corporation P owns all the stock of T. Individual A owns 50% of the P stock (directly or by attribution). Thus, P and A are related persons. Individual B owns no P stock and is unrelated to both P and A.

Situation 1. In a series of related transactions, (1) P sells all the T stock to A, and (2) A retains the T stock and sells 1% of the P stock to B.

After the transactions, P and A are no longer related persons. Thus, P's sale of the T stock to A is a QSD, and the section 336(e) election is available.

Situation 2. In a series of related transactions, (1) P sells all the T stock to A, and (2) A sells all of the T stock to B but retains all of his P stock.

After the transactions, A still owns 50% of the P stock, and so P and A are still related persons. Thus, P's sale of the T stock to A is not a QSD, and the section 336(e) election is not available. The fact that the T stock is owned by B—not a related person to P or A—is irrelevant. Because A is an individual, A's sale of the T stock to B is also not a QSD (unless T becomes an S corporation after P sells the T stock to A).

The related-person rules are likely to apply to spin-offs in which the distributing corporation wishes to make a protective section 336(e) election. In such situations, the spun-off corporation (T) commonly is a second-tier or lower-tier subsidiary of the parent (P), so that one or more intra-group stock distributions are necessary before P's spin-off of T to the P shareholders. Because the members of the P group are all related persons to one another, none of these intra-group distributions is a QSD. P's ultimate spin-off of T to the P shareholders can be a QSD so long as the P shareholders who receive T stock are not related persons to P (that is, none of them owns 50% or more of the P stock, actually or by attribution, after the distribution and any related transactions).²⁸

²⁷ See Reg. § 1.336-1(b)(5)(C).

²⁸ A P shareholder could be a related person to P by virtue of other relationships, for example, P owns stock of a corporate shareholder of P itself ("hook" stock).

As a result, in the absence of relief, if the distributions of the T stock turn out to be taxable, and a protective section 336(e) election is made, taxable gain would be recognized on both the T stock and the T assets, with a step-up in the basis of the T assets but often not in the T stock. If no protective election is made, taxable gain would be recognized on the T stock with no basis step-up in the assets and often no step-up in the basis of the T stock either.

These results are precisely what section 336(e) was intended to prevent, and the drafters added a relief provision to the consolidated return regulations.²⁹ In some situations, this provision allows a loss on the T stock to offset gain recognized in the intra-group stock distribution. Although the relief provision is commendable, it is only partly effective. It is also complex, and it leaves a potential trap for taxpayers. Overall, in our view it is not adequate.

The first problem with the relief provision is that, as a consolidated return regulation, it applies only to intercompany transactions within consolidated groups. If a subsidiary (S) distributes the T stock to a nonconsolidated P (for example, a foreign corporation), the relief provision does not apply, even if P spins off T to unrelated shareholders in a related transaction. No section 336(e) election is available for the intercompany stock distribution. Of course, if P is a foreign corporation, no section 336(e) election is available for P's spin-off of T either.

The second problem is that, even if relief is available, it may be only partial. The relief provision allows a loss on the T stock to offset the gain from the taxable intra-group distribution of the stock. The amount of this loss is limited, however. If S's basis in the T stock is less than T's net inside asset basis, the offset will not be complete. Yet the full gain on T's assets will be recognized and taxed, and inside basis step-up will still be limited to the amount of this inside gain. In other words, double tax will result. We appreciate that it is common for stock basis to be the same as or greater than net inside basis, but the opposite situation also occurs. In our view, this double tax is not warranted in any case.

The third problem is that, again even if relief is available, it requires an election by the group. Some taxpayers may be unaware of the problem and may fail to make the election, especially since the protective section 336(e) election itself may be viewed as an afterthought. We assume that the Service would be sympathetic to requests for delayed elections. Nevertheless, in our view, if the current relief provision is retained in Regulation section 1.1502-13(f)(5)(ii)(C), the treatment of that provision should be deemed elected unless the distributing corporation affirmatively elects out.

We also note that a section 336(e) election can be made available for an intra-group stock distribution, or its equivalent, using various transaction forms, but each of these forms could involve business and tax issues of its own.

²⁹Reg. § 1.1502-13(f)(5)(ii)(C).

Example III.A.-5—Tiered Spin-Offs

Background. P, the parent of a consolidated group, owns all the stock of S, and S owns all the stock of T. S and T are members of the P group. P wishes to spin off T to its unrelated shareholders. Because of concerns about section 355(e), P wishes to make a protective section 336(e) election for each stock distribution.

Situation 1. S is converted to a limited liability company, which distributes the T stock to P. Then P distributes the T stock to its shareholders with a protective section 336(e) election.

This transaction structure eliminates the double-tax problem. Apart from any business obstacles to a conversion, P's basis in the T stock is eliminated.

Situation 2. S transfers its assets other than the T stock to Newco and distributes the Newco stock to P in an intended section 355 spin-off, either with or without a protective section 336(e) election. Then, as part of the same series of related transactions, P distributes the stock of S (which owns only the T stock) to the P shareholders in an intended section 355 spin-off, with a protective section 336(e) election.

This structure also eliminates the double tax on T. If S's intra-group distribution of the Newco stock is taxable, it is a QSD, because, after P distributes the S stock (in a transaction related to S's distribution of the Newco stock to P), P and S are no longer related persons. P's spin-off of S is also a QSD if it is taxable. Apart from any business obstacles, the intercompany gain from the distribution of the Newco stock is triggered and taxed when S leaves the P group in the spin-off.³⁰

In view of these limitations in the current regulations, we recommend that the treatment of taxable stock distributions within corporate groups be revised. A section 336(e) election (protective or otherwise) should be available for a taxable intra-group stock distribution that precedes and is part of a series of related transactions with a distribution of the target stock to unrelated shareholders of the group's parent. The election should be available regardless of whether the group is eligible to file, or does file, consolidated returns.

³⁰If both distributions are taxable, and protective elections are made for both distributions, then gain is triggered and taxed on both the T assets and the Newco assets, and the bases of both the T assets and the Newco assets are stepped up. Under sections 197(f)(2) and (f)(9), there may be restrictions on amortization of Newco's intangibles, even though the gain has been taxed. Any built-in loss in Newco assets (if not disallowed) would be deferred under section 267(f).

If both distributions are taxable, and if a protective election is made for P's spin-off of S but not for S's intra-group distribution of the Newco stock, then gain is triggered and taxed on both the T assets and the Newco stock; the basis of the T assets is stepped-up; and the basis of the Newco stock, but not the basis of the Newco assets, is stepped-up.

We believe such a revision would improve the usefulness of the protective election regime without introducing abuse. The new rule could apply only if the ultimate distribution to unrelated persons is taxable, or it could apply regardless of whether it is taxable or tax-free.

Such a change could be adopted, either on its own or as part of a broader change in the related-person rules. Specifically, the definition of related person could be changed to focus not only on the relationship between the seller and the purchaser after a series of related transactions, but also on ownership of the target stock at that time. Under such a broader rule, the successive taxable sales or distributions of target stock in a series of related transactions (for example, Example I-4 Situation 2) all could be QSDs so long as the >80% target stock ends up in the hands of persons not related to any of the sellers or distributors of stock. A sale or distribution of target stock to a related person, followed by a transaction that breaks the relationship between the parties (for example, Example I-4 Situation 1 and Example I-5 Situation 2), could continue to qualify as a QSD.

In our view, although the intra-group spin-off presents the more urgent situation, the broader change ultimately should be adopted. An actual taxable-assets sale, with basis step-up, could be undertaken in such a situation, and making the section 336(e) election available would further the policy of section 336(e), again without introducing abuse or administrative difficulty.³¹ Even if the broader change is rejected, we recommend the narrower change to allow section 336(e) elections in connection with multiple-tier stock distributions.

3. *Revision to the Definition of Related Person*

If the related-person rules are retained, we believe a clarification should be made to the definition of related person.

Regulation section 1.336-1(b)(12) provides that two persons are related if stock owned by one would be attributed to the other under section 318. In contrast, for purposes of section 338, the related-person rule applies only if stock owned by the transferor would be attributed to the transferee under section 318.³² Whether stock would be attributed from the transferee to the transferor is irrelevant for purposes of section 338.

³¹The new rule could apply to a taxable stock sale to a related person followed by a tax-free transaction that separates ownership of the target stock from a person related to the original owner. The current rule, which applies to a related transaction that eliminates the relationship between seller and purchaser, applies to both taxable and tax-free transactions. As an example, the revised rule could apply to a taxable intra-group stock distribution, even if the related spin-off to unrelated shareholders is tax-free. In view of the general policy of applying section 336(e) only to fully taxable transactions, we have not considered the implications of such an expansion of a revised rule or reached a conclusion as to whether such an expansion would be appropriate.

³²See I.R.C. § 338(h)(3)(C).

Generally, this technical difference between the two related-person rules has no effect, because if stock can be attributed from one person to a second person, it typically can be attributed from the second person to the first. One notable exception is for a grandparent and grandchild. Under section 318(a), stock owned by a grandchild is attributed to a grandparent, but not the other way around.

To illustrate the difference, assume that a grandparent sells all stock of an S corporation target to a corporation of which 30% of the stock is owned by a grandchild and the remaining 70% by an unrelated person, Fred. The acquisition is a QSP, because none of the stock owned by the grandparent is attributed to the grandchild or to Fred under section 318(a).³³ Accordingly, a section 338(h)(10) election can be made for the acquisition.³⁴ However, if the grandparent sold 30% of the target stock directly to grandchild and 70% to Fred, a section 336(e) election could not be made, because grandparent would not “dispose of” the 30% interest sold to grandchild, a related person. Because less than an 80% interest in the target stock would be disposed of, the stock would not be transferred in a QSD, and a section 336(e) election could not be made for the sale.

That distinction does not seem justified. To conform the related-party definitions for purposes of section 336(e) and section 338, the first sentence of Regulation section 1.336-1(b)(12) should be amended to provide that a transferor and transferee are related only if stock owned by the transferor is attributed to the transferee under section 318(a) (other than section 318(a)(4)).

B. *Creeping QSD*

The regulations allow a QSD to include sales and distributions of target stock over a period as long as 12 months. These “creeping QSDs” offer advantages (flexibility in planning and execution of dispositions, as well as consistency with the section 338(h)(10) model). In our view, however, the complications outweigh the advantages. Although detailed rules could be adopted to resolve the issues, we believe that such refinements would not be worth the effort and added complexity. Thus, we recommend simplified rules.

If a section 336(e) election is made, the target is deemed to sell its assets and then generally to liquidate, distributing the proceeds of the stock dispositions and any remaining assets to the seller or sellers. These transactions are deemed to take place on the disposition date even if some target stock was disposed of earlier, in interim dispositions.

³³ See § 338(h)(3)(A)(iii) (defining a related-party transfer).

³⁴ If grandparent sold the target stock to a corporation wholly owned by the grandchild, the sale would not be a QSP, but not because the grandchild and grandparent are related persons. It would fail as a QSP because section 304(a)(1) (and section 301) would apply to the sale. The grandparent would be deemed to own all the stock of the target and the acquiring corporation both before and after the transfer, and the acquiring corporation would be deemed to acquire the target stock in a section 351 transfer. For that reason, the acquiring corporation would not acquire the target stock by purchase, and a section 338 election could not be made. § 338(h)(3)(A)(ii).

Sellers are treated as not transferring the target stock disposed of in the QSD, but purchasers are still treated as acquiring the stock on the date actually acquired.³⁵ Thus, if a QSD occurs over time, a seller and a purchaser may be treated as both owning the same stock at the same time.

This dual ownership creates problems that could be resolved by requiring the QSD to occur on one day. However, to deal with practicalities involving multiple purchasers in a QSD, we recommend shortening the 12-month disposition period for most QSDs but allowing a QSD to occur over some period of time in appropriate circumstances.

1. *Consolidated Targets*

In a creeping QSD, it may be unclear when a target leaves a consolidated group of which it is a member (the selling group) and—or joins a new group:

Example III.B.-1—Creeping QSD by One Consolidated Group to Another

P, the common parent of a consolidated group, owns 80% of the only class of T stock, and T is a member of the P group. X, the common parent of another consolidated group, owns the remaining 20% of the T stock. X and P are not related persons. On day 1, P sells a 60% block of the T stock to X. On day 365, P sells its remaining 20% of the T stock to Fred, who is not related to either P or X.³⁶

P has made a QSD of the T stock. Day 365 is the disposition date. If no section 336(e) election is made, T joins the X group on day 1.

If a section 336(e) election is made, P is treated “[i]n general” as owning all the T stock disposed of in the QSD until the disposition date (day 365). If this “seller general rule” applies, P is deemed to continue to own 80% of the T stock until the disposition date, and T remains a member of the P group until that date.³⁷

The regulations also contain an ownership rule for the purchaser: “Generally,” the section 336(e) election does not affect the tax consequences to which a purchaser would have been subject, and a purchaser is treated as acquiring target stock when actually acquired.³⁸ Because X actually owns 80% of the T stock beginning on day 1, if this “purchaser general rule” applies, T becomes a member of the X group on day 1.

³⁵Reg. § 1.336-2(b)(1)(i), -2(c).

³⁶We are aware of one such situation involving large, publicly-traded corporations. Robert Willens, *SWY Shareholders Will Receive a Novel Package of Consideration*, 143 TAX NOTES (TA) 123 (Apr. 7, 2014) (in IPO, target issues enough low-vote stock to be deconsolidated from parent but still controlled under section 368(c); parent spins off remaining target stock and merges with unrelated corporation so as to cause spin-off to be taxable under section 355(e)(2); when does target leave the parent group?).

³⁷Reg. § 1.336-2(b)(1)(i)(A), -2(b)(1)(iii)(A), -2(k), Ex. (6)(ii).

³⁸Reg. § 1.336-2(c).

The target cannot be a member of two consolidated groups at the same time.³⁹ The regulations do not resolve the inconsistency. An example suggests that the target remains a member of the selling group,⁴⁰ but this result is not clear, and it is at odds with the economics of the relationships among the parties.

To resolve these problems and to simplify the QSD regime for C corporation targets in general, we recommend that a stock disposition qualify as a QSD only if either of the following two prerequisites is met:

- At the beginning of the disposition date, the target is a member of the selling affiliated group (whether or not consolidated).
- On the date the target otherwise would leave the selling affiliated group (whether or not consolidated), binding contracts are in place for all remaining dispositions of target stock necessary to a QSD.

We recommend further that, if a QSD results from the “binding contract” rule—

- If no section 336(e) election is made, the target should leave a selling consolidated group under the existing consolidated return rules.
- If the binding contract or contracts provide for a section 336(e) election and the election is made, the target should leave a selling consolidated group on the date of the first stock sale that qualifies as a disposition and is included in the QSD.
- The timing of the target’s joining a new consolidated group would be coordinated with its leaving a selling consolidated group.

In our view, it would be ideal if, in a binding contract situation, an election were available to postpone the target’s departure from the selling consolidated group. We recommend that Treasury and the Service consider providing for such an election, but we would not want to see the more urgent regulations delayed by consideration of such an election.

2. *S Corporation Targets*

A fundamental difference between the regulations under section 338(h)(10) and the regulations under section 336(e) for S corporations is that only the latter create the possibility of a deemed sale election as a result of multiple dispositions of S corporation stock occurring on more than one day during the disposition period.

³⁹This conundrum is avoided in section 338(h)(10) transactions involving consolidated targets because the target must actually be a member of the selling consolidated group on the acquisition date. Reg. § 1.338(h)(10)-1(b)(2) (defining selling consolidated group), -1(d)(3) (providing that the target’s deemed sale consequences are taken into account by the selling consolidated group).

⁴⁰Reg. § 1.336-2(k), Ex. (6)(i)-(ii).

To make a section 338(h)(10) election, a target S corporation must have S corporation status on the acquisition date and therefore can have no ineligible shareholders before that date. Because section 338 requires a corporate purchaser, the target's S corporation status must terminate upon *the first purchase of target's stock included in the QSP*. Because section 338(h)(10) elections are only available if $\geq 80\%$ target stock of an S corporation can be purchased on a single day, there can be no creeping section QSP of an S corporation, and the regulations under section 338(h)(10) did not need to address any issues that would arise if it had been possible.⁴¹

In contrast, under the section 336(e) regulations, a creeping QSD of an S corporation is possible, because the purchasers of the target S corporation may be eligible to be shareholders of an S corporation.⁴² In addition, even if the purchaser in a disposition is not eligible to be an S corporation shareholder, it is possible that if all S corporation shareholders who disposed of stock in the QSD are treated as if they had retained their stock until the disposition date, the purchaser in the disposition might not be considered to be a shareholder until the day after the disposition date. Accordingly, it appears possible that a sale of target S corporation stock to an ineligible shareholder might not be considered to terminate the S status of the target until the day after the disposition date.

The issues created by creeping QSDs of S corporations are not answered by the general reference in the section 336(e) regulations to the principles of the section 338(h)(10) regulations, because section 338(h)(10) does not contemplate creeping QSPs of S corporations. The section 336(e) regulations for S corporation targets also has no guidance on, or even examples illustrating, the intended operation of section 336(e) in a creeping acquisition context.

This lack of guidance will create uncertainty for S corporations and their shareholders who may attempt to make section 336(e) elections. We think there is a significant risk that taxpayers and advisors will undertake transactions that contemplate a section 336(e) election without adequate attention to the issues that are raised by creeping dispositions.

The principal problem in the context of S corporation targets is the apparent ownership of stock for tax purposes during an extended period by a person who is not in fact the economic owner. The consolidated return context simply involves a question of whether the target should be in one group or the other. For an S corporation, the issue will generally affect a larger number of taxpayers—those who owned stock at the outset of the disposition period, those who have disposed of or purchased stock during the disposition period, and shareholders who both acquired and disposed of stock during the

⁴¹Perhaps a deemed continued ownership rule similar to Regulation section 1.336-2(b)(1)(i)(A) could have made a creeping QSP possible, but presumably it was not considered necessary because of the single-purchaser rule and the closely held-nature of S corporations.

⁴²Reg. § 1.336-2(b)(1)(i)(A).

disposition period. There are numerous possible interactions with other rules under subchapter S that might be implicated, but the impracticality of having an extended period for a creeping QSP can be readily illustrated by examining the issues relating to allocation of income under section 1366.

The section 336(e) regulations apparently contemplate that an S corporation shareholder who disposes of stock in a QSD will be treated as not having transferred the stock until the disposition date,⁴³ at which time shareholders who have made dispositions are deemed to have received the proceeds of their disposition of stock as if received in a liquidation of the S corporation target.⁴⁴ The regulations specifically indicate that all corporate level income and loss will be reported by the “S corporation shareholders” who are shareholders on the disposition date (under normal allocation rules under subchapter S), so that the correlative stock basis adjustments under section 1367 will be taken into account in determining the gain or loss on the deemed liquidating distribution.⁴⁵

The logical inference of the specified treatment of disposing shareholders is that a purchaser of stock in a disposition during the disposition period, but before the disposition date, will not take any allocation of corporate level income or loss under section 1366 to the stock purchased in a disposition

⁴³ *Id.* (providing that “S corporation shareholders” are not treated as having sold or exchanged their stock “disposed of in the qualified stock disposition”) (emphasis added). Note particularly that this does not address stock that was not “disposed of” in the QSD, if it was otherwise transferred during the disposition period. These other transferors are presumably not treated as having retained their stock until the QSD, but will take allocations under section 1366 under normal rules (including any closing of the books computations that may be agreed to).

⁴⁴ Although the regulations are not clear about this, by analogy to section 338(h)(10) transactions, it appears to be intended that the amount realized by each S corporation shareholder is the amount actually realized by that shareholder in the disposition of the S corporation target stock. Regulation section 1.336-2(b)(1)(iii)(A) provides that the S corporation shareholders are treated as if the target S corporation had “transferred all of the *consideration deemed received* from the new target in the deemed asset sale disposition” to S corporation shareholders. This reference to “consideration deemed received” might be interpreted as including assumed liabilities taken into account in the aggregate deemed asset disposition price (ADADP), rather than “the grossed up amount realized on the sale” referenced in Regulation section 1.336-2(b)(1)(iii) as the fair market value of the target stock for purposes of resetting the basis of retained stock in a QSD.

⁴⁵ Reg. § 1.336-2(b)(1)(iii)(A) (providing that “S corporation shareholders . . . take their pro-rata share of the *deemed disposition tax consequences* into account under section 1366” and are treated as if, on the disposition date after the deemed disposition and while target stock is owned by S corporation shareholders, the proceeds of the asset disposition were distributed to S corporation shareholders (emphasis added)).

that is part of the QSD.⁴⁶ However, the section 336(e) regulations provide that the federal income tax treatment of a purchaser in a QSD will *not* be affected by the making of a section 336(e) election, and will be treated as having purchased the stock so acquired on the date actually acquired.⁴⁷ As in the consolidated return context, it is not practical to consider the same stock as simultaneously owned by two different shareholders for purposes of subchapter S.

Example III.B.-2—Treatment of S Corporation Shareholders Selling Before the Disposition Date

Corporation X is an S corporation with 100 shares of stock outstanding. A and B each owns 20 shares of X stock and C owns the other 60 shares. On June 30, A disposes of all of his stock (20%) to D, an unrelated individual, and B transfers all of his stock (20%) to his child E by gift. On December 31 of the same year C sells all of his stock (60%) to F, an unrelated individual. A section 336(e) election is made with respect to the QSD, and the disposition date is December 31 by reason of the combined 80% dispositions by A to D (20%) and by C to F (60%).

X has assets with a basis of zero and a FMV of \$100,000. X generates \$10,000 of taxable income for the year from operations (excluding deemed sale income). Deemed sale income of \$100,000 arises from the section 336(e) election effective on December 31. Assets of X on the disposition date consist of cash of \$10,000 and an asset with a zero basis and a value of \$100,000.

Treatment of disposing transferor and transferees. Assume that deemed sale gain of \$100,000 is recognized by X on December 31. The following table compares how the income of X for the year of the sale (or deemed sale) would be allocated among X's shareholders if X actually sold all of its assets or if X was deemed to sell its assets under section 336(e):

⁴⁶One possible interpretation of the reference in Regulation section 1.336-2(b)(1)(iii)(A) to only "deemed disposition tax consequences" is that only the deemed disposition gain or loss is shifted to the former shareholders who have disposed of their stock, and that other income or loss of the S corporation would be reportable by the purchaser of the stock. However, there is no clear substantive demarcation between income resulting from the deemed disposition and other income. For instance, cash method accounts receivable collected on the day before the disposition date would be income arising from normal operations, but a delay in collection would cause the income to appear to be part of the deemed disposition tax consequences. We have assumed this was not the intention of the drafters of the regulations.

⁴⁷Reg. § 1.336-2(c).

Shareholder	Asset sale	Section 336(e) election
A	10% [20% x 181/365]	20% [20% x 365/365]
B	10% [20% x 181/365]	10% [20% x 181/365]
C	60% [60% x 365/365]	60% [60% x 365/365]
D	10% [20% x 184/365]	Zero [not a shareholder]
E	10% [20% x 184/365]	10% [20% x 184/365]
F	Zero [not a shareholder]	Zero [not a shareholder]

As the table illustrates, the section 336(e) regulations appear to change the allocation by disregarding D's and F's ownership of X stock until the day following the disposition date, so that the only shareholders of X for income tax purpose during year one are A, B, C, and E. The income allocated to A increases his X stock basis and is taken into account in computing his gain or loss on the proceeds of his sale to D, but treated as if received in liquidation of his stock on December 31.⁴⁸ Operating income is also recognized by X for its entire calendar year through the disposition date. The regulations do not directly address the allocation of operating income during the disposition period, because the described treatment of the S corporation shareholders is only that they take into account the "deemed disposition tax consequences,"⁴⁹ which would not address allocations of operating income. However, it appears that the regulations intend that the S corporation shareholders who dispose of stock in the QSD should be treated for *all* federal income tax purposes as not having sold or exchanged the stock disposed until the disposition date.⁵⁰

Treatment of nondisposing transferor. Because B has transferred his stock in a transaction that is not a disposition, he is not treated as continuing to be a shareholder through the disposition date. Instead, B may be allocated at least 10% of the \$110,000 for the year on a pro-rata per diem basis. The income allocated to B would be included in the basis of the stock gifted to E.⁵¹ Any allocation of any of the deemed disposition gain to E will cause E to be currently taxable on the portion of the deemed disposition gain allocated to the shares acquired by B. Gain allocated to E would be reflected in his stock basis, so that his basis would be equal to his inside basis on December 31. E is then

⁴⁸A would have a loss on the deemed liquidation, because the grossed-up disposition price used to compute ADADP will reflect the accumulated earnings of X for the year, because these earnings would be reflected in C's stock disposition proceeds, but not in A's proceeds.

⁴⁹The phrase "deemed disposition tax consequences" refers to deemed *asset* disposition tax consequences. Reg. § 1.336-1(b)(15). This appears to exclude the tax consequences to the shareholders of the deemed liquidation.

⁵⁰Reg. § 1.336-2(b)(1)(i)(A), -2(k), Ex. (6)(ii) (stating in a consolidated group context that sellers of a member of a group are not treated as having sold the stock of the target "for Federal income tax purposes").

⁵¹E's basis would be subject to the restriction of section 1015(a), limiting the basis for determining loss to the lower of the stock's fair market value or B's basis at the time of the gift.

considered to have received on December 31 the portion of X's grossed-up disposition proceeds allocated to his shares, and recognized gains (or loss) on the deemed liquidation. E's basis in the shares is then adjusted on January 1, year to equal the portion of grossed-up disposition proceeds allocated to his shares, and E starts a new holding period for the shares on the day following the disposition date.

Closing of the books election. Because A and B have terminated their entire interests in X, A and B may have agreed with their respective transferees to allocate X's income for the year on a closing of the books basis pursuant to section 1377(a)(2). However, because A is not treated as having transferred his stock until the disposition date on December 31, it appears that no such election would be available to A. Because B's transfer to E was not a disposition, the closing of the books election would be available for them. Under the closing of the books accounting on the actual stock transfer date (June 30) B would report a portion of the operating income allocable to his shares for half a year, with E reporting the remaining operating income and *all* of the deemed disposition gain realized by X allocable to his 20% stock interest in X. Depending on the amount of X income allocated to B, if B would have a basis in his X shares in excess of their fair market value, E would take a carryover basis from B (subject to use of lower fair market value as his basis in the shares for purposes of computing later loss).

If B had instead sold his shares to E (rather than gifted them), the consequences to B appear to be (1) inclusion of X's income for the year that is properly allocable to B (affected by whether the closing of the books method or default method of allocations was used by B and E), (2) recognition of gain on the sale of the shares (if any), taking into account basis adjustments for his allocation of X's income for the year under section 1367, and (3) disallowance of loss (if any) on the sale of the shares under section 267. E's tax consequences would be (1) inclusion of X's year one income allocable to E's shares that was not allocated to B, (2) recognition of gain on the deemed liquidation of the shares, as if he had received his share of the grossed up amount realized by X in liquidation, offset by any loss that had been disallowed on the sale of the shares under section 267(d) (if any), taking into account basis adjustments for his allocation of X's income for the year under section 1367. Although total taxable income is appropriately reflected for both parties (accepting the grossed-up disposition proceeds as fair market value), there is an opportunity for character mismatches between passthrough ordinary income and capital loss on the stock.

Thus, we recommend that, for S corporation targets, QSDs be limited to situations in which one or more dispositions of target stock comprising the QSD occur on a single day. Although Treasury and the Service should consider exceptions to this rule for public offerings, dispositions subject to binding contracts on the date of the first disposition included in the putative QSD and similar situations, we would not want to see the adoption of the basic rule delayed by such consideration.

C. Consistency Rule

In general, the principles of Regulation section 1.338-8 apply for a QSD for which no section 336(e) election is made. Those principles are modified in one important respect: the asset consistency rules may apply only to an asset that is owned immediately after the acquisition and on the disposition date by a five percent purchaser (including a person related to an actual five percent purchaser).⁵²

Broadly speaking, the section 338 consistency rules apply if (1) a purchasing corporation has made a QSP of a target; (2) the purchasing corporation (or a corporate affiliate) acquires a target asset during the consistency period;⁵³ (3) the asset is owned on the acquisition date for the QSP by the purchasing corporation (or a corporate affiliate), and (4) the target recognizes gain reflected in the basis of its stock under the investment adjustment rules of Regulation section 1.1502-32; but (5) no section 338 election is made for that purchase.⁵⁴ If those rules apply, the asset purchaser takes a carryover basis in the purchased asset.⁵⁵

Applying those principles as modified, the section 336(e) consistency rules apply if (1) stock of a target is sold, exchanged, or distributed in a QSD; (2) a 5% purchaser of the target stock (or a related person) acquires a target asset during the consistency period; (3) the asset is owned on the disposition date by the 5% purchaser (or the related person); and (4) the target recognizes a gain reflected in the basis of its stock under the investment adjustment rules of Regulation section 1.1502-32; but (5) no section 336(e) election is made for the disposition.⁵⁶

The statutory consistency rules in section 338, on which Regulation section 1.338-8 is based, were intended to prevent a corporation or affiliated group from selectively treating a target purchase “as a purchase of assets in part combined with a continuation of the tax attributes of the” target.⁵⁷ Those rules did not apply if a shareholder of the purchasing corporation, other than

⁵²Reg. § 1.336-1(a)(2) (defining a related person by reference to Regulation section 1.336-1(b)(12)), -1(a)(2)(b)(12) (defining two persons as related if stock owned by one person would be attributed to the other under section 318(a) (other than (a)(4)), except that neither section 318(a)(2)(A) nor (a)(3)(A) apply to attribute stock to or from a partner if the partner owns less than 5% by value of the partnership).

⁵³Generally, the consistency period should start one year before the beginning of the 12-month acquisition period and end one year after the acquisition date. I.R.C. § 338(h)(4)(A); Reg. §§ 1.338-2(c)(5), -8(j)(1).

⁵⁴See Reg. § 1.338-8(a)(2), -8(b)(1), 8(g) (extending the consistency rules in certain cases if the target paid dividends qualifying for a 100% dividends received deduction under section 243(a)(3)).

⁵⁵Reg. § 1.338-8(a)(2).

⁵⁶Reg. § 1.336-1(a)(2). For this purpose, the consistency period generally should start one year before the beginning of the 12-month disposition period and end one year after the disposition date. Cf. § 338(h)(4)(A).

⁵⁷S. COMM. ON FINANCE, TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, S. REP. NO. 97-494, at 512 (1982) [hereinafter TEFRA Report].

a corporate affiliate, acquired a target asset, even if that shareholder owned all the purchasing corporation's stock. Thus, the consistency rules were aimed at corporate-level selectivity (*i.e.*, a selective purchase of target assets and target stock by the purchasing corporation or its affiliated group).

The section 336(e) consistency rules attack a broader selectivity, potentially applying when a five percent purchaser or related person acquires a target asset, whether or not the asset acquiror is a corporation that becomes affiliated with the target. It is not clear why the section 336(e) consistency rule has a broader focus.

Example III.C.-1—Basic Operation of the Consistency Rules

P owns all the T stock, and P and T file consolidated returns. Fred owns all stock of X Corp. Neither Fred nor X is related to P. T sells an asset to Fred at a gain, and P reflects that gain in the basis of its T stock under the investment adjustment rules of Regulation section 1.1502-32. Shortly thereafter, P sells the T stock—either to X in a QSP⁵⁸ with no section 338 election, or to Fred in a QSD⁵⁹ with no section 336(e) election.

If P sells the T stock to X, the section 338 consistency rules do not apply, because Fred is not the purchasing corporation or a corporate affiliate of the purchasing corporation. Thus, Fred takes a cost basis in the asset purchased from T.

If, instead, P sells the T stock to Fred, the section 336(e) consistency rules apply, because Fred is a purchaser of at least five percent of the T stock. Thus, Fred takes a carryover basis in the asset purchased from T.

The policies that implicate the rules should be the same in either case, and following section 338 (and the limitations imposed by Congress), they should apply in neither case.⁶⁰ In addition, the stock ownership threshold for asset purchasers subject to the consistency rule should be changed to a 25% threshold or in any event to a much higher threshold than in the current five-percent rule. Further, to determine whether the consistency rule's stock ownership threshold is met, attribution of stock ownership between a partnership and its partners should be limited to partners with a 50%-or-greater partnership interest (or in any event a much larger interest than in the current rule).

⁵⁸§ 338(d)(3) (defining a QSP); *see also* Reg. § 1.336-1(b)(6)(ii)(A) (providing that if a transaction is a QSP, it will not be treated as a QSD).

⁵⁹Reg. § 1.336-1(b)(6)(i).

⁶⁰It may make sense to expand the consistency rules in either case to subject an asset or stock acquisition by a partnership to those rules if a purchasing corporation or its consolidated group owns an "affiliated" interest in the partnership. *Cf.* P.L.R. 2012-13-013 (Mar. 30, 2012) (concluding the consistency rule did not apply where a tiered partnership bought target stock and target assets).

D. *Disallowance of Net Loss in Stock Distribution*

In a taxable distribution of stock subject to a section 336(e) election, losses on deemed sales of assets are disallowed to the extent of the net loss, if any, recognized by the target.⁶¹ Although this rule is controversial, in these Comments we do not address whether this rule is appropriate in general. Assuming the rule will be retained, we recommend the following reductions in the scope of the rule to improve fairness and administrability.

1. *Distribution of Target Stock in Liquidation of Parent*

The net loss disallowance rule represents a compromise to implement the policies of section 311, while not disallowing excessive amounts of loss where gains are being taxed. This compromise is not consistent with the treatment of a deemed-asset sale. There, all losses would be allowed except to the extent otherwise provided by section 267. Nor is the compromise consistent with the treatment of a distribution of the target's assets. There, all losses would be disallowed, as was provided in the Proposed Regulations.

The compromise is roughly consistent with the treatment of a taxable distribution of the target stock, in that gains and losses of the target's assets are netted in determining gain or loss on the stock. (The consistency breaks down where the basis in the target stock differs from the target's net inside basis.) This rough consistency would appear to be the principal rationale for the compromise.

This rationale does not apply to a distribution of either target stock or target assets in a liquidation of the target's parent corporation. In such a situation, all losses would be allowed except to the extent provided in section 336(d)(2).⁶² Thus, an exception to loss disallowance should be adopted for a QSD that consists of one or more distributions of target stock to shareholders in a complete liquidation of the parent, unless section 336(d)(2) would disallow such loss.

2. *Correct Loss Disallowance Fraction*

If the QSD consists of both stock sales and distributions, the portion of the net loss that is attributable to the distributed stock is disallowed. The proportion of the net loss disallowed is determined by the "disallowed loss fraction":

$$\frac{\text{Value of all target stock distributed during 12-month disposition period}}{\text{Numerator} + \text{value of target stock sold and included in QSD}}$$

Values are determined as of the disposition date.

This disallowed loss fraction is weighted in favor of loss disallowance: The numerator includes all target stock distributed during the 12-month

⁶¹Reg § 1.336-2(b)(2)(ii)-(iii).

⁶²Section 336(d)(1) disallows a loss only where, *inter alia*, the distributee shareholder is a related person to the liquidating corporation, and section 336(d)(3) disallows losses only in section 332 liquidations. In neither case could the liquidation be a QSD.

disposition period, regardless of whether all of these distributions are included in the QSD. That is, the numerator includes stock distributed to a “related person” and stock distributed after the disposition date but within the 12-month disposition period. By contrast, stock sold is included in the denominator only if the stock sale is included in the QSD. Other stock that is sold, for example, to related persons, and stock that is neither sold nor distributed are excluded from both numerator and denominator.⁶³

In our view, the fraction that determines the proportion of loss disallowed should be revised to operate in a more balanced manner. The denominator should include all target stock sold during the 12-month disposition period, whether or not included in the QSD, in a manner consistent with the treatment of the stock distributions.

3. Determine and Compute Disallowed Net Loss on Aggregate Basis

In a taxable distribution of target stock with a section 336(e) election (protective or otherwise), losses on the deemed sale of target’s assets are disallowed to the extent of the net loss, if any. If the target has subsidiaries for which section 336(e) elections are also made, built-in gain or loss on the stock of such subsidiaries is disregarded, but the determination of net loss is made separately for each electing subsidiary. If a subsidiary has a net loss, that loss is disallowed even if the target itself and other subsidiaries have net gains.

Determining net gain or loss on a separate-entity basis is consistent with the mechanics of the transactions deemed to occur as a result of the election. Nevertheless, in our view, the requirement to make these separate-entity gain or loss determinations is not warranted from a policy perspective and is neither practical nor administrable. Accordingly, we recommend that the net loss determination be made for all electing corporations in the aggregate.

As discussed in Part IV.A. below, the net loss disallowance rule represents a compromise to implement the policies of section 311, while not disallowing excessive amounts of loss. This compromise is not consistent with either the treatment of a deemed asset sale or the treatment of a distribution of the target’s assets. The compromise is roughly consistent with the treatment of a taxable distribution of the target stock, in that gains and losses of the target’s assets are netted in determining gain or loss on the stock. In our view, determining and computing the disallowed loss on an aggregate basis is more consistent with the treatment of a taxable distribution of target stock than is the current entity-by-entity method.

Apart from this conceptual point, an aggregate method would have significant practical advantages. One of the benefits of the compromise is that it eliminates the need to value individual assets in many situations. The separate-entity method of determining and computing disallowed loss undercuts this benefit. It creates difficult valuation issues, especially where business operations are dispersed among subsidiaries, and there are contracts, loans,

⁶³Reg. § 1.336-2(b)(1)(iii).

leases, and other business arrangements among subsidiaries. Valuing assets within individual subsidiaries will be burdensome and will lead to uncertainties and controversies between taxpayers and the Service.⁶⁴ An aggregate method would eliminate these problems.

The separate-entity method of determining and computing net loss is not consistent with business practice, and some taxpayers will plan transactions without realizing that this method is required. In other words, the method is a trap for the unwary.

More important, taxpayers who are aware of the requirement are likely to avoid it by engaging in self-help, such as carryover basis transactions to move built-in gains or losses from one entity to another (for example, intercompany reorganizations, liquidations (including conversions to passthroughs) and section 351 transfers) and transactions to trigger recognition of losses (for example, intercompany sales of loss property). In our view, transactions to avoid the separate-entity rule are unproductive and should not be necessary. In the absence of further guidance, these self-help transactions will lead to controversies involving difficult issues under various anti-abuse regulations and judicial doctrines.⁶⁵

In our view, complications like these are generally undesirable, but they are particularly out of place in connection with a protective election that is intended never to take effect. Especially in this situation, it is not appropriate to complicate the election or its consequences unnecessarily, as the separate-entity method does.

In view of these considerations, we recommend abandonment of the separate-entity method of determining and computing net built-in loss. For purposes of determining and computing net built-in loss, lower-tier electing subsidiaries should be deemed liquidated upstream, ultimately into the distributed target, before the other deemed transactions.

If this recommendation is not followed, we recommend guidance to the effect that restructurings to net losses and gains within a single entity will be given effect for tax purposes so long as they have objective substance and are not transitory.

E. Kimbell-Diamond *Doctrine-Step-Transaction Considerations*

In this Part, we discuss the rationale for our recommendation that the *Kimbell-Diamond* doctrine not apply to create a deemed taxable purchase of

⁶⁴This problem is similar to the problem with the requirement in the proposed active trade or business regulations to locate goodwill within a group. Prop. Reg. § 1.355-3(b)(2)(iii).

⁶⁵The issues will be similar to those involved in anti-stuffing rules such as Regulation section 1.338-1(c) and section 382(l)(1).

corporate assets if a QSD is followed by a pre-planned liquidation or merger of the target, and no section 336(e) election is made.⁶⁶

In support of our recommendation, the discussion focuses on three points:

- The legislative history of section 338 establishes that Congress intended to eliminate any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine, regardless of whether the stock purchase qualifies as a QSP.
- If uncertainty remains as to whether the *Kimbell-Diamond* doctrine can still apply after enactment of section 338, the doctrine should be deemed either revoked or obsolete as a result of the subsequent repeal of *General Utilities* and the adoption of the regulations implementing section 336(e).
- Establishing a clear prohibition on the application of the *Kimbell-Diamond* doctrine to a QSD would protect the integrity of the election under section 336(e) and facilitate certain types of multi-step acquisitions, which are often undertaken for a wide variety of important business purposes.

A question also exists as to whether the *Kimbell-Diamond* doctrine may apply to create a deemed asset purchase in the case of other types of multi-step transactions that do not involve either a QSP or a QSD. Although we do not address these cases, our recommendation regarding QSDs is consistent with other written comments that have evaluated such cases in conjunction with QSDs.⁶⁷

⁶⁶These Comments do not include a detailed discussion of the rationale for applying step-transaction principles where no section 336(e) election is made, and the integrated transaction constitutes a reorganization. Such an approach is well established within the context of a QSP and should not be viewed as controversial in the context of a QSD. *See generally* Reg. § 1.338(h)(10)-1(e), Exs. (11)-(12); Rev. Rul. 90-95, 1990-2 C.B. 67 (Situation 2); Rev. Rul. 2001-46, 2001-2 C.B. 321 (*amplifying* Rev. Rul. 67-274, 1967-2 C.B. 141); Rev. Rul. 2008-25, 2008-1 C.B. 986. However, as compared with the situation of a first-step QSP, it would be unusual for a transaction to constitute a QSD and, at the same time, also qualify as a reorganization after integrating the second-step liquidation or merger of the target corporation.

⁶⁷*See, e.g.*, NEW YORK STATE BAR ASSOCIATION TAX SECTION COMMENTS ON KIMBELL-DIAMOND DOCTRINE (Oct. 24, 2014) [hereinafter NYSBA K-D Report], recommending that:

[The] tax consequences of the acquisition of the stock of a target corporation by an acquirer in a QSD or any other transaction that is not a QSP, followed by a liquidation or merger of the target . . . into the acquirer, should follow the form of the transactions, taking into account all other relevant transactions that occur in connection with the acquisition and the . . . liquidation or merger.

1. *Enactment of Section 338 and Congressional Intent to Eliminate the Kimbell-Diamond Doctrine*

a. Overview of the Kimbell-Diamond Doctrine. The *Kimbell-Diamond* case was decided in 1950.⁶⁸ Pursuant to the *Kimbell-Diamond* doctrine, a step-transaction analysis may be used to cause a first-step stock acquisition and a second-step liquidation or merger of the target into the acquirer to be treated as the acquirer's direct acquisition of the target's assets.⁶⁹

In such a situation, notwithstanding the form of the transaction, the acquirer obtains a tax basis in the target's assets equal to the price paid for the target's stock (plus the target's liabilities), rather than inheriting the target's historic basis in its assets, as would be the case if the second-step liquidation constituted a nontaxable event under section 332 or section 368.⁷⁰

However, under existing judicial authority, the tax treatment of the target and its shareholders is less certain. In general, the courts have applied the *Kimbell-Diamond* doctrine using an "asymmetric" model. Under this

⁶⁸*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). The Tax Court issued two opinions regarding the *Kimbell-Diamond* transaction. The first opinion was rendered in 1948 and dealt with an issue that was separate but related to the second opinion. See *Kimbell-Diamond Milling Co. v. Commissioner*, 10 T.C. 7 (1948). Most discussions of the "*Kimbell-Diamond* doctrine" typically refer to the holding set forth in the second opinion rendered by the Tax Court in 1950.

⁶⁹For a discussion of the specific legal issues involved in the two companion *Kimbell-Diamond* cases, which involved the involuntary conversion rules under the 1939 Code, and how any continued application of the *Kimbell-Diamond* doctrine outside that particular context is questionable, see NYSBA K-D Report, *supra* note 67, at 30 ("As a result of subsequent changes to Section 1033, the rationale for *Kimbell-Diamond* is now obsolete."). For another critique that also argues against any continued application of the *Kimbell-Diamond* doctrine, see Jasper L. Cummings, *Another Kimbell-Diamond Article!*, 143 TAX NOTES 707, 714 (May 12, 2014) ("The history explained above shows that there was no firm basis for making *K-D* a controlling principle of law in the first place. There is much less basis to keep it alive in 2014.").

⁷⁰See generally *Kimbell Diamond Milling Co.*, 14 T.C. at 80 ("the purchase of [the target corporation's] stock and its subsequent liquidation must be considered as one transaction, namely, the purchase of [the target corporation's] assets which was [the acquiring corporation's] sole intention").

approach, the transfer of stock by the target shareholders is respected, despite the fact that the acquirer is treated as acquiring the target's assets.⁷¹

b. *Enactment of Section 334(b)(2)*. Section 334(b)(2) was enacted in 1954, about four years after the decision in *Kimbell-Diamond*.⁷² Under section 334(b)(2), if an acquiring corporation acquired control of the stock of a target by purchase within a 12-month period and liquidated the target pursuant to a plan adopted within two years after the purchase, the acquirer's basis in the target assets would generally equal the cost of the target stock plus the target's liabilities. Consistent with the asymmetric *Kimbell-Diamond* doctrine, section 334(b)(2) affected only the purchaser's basis in the target's assets. The target shareholders were still treated as selling the target stock, and the target recognized no gain or loss.

The enactment of section 334(b)(2) eliminated the need to evaluate the subjective intent of the purchaser in connection with a taxable stock purchase followed by a liquidation. Under the House bill, the new rule would have applied to both individual and corporate purchasers.⁷³ However, the Senate version limited section 334(b)(2) to corporate purchasers.⁷⁴ In explaining the reason for the change, the Senate Report stated:

Under the House bill, a shareholder would in all cases be permitted to receive the purchase price for his stock as his basis for the assets distributed to him regardless of the assets' cost to the corporation. In this respect the principle of *Kimbell-Diamond Milling Company* (187 F.2d 718) was effectuated. *Since the application of the rule in this case is primarily in the area of liquidations by a parent corporation of its subsidiary, the rule has been limited by your committee to liquidations of this type.*⁷⁵

c. *Repeal of Section 334(b)(2) and Enactment of Section 338*. As part of the Tax Equity and Fiscal Responsibility Act of 1982, section 334(b)(2) was repealed and replaced by section 338.⁷⁶ Under section 338, a purchaser is

⁷¹ See, e.g., *Pittsburgh Realty Investment Trust v. Commissioner*, 67 T.C. 260, 276 (1976) (holding that the application of the *Kimbell-Diamond* doctrine does not warrant a recharacterization of the transaction other than for purposes of determining the acquiring corporation's tax basis in the target corporation's assets); see also *Dallas Downtown Development Co. v. Commissioner*, 12 T.C. 114 (1949), acq. 1950-1 C.B. 2; *Bethlehem Steel Co. v. Commissioner*, 9 T.C.M. (CCH) 864 (1950); *Vendig v. Commissioner*, 229 F.2d 93 (2d Cir. 1956); *Robert Campbell v. Commissioner*, 15 T.C. 312 (1950), acq. 1951-1 C.B. 1. For detailed discussions of the judicial authorities that have evolved in relation to the *Kimbell-Diamond* doctrine see, for example, Kimberly S. Blanchard, *Reflections on Rev. Rul. 2001-46 and the Continued Vitality of the Kimbell-Diamond Doctrine*, 200 TAX NOTES TODAY 2-34; Don W. Bakke, *Perspectives on Business Law: Dusting Off Kimbell-Diamond: The Continued Viability of the Asset Acquisition Doctrine for Non-Corporate Purchasers*, 28 WM. MITCHELL L. REV. 1443 (2002); see also NYSBA K-D Report, *supra* note 67, at 5-14; Cummings, *supra* note 69, at 713-14.

⁷² I.R.C. § 334(b)(2).

⁷³ H.R. REP. NO. 83-1337, at 38 (1954).

⁷⁴ S. REP. NO. 83-1662, at 48 (1954) (emphasis added).

⁷⁵ *Id.* (emphasis added).

⁷⁶ Pub. L. No. 97-248, § 338, 98 Stat. 324, 488 (1982).

not required to liquidate the target corporation and may instead elect to treat a QSP as involving an asset purchase. In large part, Congress enacted section 338 to eliminate the complexities and inconsistencies associated with the asymmetric nature of the section 334(b)(2) regime, which generally respected the existence of the target as a separate entity during the period following the target's acquisition and prior to its liquidation.⁷⁷

With respect to the general state of the *Kimbell-Diamond* doctrine, and in particular as it related to noncorporate purchasers, the Senate Report made this observation about the state of the law prior to the repeal of section 334(b)(2):

Cases interpreting the law applicable before the rules in section 334(b)(2) were adopted treated the purchase of stock and prompt liquidation in some cases as a purchase of assets It is not clear whether such treatment may still apply in some cases where the requirements of section 334(b)(2) are not met.⁷⁸

Furthermore, the Conference Committee Report stated:

The Senate amendment repeals the provision of present law (sec. 334(b)(2)) that treats a purchase and liquidation of a subsidiary as an asset purchase. *The bill is also intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine.* Instead, an acquiring corporation, [pursuant to the statutory provisions of section 338], may elect to treat an acquired subsidiary (target corporation) as if it sold all its assets in a complete liquidation on the stock acquisition date.⁷⁹

d. *Implications for QSDs.* We believe the legislative history to section 338 clearly establishes a general Congressional intent to eliminate any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine, regardless of whether the stock purchase in question qualifies as a QSP.

In particular, when viewing section 338 in historical context, it is evident that Congress first chose to move from the subjective state of the law as it existed under the *Kimbell-Diamond* doctrine to the objective requirements of section 334(b)(2). Moreover, in enacting section 334(b)(2), the Senate acknowledged that the primary context in which the *Kimbell-Diamond* doctrine was relevant involved a corporate acquirer (because a subsequent liquidation of the target would not result in a step-up in asset basis under section 332 or section 368). Therefore, section 334(b)(2) by its terms was limited to corporate purchasers. At the same time, noncorporate purchasers generally would have been able to obtain a step-up in asset basis in connection with an actual liquidation of the target corporation under sections 331 and 336.

⁷⁷ See generally TEFRA Report, *supra* note 57, at 191-192.

⁷⁸ *Id.* at 191 (citation to *Kimbell-Diamond* case omitted).

⁷⁹ S. COMM. ON FINANCE, TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, S. REP. NO. 97-530, at 536 (1982) (Conf. Rep.) (emphasis added).

Later, in repealing section 334(b)(2) and in migrating to the section 338 regime, the Senate once again considered the state of the *Kimbell-Diamond* doctrine and noted that it was unclear whether it still applied to noncorporate purchasers that were not subject to section 334(b)(2). The Conference Committee Report expressed a specific intent not only to repeal section 334(b)(2) as applied to corporate acquirers but to also simultaneously “replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine.”⁸⁰

In the end, we think Congress’s stated desire to eliminate the *Kimbell-Diamond* doctrine for all taxable stock purchases, including purchases effected by both corporate acquirers and noncorporate acquirers, is clear and logical in light of the history that preceded the enactment of section 338.⁸¹

2. *Repeal of the General Utilities Doctrine and the Adoption of Regulations Implementing Section 336(e)*

To the extent any uncertainty remains whether the *Kimbell-Diamond* doctrine can apply to a stock sale after enactment of section 338, the doctrine should be deemed revoked or obsolete as a result of the subsequent repeal of *General Utilities* and the adoption of regulations implementing section 336(e).

As noted above, the *Kimbell-Diamond* doctrine was typically applied in an asymmetric fashion. Only the acquirer was subjected to a tax fiction and treated as though it had purchased the target’s assets. The tax consequences followed the form of the transaction with respect to the target shareholders. As a result, no corporate-level tax was triggered even though the acquirer received a step-up in basis.

During the period prior to the repeal of *General Utilities* in 1986, this asymmetric application of the *Kimbell-Diamond* doctrine reflected a reasonable approach, because no corporate-level tax would have been triggered even if the doctrine had been applied on a symmetric basis to both the acquirer and

⁸⁰ *Id.* (emphasis added).

⁸¹ Most commentators agree with this conclusion. See, e.g., NYSBA K-D Report, *supra* note 67, at 29 (“The repeal of Section 334(b)(2) and the enactment of Section 338 shows that Congress intended to abolish the KD doctrine entirely.”); Cummings, *supra* note 69, at 709 (“The legislative history of section 338 clearly states that Congress intended its elections to wholly replace the K-D method of obtaining a cost basis in assets of a corporation whose stock was purchased, regardless of whether the integrated stock purchase qualified as a QSP”). But see Bakke, *supra* note 71, at 1470-71 (“As illustrated above, the corporate KD Doctrine has been largely preempted by section 338. The noncorporate KD Doctrine, in contrast, has not been specifically preempted, and presumably remains a viable doctrine.” (citation omitted)).

the target.⁸² However, following the repeal of *General Utilities*, asymmetric application of the *Kimbell-Diamond* doctrine would violate a Congressional tax policy imperative as the target's assets would escape taxation at the corporate level.⁸³ Therefore, if it is believed that Congress did not intend to eliminate the *Kimbell-Diamond* doctrine through the enactment of section 338, Treasury and the Service should deem the doctrine effectively revoked or made obsolete as a result of the 1986 Tax Act.⁸⁴

Furthermore, by enacting section 336(e) Congress sought to create an express statutory election for taxpayers to use in order to obtain asset sale and purchase treatment for QSDs. Accordingly, notwithstanding whatever impact the prior enactment of section 338 and the repeal of *General Utilities* may have had upon the *Kimbell-Diamond* doctrine, Treasury and the Service should deem the doctrine revoked or obsolete in relation to QSDs due to the adoption of regulations implementing section 336(e).

3. *Protecting the Integrity of the Election Under Section 336(e) and Facilitating the Use of Integrated, Multi-Step Transactions*

Treasury and the Service have worked hard to create final regulations under section 336(e) and to make a statutory election available to taxpayers in relation to QSDs. At the same time, taxpayers and their advisors have invested substantial amounts of time and energy to understand the new regulatory regime and to evaluate the circumstances under which a section 336(e) election either may or may not be available.

As a result, all constituencies will be best served by the issuance of definitive guidance which establishes the exclusivity of the section 336(e) election as the sole means of potentially obtaining asset purchase treatment in connection with a first-step QSD that is followed by the acquirer's liquidation or merger

⁸²Before the 1986 Tax Act, and in accordance with the holding of *Gen. Util. & Operating Co. v. Helvering*, 296 U.S. 200 (1935), under section 336 a corporation generally did not recognize any gain or loss on the distribution of its assets in partial or complete liquidation, and under section 337 a corporation did not recognize any gain or loss on any sale or exchange of property if, within a 12-month period, it adopted a plan of complete liquidation and distributed all of its assets (including the proceeds of any asset sales) in complete liquidation.

⁸³See generally revisions to sections 311(b) and 337 in the 1986 Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

⁸⁴See, e.g., NYSBA K-D Report, *supra* note 67, at 31 ("The enactment of Section 338 and the subsequent repeal of the *General Utilities* doctrine altered the statutory framework in which the KD doctrine had developed. Consistent with this change in statutory framework, the judicial and administrative authorities applying the KD doctrine to recast a stock purchase as an asset purchase generally are limited to transactions occurring before the enactment of Section 338 in 1982 and the repeal of the *General Utilities* doctrine in 1986." (citation omitted)); Blanchard, *supra* 71, at 1884 ("After the repeal of *General Utilities* in 1986, allowing [an asymmetric] treatment to continue is clearly intolerable if it avoids corporate-level tax to [the target corporation]."); Bakke, *supra* note 71, at 1475 ("Significantly, there has not been a reported case involving the noncorporate KD Doctrine since the repeal of *General Utilities*. This may well reflect an implicit recognition that the operating assumptions existing when [prior cases] arose do not exist anymore, bringing the validity of such cases into question.").

of the target corporation. The absence of guidance in this area will not only perpetuate unnecessary uncertainty, but it will also seriously undermine the integrity of the section 336(e) election and stand as an inexplicable deviation from the approach adopted by the regulations under section 338.

In our experience taxpayers often undertake multi-step acquisitions for a wide range of important business reasons, including the functional integration of operating divisions to achieve synergies, reduction of administrative burdens and overhead expenses, accommodation of debt covenants or other financing requirements, and simplification of the organizational and legal structure of the acquirer after an acquisition. In these situations, guidance which makes clear that the *Kimbell-Diamond* doctrine or other step-transaction authorities cannot apply to a first-step QSD that is followed by the acquirer's liquidation or merger of the target will be highly valuable and will help facilitate these meaningful business objectives.

4. Conclusion

We recommend that Treasury and the Service supplement the regulations under section 336(e) to confirm that the *Kimbell-Diamond* doctrine *will not apply* to a QSD that is followed by a liquidation or merger of the target, and if no section 336(e) election is made, unless the overall integrated transaction otherwise qualifies as a reorganization. We envision that these additional regulatory provisions would be very similar to those already set forth in Regulation sections 1.338-3(d) and 1.338(h)(10)-1(e), Examples 11, 12, 13, and 14, and that the preexisting regulatory provisions under section 338 could be incorporated by reference and modified, as appropriate, to align with the specific context of a first-step QSD.

F. Excess Loss Accounts

If a member disposes of target stock in a QSD with a section 336(e) election, and if the target stock has an ELA, the ELA generally should not be triggered. In most cases, an ambiguity makes that result uncertain. However, if the election is made for a distribution subject to section 355(d) or (e), the result under the regulations is that the ELA is triggered.

1. General Rule

Generally, a group member takes an ELA in a subsidiary share into account when the member is treated as disposing of the share. For that purpose, a share is disposed of when the member transfers or otherwise ceases to own the share for federal income tax purposes. If the subsidiary liquidates, and section 332 applies to the liquidation, however, any ELA in its shares disappears without being triggered.⁸⁵

If an election is made for a QSD other than a section 355(d) or (e) distribution, “[i]n general” the seller is treated as not transferring target stock, and

⁸⁵Reg. § 1.1502-19(b)(1)(i), (b)(2), (c)(1)(i)(A).

the seller is treated as receiving a distribution in liquidation of the target, a liquidation to which section 332 typically applies.⁸⁶ If section 332 applies to the deemed liquidation, the seller should not trigger any ELA on target stock that it transfers in the QSD.

It is not clear, however, when, if ever, an exception to the general rule applies. If the general rule does not apply, the ELA will be triggered, because the seller will be treated as having transferred shares to a nonmember for federal income tax purposes. Following the principles of section 338(h)(10), the ELA should never be triggered on target stock disposed of in the QSD if the target's deemed liquidation is described in section 332.⁸⁷ The regulations should make that point clear.

2. Section 355(d) or (e) Stock Distribution

The section 336(e) regulations do not afford the same ambiguity when an election is made for a section 355(d) or (e) distribution. With this election, the target is not deemed to liquidate. Thus, if the target stock is distributed by a consolidated group member to a nonmember, and the distributed stock has an ELA, the ELA is triggered by the distribution (*i.e.*, it is treated as a disposition under Regulation section 1.1502-19).⁸⁸

The target is not deemed to liquidate in these situations, in order to preserve the target's tax attributes, including earnings and profits.⁸⁹ However, just as with the general election, the target is deemed to sell its assets in a fully taxable sale, and, as with the general election, we believe it is the fully taxable sale that justifies eliminating the ELA. To provide for that result, the regulations could be amended to state that, for purposes of Regulation section 1.1502-19(b)(2)(1), the target is deemed to liquidate.⁹⁰

G. Other S Corporation Matters

Over 20 years ago Treasury extended section 338(h)(10) elections to purchases of S corporations through Regulation section 1.338(h)(10)-1. The application of section 338(h)(10) to S corporations solved practical business problems associated with asset sale structures and has been very useful in avoiding nontax frictional costs in sales of S corporations. The consequences and mechanics of these elections for S corporation targets and their shareholders are well understood by the relevant community of taxpayers and their

⁸⁶ Reg. § 1.336-2(b)(1)(i)(A), -2(b)(1)(iii)(A).

⁸⁷ Rev. Rul. 89-98, 1989-2 C.B. 219; P.L.R. 91-42-013 (Oct. 18, 1991).

⁸⁸ Reg. §§ 1.336-2(b)(2)(i)(A)(I), 1.1502-19(c)(1)(ii).

⁸⁹ Prop. Reg. §§ 1.336-2(h)(2), 1.336-4(c)(4), 73 Fed. Reg. 49,965, 49,968 (Aug. 25, 2008) (preamble to proposed regulations discussing election for distribution to which section 355(d) or (e) applies).

⁹⁰ *Cf.* Reg. § 1.336-1(b)(2)(i)(A)(2) (target deemed to liquidate for purposes of applying Regulation section 1.1502-13(f)(5)(ii)(C) if an election is made for a section 355(d) or (e) distribution).

advisors and these elections are now commonly used for corporate acquisitions of S corporations.

As proposed in 2008, the section 336(e) regulations would not have allowed section 336(e) elections for acquisitions of S corporations. Subsequent comments on the Proposed Regulations correctly observed that the policy objectives that had warranted the extension of section 338(h)(10) elections to S corporations were equally applicable to section 336(e) elections.⁹¹ There is no question that parallel treatment under section 336(e) would be appropriate from a policy perspective. However, the comments did not provide any detailed suggestions as to how to implement section 336(e) for S corporations.

Without having received detailed comments on the application of the Proposed Regulations for S corporations, the final section 336(e) regulations appear to assume that reference to the principles of Regulation section 1.338(h)(10)-1 will provide adequate guidance for such transactions. However, unless the regulations are modified, there are differences in the operation of section 336(e) for S corporations that present some difficult issues for S corporations that might make this election.

1. *Complex Structure of the Regulations*

The extension of section 336(e) to S corporations was accomplished by weaving the discussion of elections for S corporations into the previously drafted regulations. This approach, together with the liberal use of possibly confusing defined terms, makes it difficult to find and understand the essential rules for S corporations without detailed study of the regulations. Points of likely confusion to a reader include:

- The term “seller” is used to refer only to a *corporate* seller of stock of a target corporation, and generally⁹² does not include S corporation shareholders who sell stock of a target.⁹³ We think the regulations would be easier to understand if the terms “corporate transferor” and “subchapter S transferor” were consistently used where appropriate.
- The term “S corporation shareholders” creates ambiguity because it is often used in a way that does not specify the temporal aspect of the definition. This leaves it unclear whether the term refers to shareholders of the S corporation (1) at any time during the 12-month disposition

⁹¹ Letter from New York State Bar Association Tax Section, submitting comments on Prop. Reg. § 1.336, TAX NOTES (TA) (Dec. 31, 2008).

⁹² Because section 1361(c)(6) permits corporations that are exempt from tax under section 501(a)(3) to be S corporation shareholders, the definition of “seller” may also overlap with the “definition of S corporation shareholder. The appropriate fix would be to exclude any “S corporation shareholder” from the meaning of “seller.” (Revision to the definition of “domestic corporation” to exclude such exempt organizations would inappropriately exclude such corporations from status as an permissible target corporation.)

⁹³ This problem is compounded by the use of the term “seller” in many headings in the regulations, when the material under the heading also applies to S corporation shareholders.

period, (2) at any time in the taxable year in which the QSD occurs, or (3) as of the disposition date.⁹⁴ This temporal aspect is made even more uncertain by the treatment of persons who made a disposition in a QSD as not having disposed of their S corporation stock until the deemed liquidation on the “disposition date,” and by the treatment of persons who acquired stock in the S corporation in a disposition during the “12-month disposition period.” We believe it would be helpful to use defined terms to distinguish between persons who are sellers of S corporation stock in dispositions counted toward a QSP (such as “disposing S corporation shareholders”) and other S corporation shareholders. It would also be helpful to clarify which stockholders will be required to report pass-through income under section 1366 that constitute “deemed disposition tax consequences.”

- The term “disposition” is used to refer only to transfers of stock that count toward a particular “qualified stock disposition,” and can easily be misunderstood to be used in the colloquial sense of “sale, exchange or other transfer.” We think it would be helpful to refer to “dispositions” as “eligible dispositions.”
- The term “qualified stock disposition” appears to be intended to describe the effect of one or more “dispositions” that together satisfy the >80% acquisition requirement during a disposition period, but the term easily can be misunderstood to refer to any particular “disposition” that can contribute to completion of a QSD.⁹⁵ The regulations even appear to make this mistake on occasion.⁹⁶ We think it would be helpful to clearly separate these concepts, perhaps by defining a term such as “qualifying disposition” where the intention is refer to a particular disposition that may count toward satisfying the $\geq 80\%$ acquisition requirement (without regard to whether it will actually be part of a QSD).

More generally, Regulation section 1.336-2 suffers from a complex substructure, sometimes extending to six sublevels. We expect that practitioners without substantial experience with these regulations will likely find it difficult to readily identify the relevant guidance in the regulations, and may not understand the collateral economic effects of these transactions well enough to properly address them in the transactional documents related to a stock disposition (or in stockholders’ agreements that may contemplate such transaction).

⁹⁴ See *infra* Part G.2 discussing the uncertainty as to which stockholders are required to join in the section 336(e) election agreement.

⁹⁵ This ambiguity exists under section 338(d)(1) and (3) as well with respect to “qualified stock purchase,” but creates less risk of confusion because there is only a single acquiror (or group acquiror) in a QSP.

⁹⁶ See Reg. § 1.336-1(b)(5) (describing a “seller” as a corporation that makes a “qualified stock disposition” of stock). Properly stated, the definition would describe “a corporation that makes a disposition of stock that is included as part of a qualified stock disposition.”

We recommend that regulations be adopted to cover the treatment of section 336(e) elections for S corporation targets in a separate section, which specifically cross-references general principles found in the regulations under sections 336 and 338 that are applicable (or inapplicable) to S corporations.

We also recommend that the regulations provide examples that clearly illustrate the intended operation of section 336(e) for S corporations.

2. Identification of S Corporation Shareholders to Join in the Election

The section 336(e) election is made by the “S corporation shareholders” being a party to an agreement described in Regulation section 1.336-2(h)(3)(i) (the “section 336(e) election agreement”). An “S corporation shareholder” is defined in Regulation section 1.336-1(b)(4), as well as in Regulation section 1.338(h)(10)-1(b)(5), as “the S corporation target’s shareholders” (whether or not they sell their stock in the QSD or QSP).

In the context of a section 338(h)(10) election, the regulation is generally understood to refer to the shareholders of the target on the “acquisition date” (date of the QSP).⁹⁷ The absence of clear language referring to all shareholders during the year of the election suggests that the section 338(h)(10) and section 336(e) regulations intended only that the shareholders as of the date of the QSP or QSD are required to be a party to the election.⁹⁸

However, in light of the rule that a seller in a QSD is not treated as having sold his stock, but instead as having remained as a stockholder through the disposition date,⁹⁹ it is possible that the section 336(e) regulations intended that the reference to “S corporation shareholders” would include former stockholders who are deemed to be owners of S corporation target stock through the disposition date (and to exclude all shareholders who acquired stock during the disposition period).

In the case of a QSD, the effect of this ambiguity is further increased because the shareholders whose stock sale would create the QSD may have sold their stock at any time in the preceding 12 months, which may be in a preceding taxable year of the S corporation. As a practical matter, it would be a surprising result to require shareholders who were not shareholders at

⁹⁷Whether the regulation should be interpreted to require election by all persons who were target shareholders at any time during the taxable year in which the QSP occurs is unclear. A shareholder who disposes of his stock may protect himself by requiring in connection with the disposition of his stock that the buyer (or the corporation and all stockholders) consent to a closing of the books election under section 1377(a)(2)(B) or Regulation section 1.1368-1(g)(2). However not all stock sales will be covered by these provisions, so that some shareholders unavoidably will be exposed to the risk of unanticipated tax consequences from a QSP occurring in the same year as their sale of stock, even though they were not aware of the subsequent transactions that would permit a section 336(e) election to be made, unless they can contractually prohibit the making of such an election without their consent.

⁹⁸*Cf.* Reg. § 1.1368-1(g)(2)(iii) (requiring that “each shareholder who held stock in the corporation during the taxable year (without regard to the election under Regulation section 1.1368-1(g)(2)(i)) consents to this election”).

⁹⁹Reg. § 1.336-2(b)(1)(i)(A).

all during the year of the QSD to report gain on a deemed sale of assets of the corporation as a result of a QSD. Unless this extended period of deemed ownership was intended, there seems to be no reason to require consent of the selling S corporation stockholders during the portion of the disposition period that was in a prior year of the target corporation.

What is essential is that the regulations make clear who must participate in the section 336(e) election agreement for the election to be valid. Clarity on this point will also permit S corporation shareholders to enter into stock sale agreements that correctly reflect the extent (if any) to which they retain control over whether a section 336(e) election will be made. If our separate recommendation to restrict the disposition period to a very short period is adopted, concerns about disadvantages to former shareholders will be reduced, but will still exist.

A well-advised terminating shareholder can obtain contractual protection from an unexpected allocation of S corporation deemed disposition income by entering into an agreement to allocate income under the closing of the books method pursuant to section 1377(a)(2). However, as a policy matter, we believe that it is preferable to include as required participants in the section 336(e) election all persons who would experience a section 1366 flow-through tax effect as a result of the deemed disposition tax consequences of the section 336(e) election. We recognize that many shareholders, particularly employee shareholders, may not be aware that on a disposition of stock the pro-rata per diem allocation default rule exposes them to the risk of changed tax consequences due to a later occurring QSD. Although the section 338 regulations apparently assume that shareholders would be adequately protected by the availability of section 1377(a)(2) agreements, we think that the circumstances under which a section 336(e) election might be made warrant a higher level of protection for former shareholders who are not disposing of stock in the QSD.

Balanced against this concern for former stockholders, we are also sensitive to the practical difficulty of marshalling all the required agreements from a potentially large group of shareholders so that acquirors can have a high level of assurance of the validity of the section 336(e) election.

We think a reasonable compromise of these competing concerns would be (1) to not require former stockholders whose transfer of stock is not a disposition that counts toward the $\geq 80\%$ target stock threshold to be a party to a section 336(e) election agreement, (2) if a section 336(e) election is made, to reverse the default allocation method for former shareholders to be a closing of the books method, (3) to make clear that the written agreement of shareholders to make the section 336(e) election can be obtained in advance without regard to any specific QSD (for instance by inclusion in a shareholders' agreement), and (4) a shareholder may authorize another person to enter into a section 336(e) election agreement on his behalf by a power of attorney specifically granted for that purpose.

Thus, we make the following recommendations:

- All persons who are actually stockholders of a S corporation target on the disposition date and all former stockholders who are “affected stockholders” with respect to the taxable year of the S corporation target in which the QSD occurs must be parties to a section 336(e) election agreement as described in Regulation section 1.336-2(h)(3).
- “Affected stockholders” include (1) all former stockholders of the S corporation target who will be deemed to hold S corporation stock on the disposition date by reason of the section 336(e) election (that is, all stockholders who made a “disposition” during the disposition period) and (2) all other former stockholders who held stock of the S corporation Target at any time during the taxable year of the target ending on the disposition date, other than any stockholder who, pursuant to a written agreement (or by default rule), will be allocated income for that taxable year based on the closing of the books method pursuant to section 1377(a)(2) (a section 1377(a)(2) agreement).
- The requirement for a section 336(e) election agreement under Regulation section 1.336-2(h)(3) or a section 1377(a)(2) agreement if necessary, will be considered satisfied for any stockholder or former stockholder by a binding agreement to which the S corporation target is a party (such as a stockholders’ agreement) if that agreement requires such stockholder to join in either such election, or authorizes the corporation or one of its officers to make such election on behalf of such stockholder, and may be executed on behalf of such stockholder under power of attorney granted for such purpose.
- The section 336(e) regulations should deem an election to be made under section 1377(a)(2) to use the closing of the books method of allocation for any former S corporation stockholder who is not a party to a section 336(e) election agreement.

3. *Inapplicability of Consistency Rules to S Corporations*

As explained in ANALYSIS Part III.C., above, the consistency rules were aimed at corporate-level selectivity (*i.e.*, a selective purchase of target assets and target stock by a purchasing corporation or its affiliated group). Accordingly, the section 338(h)(10) regulations narrowed the consistency rules in the domestic context generally to apply only to cases in which the target corporation is a subsidiary in a consolidated group, such that the consolidated return investment adjustment rules cause gain on the sale of an asset of the target to be reflected in the basis of the target’s stock, and thus reduce the gain that would be recognized by the selling parent corporation if a section 338 election is not made.¹⁰⁰ These consistency rules do not apply to acquisitions of assets of an S corporation target in connection with a section 338(h)(10) election.

¹⁰⁰Reg. § 1.338-8(a)(2).

Notwithstanding the clear inapplicability of the consistency rules to S corporation targets under section 338, the increase in basis of stock of an S corporation resulting from gain recognized on a sale of an asset of the S corporation target to a person acquiring stock of the S corporation target may appear to be similar to the consolidated return investment adjustment rules, in that the target's gain recognition reduces the gain recognition to the selling shareholder.

By referencing the "principles" of the section 338 regulations, the section 336(e) regulations may create unnecessary concern for taxpayers and advisors, who are not familiar with the consolidated-return based rationale for the consistency rules.

Thus, we recommend that the section 336(e) regulations specifically state that no asset or stock consistency rules apply to purchases of stock of an S corporation target, or stock of a subsidiary of an S corporation target.

4. *Spin-off of QSub to be Treated as a Disposition*

Section 336(e) elections provide welcome relief from the risk of double taxation protection in the case of a distribution of a subsidiary of the S corporation in a transaction intended to qualify under section 355.¹⁰¹ Gain may be recognized at the corporate level because of the applicability of section 355(d) or (e), or because the transaction fails to qualify at all under section 355. We have made recommendations elsewhere in this report to make the benefit of section 336(e) elections more broadly applicable to these situations because the election provides an appropriate correlative basis increase for gain that has been taxed to the shareholders of the distributing S corporation.

Typically, if an S corporation makes a section 355 distribution, it distributes stock of a wholly owned subsidiary, a subsidiary that is a QSub immediately before the distribution.¹⁰² A QSub is treated as a disregarded entity for income tax purposes until it ceases to be wholly owned by an S corporation. Upon a transfer of any of its stock the QSub becomes a corporation for income tax purposes. Generally, the conversion from disregarded entity to corporate status is characterized as a transfer of assets of the QSub as a contribution to capital of a new corporation in exchange for stock of the former

¹⁰¹Whether double taxation occurs in this context depends on whether the controlled corporation becomes an S corporation after the distribution. If it is a C corporation after the distribution, the unrealized gain in assets (in the absence of an election under section 336(e)), would thereafter be exposed to corporate level tax if it were later recognized. If it is an S corporation after the distribution, the unrealized gain in the assets will not be subject to corporate level tax but that gain may distort the shareholders' tax liabilities, because its later recognition by the controlled corporation will result in a second round of individual tax incurred on the gain, a gain that was already taxed on distribution of the stock. This tax on this duplicated individual-level gain may be later recouped through a correlative capital loss in the stock of controlled corporation, but the ability of that loss to offset other income will be limited because it will be a capital loss.

¹⁰²I.R.C. § 1361(b)(3).

QSub. The precise form of the incorporating recast depends on whether the transfer of the QSub's stock is a sale or some other type of transfer.

In general, upon termination of QSub status, the S corporation is deemed by statute to transfer all of the assets of the QSub to a corporation in exchange for all of stock of the corporation in a transaction that would normally qualify for nonrecognition under section 351.¹⁰³ If the transaction that caused the termination of QSub status was a sale of the QSubs stock by the S corporation, the effect of this characterization was to cause the S corporation to recognize gain on *all* of the QSub's assets in a busted section 351 transaction if the S corporation had sold more than 20% of the stock of a QSub.

To prevent this inappropriate full gain recognition event, the statute was amended to recharacterize the deemed transaction that results on a termination of QSub status by reason of a partial "sale" of stock of the QSub. In that case, the S corporation is deemed to transfer to the purchaser an undivided share in the assets of the QSub corresponding to the percentage of the QSub stock sold, and then the S corporation and the purchaser are deemed to contribute their respect share of the QSub's assets to a newly formed corporation in exchange for stock of the corporation.¹⁰⁴ This second step will normally be a nonrecognition transfer for the QSub under section 351. The result is that the S corporation recognizes gain only on the portion of the assets of the QSub that were deemed sold to the purchaser, and avoids gain recognition on the retained interest in the former QSub.

In a distribution that qualifies as an intended section 355 distribution, these rules work correctly by treating the distribution by the S corporation as a distribution of stock of the former QSub so as to satisfy the distribution requirement of section 355. If section 355(d) or (e) applies, the distributing S corporation will recognize gain (but not loss) on the distribution of the stock of the QSub under section 355(c)(2)(A)(ii) "as if such property were sold to the distributee at its fair market value." This gain would be reported by the S corporation's shareholders under section 1366, but would not be reflected in the basis of the former QSub's assets after the distribution. In such a case it is appropriate that an election be available under section 336(e).

If the distribution completely fails to qualify under section 355, the proper characterization of the transaction is uncertain. The S corporation may be treated as having distributed the assets held by the QSub to its shareholders, or may be treated as having distributed the QSub stock. In either case, gain (but not loss) would be recognized by the distributing S corporation under section 311(b) "as if such property were sold to the distributee at its fair market value."

The characterization of the distribution as being of assets or stock depends on whether the transfer of stock in a gain recognition transaction under

¹⁰³ § 1361(b)(3)(C)(i).

¹⁰⁴ § 1361(b)(3)(C)(ii). The Regulations under this section have not been updated to reflect this amendment, and accordingly do not presently describe the effect of these transactions.

section 355(c)(2)(A)(ii) or 311(b) is considered to be a sale for purposes of section 1361(b)(3)(C)(ii). If the distribution is treated as a “sale” for this purpose, then the distribution is a distribution of assets of the QSub, on which the distributing S corporation recognizes gain, the shareholders take a fair market value basis in the distributed assets, and are deemed to contribute those assets to a new corporation in a transaction under section 351, resulting in a carryover fair market value basis. If the transaction is not treated as a sale, then the transaction is treated as section 351 contribution by the S corporation to a newly-formed corporation, and a distribution of stock of that newly-formed corporation on which the distributing S corporation would recognize net gain equal to the excess of the fair market value of the stock over its tax basis determined under section 358.

Ultimately, the difference between these two transactions is that if the transaction is recast as a distribution of assets, the distributing S corporation will recognize gain but not loss on each of the assets distributed, but if the transaction is treated as a stock distribution, the distributing S corporation will be entitled to offset gains and losses on the discrete assets (but not produce a net loss).¹⁰⁵

We recommend that the regulations under either section 336(e) or section 1361(b)(3) be amended to clarify that distributions by an S corporation of the stock of a QSub to which either section 311 or section 355(d) or (e) applies will be treated as a “sale” of the QSub stock by the S corporation for purposes of section 1361(b)(3)(C)(ii). As a result, the S corporation would be deemed to distribute assets rather than stock, and a protective section 336(e) election would be unnecessary for a distribution of stock of a QSub that fails to qualify for nonrecognition at the corporate level.

H. *AGUB, Gain Recognition Election and Nonrecently Disposed Stock*

If a section 336(e) election is made, the target is deemed to acquire its assets in a single transaction from an unrelated person for an aggregate amount equal to the adjusted grossed-up basis (AGUB).¹⁰⁶ For the reasons noted below, we recommend the following revisions to the regulations:

- The computation of AGUB is unnecessarily complex and should be clarified and simplified.
- The definition of “nonrecently disposed stock,” a factor in the computation of AGUB, should be narrowed.
- Losses as well as gains should be recognized and allowed to holders of nonrecently disposed stock that make (or are deemed to make) the gain recognition election.

¹⁰⁵Reg. § 1.336-2(b)(1)(ii)(B)(iii).

¹⁰⁶Reg. § 1.336-4(a).

1. *Clarifying and Simplifying AGUB Computation*

Generally and except as the context requires, AGUB in a QSD with a section 336(e) election is determined using the principles of Regulation section 1.338-5.¹⁰⁷ In applying those principles, terms used in Regulation section 1.338-5 are to be read as follows:

- The “purchasing corporation” refers to any purchaser of target stock in the QSD.
- The “acquisition date” refers to the disposition date.
- A “section 338 election” (including a “section 338(h)(10) election”) refers to a section 336(e) election.
- “Recently purchased stock” refers to recently disposed stock.
- “Nonrecently purchased stock” refers to nonrecently disposed stock.

a. *Multiple Purchasers.* In some situations, it is not clear how the principles of Regulation section 1.338-5 apply to QSDs, because section 338 assumes a single purchaser, whereas section 336(e) allows multiple purchasers.

For purposes of section 338, AGUB equals the sum of (1) the grossed-up basis in the *purchasing corporation's* recently purchased stock, plus (2) the *purchasing corporation's* basis in nonrecently purchased stock, plus (3) the target liabilities.¹⁰⁸ Adapting that formula to section 336(e), a literal reading of Regulation section 1.336-4 suggests that a grossed-up basis amount must be calculated separately for each purchaser and then combined, since a reference in Regulation section 1.338-5 to the “purchasing corporation” is read as a reference to “a” purchaser.¹⁰⁹

If a separate AGUB computation must be made for each purchaser, however, it creates some uncertainty about how each purchaser should gross up its basis of recently disposed stock and how the target's liabilities should be allocated among the purchasers. For example, should each purchaser's basis in recently disposed stock be grossed up separately, and if it is, should the value of that stock be determined when it was disposed of or on the disposition date? Further, should liabilities be determined when the stock was disposed of or on the disposition date?

Those and other questions are neatly avoided if the AGUB is computed for all purchasers collectively, an approach suggested by the context of the regulations. First, the regulations provide for no adjustments to the section 338 AGUB formula to account for multiple purchasers. That formula assumes a single computation, not only because it takes into account all target liabilities but also because it determines a value for all the target stock. Second,

¹⁰⁷ *Id.*; Reg. § 1.338-5(a); *see also* I.R.C. § 338(a)(2). It is not clear when the context would require that those principles do not apply. The Regulations do not provide general principles to determine that context.

¹⁰⁸ Reg. § 1.338-5(b)(1).

¹⁰⁹ Reg. § 1.336-4(b)(1).

the section 336(e) regulations expressly provide for a purchaser-by-purchaser determination for just one aspect of the AGUB computation.¹¹⁰ That exceptional treatment implies that the AGUB formula generally contemplates a collective computation. Finally, the regulations provide an example that assumes a collective computation.¹¹¹

Thus, AGUB should equal the sum of:

- The aggregate grossed-up basis in the purchasers' recently disposed target stock,
- The purchasers' aggregate basis in nonrecently disposed target stock, and
- The liabilities of the new target.

We recommend that the regulations be revised to eliminate the uncertainty and spell out this formula explicitly.

b. *Simplifying the AGUB Formula.* For AGUB purposes, nonrecently disposed target stock is target stock that meets three requirements:

- It is not recently disposed target stock.¹¹²
- On the disposition date, it is held by a purchaser or person related to a purchaser.
- On that date, the holder owns, actually and constructively, at least 10% of the total voting power or value of the target stock.¹¹³

AGUB takes into account the holder's aggregate basis in nonrecently disposed target stock. Basis in that stock may be adjusted if the purchaser makes (or is deemed to make) a gain recognition election.¹¹⁴ This election is deemed made by any 80% purchaser or any person related to the 80% purchaser for its nonrecently disposed target stock. Any other person must affirmatively make the gain recognition election.¹¹⁵

If an owner makes (or is deemed to make) a gain recognition election for its nonrecently disposed target stock, it is deemed to sell that stock on the

¹¹⁰Reg. § 1.336-4(c)(1) (providing that the gain recognition election is made with reference to each owner's stock, rather than in the aggregate).

¹¹¹Reg. § 1.336-4 (d), Ex. (1) (involving collective computation but only where the target has no liabilities).

¹¹²Recently disposed target stock is target stock (1) that is not held by the seller, a member of the seller's consolidated group, or an S corporation shareholder immediately after the disposition date and (2) that was disposed of by the seller, a member of the seller's consolidated group, or an S corporation shareholder during the 12-month disposition period. Reg. § 1.336-1(b)(17).

¹¹³Reg. § 1.336-1(b)(18) (ownership determined by applying section 318(a), other than section 318(a)(4)).

¹¹⁴Reg. §§ 1.336-4(c), 1.338-5(d)(1), -5(d)(3).

¹¹⁵Reg. § 1.336-4(c)(2), -4(c)(3).

disposition date for its “basis amount,” recognizing all of its realized gain but none of its realized loss.¹¹⁶

The “basis amount” for that stock equals $A*B/C$, where –

- A = The owner’s basis in recently disposed target stock at the beginning of the day after the disposition date (determined without taking capitalized, third-party acquisition costs into account).¹¹⁷
- B = The percentage of the target stock owned by the owner (by value, determined on the disposition date) that is nonrecently disposed stock.
- C = The percentage of the target stock owned by the owner (by value, determined on the disposition date) that is recently disposed stock.

As currently drafted, the regulations actually require computations under two formulas that reach the same results as this combined formula.¹¹⁸ As a simplification measure, we recommend that the section 338 regulations be redrafted to state the combined formula.

2. *Narrowing Definition of Nonrecently Disposed Stock*

The gain recognition election under section 336(e) mirrors the election under section 338(b)(3).¹¹⁹ The latter election applies to nonrecently purchased target stock held by the purchasing corporation, and if the election is made, the purchasing corporation recognizes gain but not loss on that stock.¹²⁰ A gain-recognition election is deemed to occur in a section 338(h)(10) transaction.

Through a QSP, the purchasing corporation becomes affiliated with the target, and, if it liquidates the target, it eliminates its built-in stock gain without tax, gain that would have been recognized if the target had sold its assets and liquidated. AGUB preserves that built-in gain but moves it to the target’s assets unless the gain recognition election is made. Thus, the preserved built-in gain in the target assets is a surrogate for the built-in gain in the purchasing corporation’s nonrecently purchased stock. If the gain recognition election is made, the gain in the stock is recognized and potential asset gain eliminated.

Under section 336(e), however, AGUB and the gain recognition election often work in tandem to duplicate gain but rarely to prevent its elimination. Because AGUB takes into account purchasers’ bases in nonrecently disposed stock, if that stock has built-in gain, AGUB preserves that gain in the form

¹¹⁶Reg. § 1.338-5(d)(3)(i)(A), -5(d)(3)(iii).

¹¹⁷Those capitalized costs are described in Regulation section 1.338-5(c)(3).

¹¹⁸The text simplifies the formula set forth in the regulations: $A * (B / (100 - B)) * ((100 - B) / C)$. Reg. § 1.338-5(d)(3)(ii), -5(c)(1), -5(c)(2). The formula set forth in the regulations does not work in one obvious case: If the owner actually owns no recently disposed target stock, the denominators in the gain recognition formula are both zero, so that each fraction in the formula would be undefined.

¹¹⁹Compare Reg § 1.336-4(c)(1), with Reg. § 1.338-5(d)(3).

¹²⁰Reg. § 1.338-5(d)(3).

of a reduction to new target's asset basis, unless a gain-recognition election is made. If the election is made or deemed made by a purchaser, the purchaser and any related person recognize gain but not loss on his, her, or its nonrecently disposed stock.

Unlike the situation under section 338, rarely is the person recognizing this gain a corporation that becomes affiliated with the target through a QSD. Thus, the target's liquidation rarely eliminates built-in stock gain without tax. That means that the gain recognition and AGUB rules under section 336(e) work in tandem to solve a problem that rarely exists, instead generally duplicating corporate-level gain (or loss).

The following examples illustrates the overbreadth of the section 336(e) rules, beginning with an example illustrating the section 338 rules and followed by a similar example illustrating the section 336(e) rules:

Example III.H.-1—Gain Recognition and AGUB Rules under Section 338

T is a subsidiary of a consolidated group, and P, the group's common parent, owns 80% of T's single class of stock. Fred, who is not related to P, owns the remaining 20% of that stock. Fred's T stock has a \$20 basis and \$200 value. T has one asset with a \$100 basis and \$1,000 value. T has no liabilities. X, a corporation not related to P, buys all of P's T stock on one day for \$800. Fred retains his T stock. X has made a QSP of T. A section 338(h)(10) election is made.

T is deemed to sell its asset for \$1,000, recognizing a \$900 gain, and "new T" is deemed to purchase the asset for the same amount, taking \$1,000 basis. Fred's basis in his T stock is irrelevant, because his T stock is not recently purchased T stock; only the purchasing corporation (*i.e.*, X) can hold recently purchased stock. Thus, T suffers no basis penalty because of Fred's built-in gain in his T stock, and the gain recognition rule does not apply because P holds no nonrecently purchased stock.

Example III.H.-2—Gain Recognition and AGUB Rules under Section 336(e)

The facts are the same as in the previous example, except that X buys a 79% block of T stock from P for \$790, and Fred buys P's remaining T stock for \$10. The transaction is not a QSP, but it is a QSD. A section 336(e) election is made.

T is deemed to sell its asset for \$1,000, recognizing \$900 gain.¹²¹ If Fred does not make a gain recognition election, "New T" is deemed to purchase the asset for only \$820, because Fred's historic 20% block is nonrecently disposed stock. AGUB equals (1) \$800, the grossed-

¹²¹The ADADP equals \$800/80% or \$1,000. Reg. § 1.336-3(b)(1), -3(c)(1). All the T stock sold by P is recently disposed stock. Reg. § 1.336-1(b)(17).

up basis in X and Fred's recently disposed T stock,¹²² plus (2) \$20, Fred's basis in his nonrecently disposed T stock.¹²³ Thus, if Fred does not make a gain recognition election, T will duplicate \$180 of gain. If Fred does make the election, he will recognize his \$180 gain in T stock, and New T's AGUB will be \$1,000.

In both examples, if T had been liquidated after the QSP or the QSD, Fred would have recognized the \$180 built-in gain in his historic 20% block of T stock. In neither case could T's liquidation eliminate any taxable gain. As Example VIII-1 shows, section 338 disregards Fred's historic ownership of T stock. To be consistent with the principles of section 338, section 336(e) should as well. Thus, Fred's stock should not be nonrecently disposed stock. In Example VIII-2, if X, rather than Fred, historically owned a 20% block of T stock, T's liquidation would eliminate X's built-in gain in that stock. Thus, X's shareholder-level gain could be avoided unless X's historic T stock were treated as nonrecently disposed T stock. To cover similar cases but avoid cases like Fred's, nonrecently disposed stock should include only stock owned by a corporate purchaser that is affiliated with the target on the disposition date immediately following the QSD.¹²⁴

If the regulations adopted this recommendation, there would be an additional advantage. Currently, the regulations could duplicate not only corporate gain but also loss. For example, assume that, in Example III.H.-2, T's asset had \$3,000 basis and \$1,000 value, and Fred's T stock had \$600 basis and \$200 value. On its deemed asset sale, T would recognize \$2,000 loss. Unless Fred made a gain recognition election,¹²⁵ T would take \$1,400 basis in the asset (\$800, the grossed-up basis of the recently disposed stock plus Fred's \$600 basis in his historically owned T stock). Thus, \$400 of corporate loss could be duplicated. The proposed revision would prevent that loss duplication.

¹²²That grossed-up basis equals \$800, which is Fred and X's aggregate basis in recently disposed T stock at the beginning of the day after the disposition date multiplied by the following fraction: (1) 80 or 100 minus the 20, which is the percentage of T target stock attributable to the purchasers' nonrecently disposed target stock, divided by (2) 80, which is the percentage of the T stock attributable to the purchasers' recently disposed target stock. Reg. § 1.338-5(c).

¹²³See Reg. § 1.338-5(b).

¹²⁴The definition of nonrecently disposed stock could also include target stock historically owned by any significant *corporate* purchaser, because the purchaser may acquire an affiliated interest and eliminate its built-in gain by liquidating the target. The Service has ruled, however, that, if a parent owns a non-affiliated interest in subsidiary stock with built-in gain and then purchases enough stock to create affiliation the parent may eliminate its built-in gain by liquidating the subsidiary. Rev. Rul. 75-521, 1975-2 C.B. 120. See also Don Leatherman, *The Scope of the General Utilities Repeal*, 65 TAXES – The Tax Magazine 235, 246 (Mar. 2013).

¹²⁵Fred's election would be nothing short of foolish, because his loss would be disallowed, and T would lose a basis benefit. Reg. § 1.338-5(d)(3)(iii).

3. *Allowing Loss in Gain Recognition Election*

If a gain recognition election is made (or deemed made), gain on the affected stock is recognized, but loss is eliminated. Under section 338, loss elimination could be justified, at least historically, because a purchasing corporation would elect to recognize loss but not gain. If an election could have been made to recognize loss, the target would take lower basis in its assets, but that basis reduction likely would attach to goodwill. With 15-year amortization, the present value of that cost could be far less than the immediate tax benefit of the stock loss. Similarly, an election to recognize gain would likely increase the basis of goodwill, benefitting the purchasing corporation far less than the tax imposed on the stock gain.

If a section 338(h)(10) election is made, a gain recognition election is deemed made, and the regulations may deem the election to further the construct under section 338(h)(10) that the target is deemed to liquidate. If the target had actually liquidated, the purchasing corporation would recognize its stock gain on its nonrecently purchased stock.

The purchasing corporation would also recognize any loss on its nonrecently purchased stock if the target actually liquidated, but that loss is eliminated under the gain recognition rule. This elimination may have been justifiable before the repeal of the *General Utilities* doctrine. At that time, the tax costs of section 338(g) and section 338(h)(10) elections were similar.¹²⁶ If the purchasing corporation had nonrecently purchased stock and could recognize loss on that stock with a section 338(h)(10) election but avoid gain on that stock with a section 338(g) election, it might make the section 338(h)(10) election to recognize loss but the section 338(g) election to avoid gain.

Since the doctrine's repeal, the tax costs of regular and section 338(h)(10) elections can vary significantly, restraining loss selectivity and making it harder to justify the loss-elimination rule. Nevertheless, the section 338(h)(10) regulations retain the rule. We recommend that this rule be re-examined.

The section 336(e) regulations should do away with the loss-elimination rule if the definition of nonrecently disposed stock is revised as suggested above.¹²⁷ Under the regulations, a gain recognition election is deemed made by any 80% purchaser or related person.¹²⁸ If the recommended revision were made, an election would be deemed made for all nonrecently disposed stock,

¹²⁶Before repeal, with a section 338(g) election, the target generally did not recognize gain or loss on its deemed asset sale, but the selling target shareholders recognized their stock gain or loss. With a section 338(h)(10) election, the target recognized gain or loss on its deemed asset sale, but the selling consolidated group did not recognize gain or loss on its sale of target stock.

¹²⁷The New York State Bar Association has recommended eliminating the gain recognition rule under both sections 336(e) and 338(h)(10). *New York State Bar Association Tax Section Report on Proposed Regulations Implementing Section 336(e)*, 2009 TAX NOTES TODAY 1-21 at *45 (Dec. 31, 2008).

¹²⁸Reg. § 1.336-4(c)(2).

because it would always be held by an 80% purchaser.¹²⁹ Practically, therefore, there would be no election; instead, gain recognition would always occur. With no election, there could be no choice to recognize loss but avoid gain (*i.e.*, no selective loss recognition) and therefore no justification for loss elimination. Thus, if the definition of the nonrecently disposed stock is revised as suggested above, the loss-elimination rule should be scuttled, and the 80% corporate purchaser should recognize built-in gain *and* loss on its nonrecently disposed stock.

4. *Discontinuity Between AGUB and ADADP*

Even if the regulations were amended to adopt the suggested changes to both the definition of nonrecently disposed stock and the operation of the gain recognition election, the regulations could create non-economic loss. That loss could arise because the purchaser's gain recognition election takes into account only *the purchaser's* recently disposed stock, potentially creating a discontinuity between AGUB and the aggregate deemed asset disposition price (ADADP). That discontinuity would not occur, however, if the gain recognition election took into account *all* recently disposed stock, an approach that we recommend.¹³⁰

Example III.H.-3—Non-Economic Loss

P owns 80% of the only class of T stock, and P and T file consolidated returns. X, the common parent of another consolidated group, owns the remaining 20% of the T stock. P's basis in its T stock is \$800, X's basis in its T stock is \$200, and X and P are not related persons. T owns assets with a \$1,000 basis and \$1,000 value.

On day 1, P sells a 60% block of T stock to X for \$600. Over the course of the year, T's assets decline in value to \$100, and on day 365 P sells its remaining 20% block of T stock to Fred, an unrelated person, for \$20. P has made a QSD of the T stock, and day 365 is the disposition date. After the QSD, T sells its assets, and then X sells its T stock.

If no section 336(e) election is made, T joins the X group on day 1. P realizes no gain or loss on its sale of T stock to X (\$600 amount realized less \$600 basis) and recognizes a \$180 loss on its sale of T stock to Fred (\$200 basis less \$20 amount realized). When T sells its assets for \$100, it recognizes a \$900 loss (\$1,000 basis less \$100 amount realized). Assuming the X group takes that loss into account,

¹²⁹This result is entirely consistent with section 338(h)(10), where a gain recognition election is also deemed made. Reg. § 1.338(h)(10)-1(d)(1). Thus, the result also accords with applicable legislative history, which directed that section 336(e) be implemented using "principles similar to those of section 338(h)(10)." H.R. REP. NO. 99-841, VOL. II, AT II-204 (1986) (Conf. Rep.).

¹³⁰This same issue does not arise under section 338 because that section involves a single purchaser.

X reduces its T stock basis by \$720, from \$800 to \$80.¹³¹ When X later sells its T stock for \$80, it recognizes no gain or loss. Overall, P, T and X recognize \$1,080 loss (\$180 recognized by P, \$900 by T in the X group and \$0 by X).¹³²

The results change if a section 336(e) election is made for P's QSD. Assume that T remains a member of the P group through day 365 (see Example III.B.-1, above) and is deemed to sell its assets for ADADP at the end of that day. ADADP equals \$775,¹³³ and T recognizes \$225 loss (\$1,000 basis minus \$775 amount realized). P is treated as not selling its T stock but is deemed to receive the sale proceeds (\$620) in T's deemed liquidation. Because P is deemed to own 80% of the T stock on the disposition date, it recognizes no gain or loss on the deemed liquidation. T is treated as purchasing its assets as a new corporation for AGUB, which equals \$820 (\$620—X's basis and Fred's basis in the recently disposed stock-plus \$200—X's basis in its historically owned T stock).¹³⁴ When T then sells its assets for \$100, it recognizes \$720 loss. Assuming the X group absorbs that loss, X reduces its T stock basis by \$576, from \$800 to \$224. Finally, X sells its T stock for \$80, recognizing \$144 loss. Overall, P, T, and X recognize a \$1,089 loss (\$225 by T while a member of the P group, \$720 by T while a member of the X group and \$144 by X on its sale of the T stock).

¹³¹Reg. § 1.1502-32(b)(2)(i), -32(b)(3)(i), -32(c)(2)(i).

¹³²That overall loss equals not only T's \$900 built-in asset loss plus X's \$180 built-in loss in the nonrecently disposed stock but also the overall loss that P, T, and X would have recognized if T had merged into an unrelated corporation in a fully taxable transaction.

¹³³That amount equals (1) \$620 (the amount realized on the sale of the recently disposed stock (\$600 on the sale to X and \$20 on the sale to Fred), divided by (2) 80% (the percentage of T stock sold that is recently disposed stock). Reg. § 1.336-3(b)(1), -3(c)(1).

¹³⁴X is deemed to make a gain recognition election for its historically owned 20% block of T stock (which is nonrecently disposed stock), that stock is deemed sold for \$200, because the deemed sale price is pegged to X's basis in its recently disposed stock (which happens to have the same basis per share). Reg. § 1.1502-36-4(v)(1). Fred's lower stock basis, reflecting the decline in the value of T, is disregarded.

The section 336(e) election creates \$9 non-economic loss,¹³⁵ a loss that is eliminated if the gain recognition election is instead determined with reference to all recently disposed stock. With that change (and assuming that X recognizes any loss when the “gain recognition” election is deemed made), the overall loss would be only \$1,080. Assume that a section 336(e) election is made for P’s QSD. Again, T is deemed to sell its assets for ADADP at the end of the disposition date for \$775, recognizing a \$225 loss. X is deemed to make a “gain recognition” election and sell its historically owned 20% block of T stock for \$155, recognizing a \$45 loss.¹³⁶ X’s basis in that historically owned T stock is then \$155, the deemed sales price. T is treated as purchasing its assets for AGUB, which equals \$775 (\$620, X and Fred’s basis in the recently disposed stock, plus \$155, X’s new basis in its nonrecently disposed stock). When T sells its assets for \$100, it recognizes a \$675 loss (\$775 basis minus \$100 amount realized). Assuming the X group absorbs that loss, X reduces its T stock basis by \$540, from \$755 to \$215. Finally, X sells its T stock for \$80, recognizing \$135 loss. Overall, P, T, and X recognize \$1,080 loss (\$900 by T on its assets (\$225 by T while a member of the P group and \$675 while a member of the X group) and \$180 by X on its T stock (\$45 on the “gain” recognition election and \$135 on its sale of the T stock)).

Note that even if creeping acquisitions are no longer allowed, the problem illustrated by Example VIII-3 may arise if P sells the T stock to Fred and X on the same day but X pays a control premium.

¹³⁵Because AGUB exceeds ADADP by \$45, T recognizes an extra \$45 loss, which results in basis reduction in X’s T stock. Because X owns only 80% of the T stock, however, the reduction is only \$36 (i.e., 80% of \$45). Thus, the net extra benefit is \$9 (\$45 loss minus \$36 basis reduction).

AGUB exceeds ADADP, because their computations take Fred’s T stock into account in different ways. ADADP takes into account the grossed-up amount realized for recently disposed stock, including Fred’s T stock. The grossed-up amount equals (1) the amount realized by P on its sales to X and Fred, divided by (2) 80% (the percentage of T stock that is recently disposed stock). Thus, the amount realized for Fred’s 20% T stock interest is grossed up, accounting for 25% (20%/80%) of the total grossed-up amount realized, which in this case equals ADADP. In contrast, Fred’s basis in the T stock (equal to the P’s amount realized for the stock) accounts for only 20% of AGUB, because it is not grossed up. In effect, only X’s basis in its recently disposed stock is grossed up. Because X has a higher average basis in each share of recently disposed stock than Fred, AGUB exceeds ADADP.

¹³⁶The sales price would equal \$620 (the amount realized for the recently disposed T stock, \$600 for X and \$20 for Fred), multiplied by 20% (the percentage of nonrecently disposed stock), and divided by 80% (the percentage of all recently disposed stock). X’s \$45 loss would equal the excess of X’s \$200 basis in that stock over the \$155 sales price.

5. *Gain-Recognition Election*

Regulation section 1.336-4(c)(2) provides that a gain-recognition election is deemed made by any 80% purchaser and any person related to that purchaser. Each “holder” determines the consequences of that election separately by considering its own recently disposed and nonrecently disposed stock.¹³⁷ In relevant part, the holder must compute a fraction, the denominator of which is the percentage of recently disposed stock actually owned by the holder.¹³⁸ However, a holder may be a person who is related to an 80% purchaser but actually owns only nonrecently purchased stock (and thus owns no recently disposed stock). For that holder, the denominator would be zero, and the fraction’s value indeterminable. To avoid that anomaly, such a holder could take into account relevant attributes of the related person who owns recently disposed target stock and whose gain recognition election forced the holder’s election.

I. *Target-Stock Redemptions*

The regulations should describe how redemptions of target stock are taken into account in determining when a QSD occurs. That treatment could follow the approach used for purposes of section 338: a qualified stock purchase occurs on the first day on which an affiliated interest in target stock both is held by the purchasing corporation and has been purchased by that corporation during the 12-month period ending on that day.¹³⁹ For this purpose, if the target redeems its stock from persons unrelated to the purchasing corporation, the redemption reduces the target’s outstanding stock.¹⁴⁰ With limited exceptions, however, stock redeemed from the purchasing corporation or a person related to the purchasing corporation is not deemed to reduce the target’s outstanding stock.¹⁴¹ Consistent with the section 338 approach, in measuring whether a QSD occurs, redemptions could reduce a target’s outstanding stock, unless the stock is redeemed from a purchaser or a person related to the purchaser. As we understand it, this treatment is intended to prevail under the current regulations, due to the application of section 338(h)(10) principles in the section 336(e) regulations.

We believe Treasury and the Service should consider a different approach to stock redemptions for purposes of section 336(e). Specifically, redemptions of target stock could be treated as dispositions of the stock in at least some situations. The language of section 336(e) that refers to “stock of another corporation” should not foreclose such treatment if some target stock is sold

¹³⁷ Reg. § 1.336-4(c)(1).

¹³⁸ See Reg. § 1.338-5(c), -5(d)(3)(ii).

¹³⁹ Reg. § 1.338-3(b)(5)(i).

¹⁴⁰ Reg. § 1.338-3(b)(5)(ii).

¹⁴¹ Reg. § 1.338-3(b)(5)(iii)(A); see also Reg. § 1.338-3(b)(5)(B)(iii)(B) (exception for stock redeemed from a related person if that stock would have been considered purchased under section 338(h)(3)(C) if acquired by the purchasing corporation).

or distributed to third parties. If creeping QSDs are eliminated or restricted, as described in the Appendix Part II, such redemptions would be closely connected to the other stock dispositions.

If the section 338 treatment of redemptions rule is retained for purposes of section 336(e), the regulations should make clear that redeemed stock is disregarded in computing both ADADP and AGUB. As currently constructed, the regulations could be read to treat redeemed stock as “disposed of” and therefore treated as recently disposed stock, artificially inflating both the ADADP and AGUB.¹⁴²

J. *Target-Stock Issuances*

The regulations do not state whether or under what circumstances a stock issuance by a target could be a disposition of the stock. So long as section 351 does not apply, it seems possible that a stock issuance could be treated as a disposition of the stock by the issuer.

It is not clear whether a disposition may include an issuance by a corporation of its own stock if that issuance falls outside of section 351.¹⁴³ No regulations exclude a transfer subject to section 1032 but not section 351. Thus, the definition of disposition could be read to make these transactions “dispositions” in appropriate cases.¹⁴⁴ We are not able to recommend how stock issuances should be treated, but we believe the regulations should be amended to answer the question.

K. *Miscellaneous Matters*

1. *Reacquisitions of Disposed of Stock (Netting Dispositions and Purchases)*

Regulation section 1.336-1(b)(5)(v) disregards dispositions of stock of a target if the disposing shareholder “reacquires” the disposed of stock. The purpose of this rule appears to be to restrict sales and repurchases entered into for the purpose of generating a section 336(e) election. After the repeal of *General Utilities*, it is unclear whether there is a compelling policy supporting such a rule, especially since voluntary gain recognition transactions are readily available.

¹⁴² See Reg. § 1.336-1(b)(5)(i) (defining “disposed of” to include any sale of stock with limited exceptions), -1(b)(17) (defining recently disposed stock).

¹⁴³ Regulation section 1.336-1(b)(5)(i)(B) excludes from dispositions any transfer of stock in which gain or loss is not recognized only if the transaction is “described in regulations.” Section 338(h)(3)(A)(ii) provides that a “purchase” excludes “any other transaction described in regulations in which the transferor does not recognize its entire amount of gain or loss realized.”

¹⁴⁴ See Reg. §§ 1.336-1(b)(6)(i) (defining a QSD to include a disposition of stock of a domestic corporation by another corporation), -1(b)(1) (providing that “generally all consolidated group members are treated as a single seller), 1.336-2(g)(2) (providing that all consolidated group members are treated as a single seller “regardless of which member or members actually dispose of any stock”).

The benefits of such transactions are limited by provisions such as sections 267, 1239, and 197(f), as well as the related-person rule in the section 336(e) regulations. If, as we recommend,¹⁴⁵ sales of target stock to related parties qualify as dispositions, the general principle of Regulation section 1.338-1(b)(1)(i) that old target and new target are not to be related persons should be limited so that old and new target may be treated as related for purposes such as sections 1239 and 267 if there is sufficient overlapping ownership between the target and new target.¹⁴⁶

If the reacquisition rule is retained, we recommend the following changes be considered to clarify the rule and to address stock transfers that do not result in a change in ownership consistent with the purposes of the >80% stock disposition requirement:

- Regulation section 1.336-1(b)(5)(v) should be clarified to reflect that the purpose of the rule is to properly reflect dispositions as net dispositions of stock.
- The term “reacquisition” should be replaced with the term “replacement” and clarified to mean an acquisition of *any* shares of the target from any person by a person who otherwise would be considered to dispose of target stock within the disposition period. The term “replacement” should be defined to indicate that the order of the disposition and offsetting acquisition is not relevant.
- The replacement rule should be applied only to match acquisitions and dispositions to the extent the outbound transfer would be a “disposition” that otherwise would count toward a QSD.
- Acquisitions should be netted against dispositions only if they occur within the same affiliated group, or where the relationship is such that the acquisition and disposition is directly or indirectly between persons who share an identity of economic interest.

2. *Revision to Definition of Recently Disposed Stock*

Regulation section 1.336-1(b)(17) provides that recently disposed target stock is target stock that meets two requirements:

- It is not held by the seller, a member of the seller’s consolidated group, or an S corporation shareholder immediately after the disposition date.
- It was disposed of by the seller, a member of the seller’s consolidated group, or an S corporation shareholder during the disposition period.

¹⁴⁵ See *infra* Appendix, Part I.

¹⁴⁶ See, e.g., Reg. § 1.197-2(h)(8) (new target not treated as related to old target for purposes of anti-churning rules, but may be subject to such rules if new and old target are related after the transaction).

This definition can distort the computation of ADADP or AGUB in two possible ways.

First, recently disposed stock excludes stock acquired by an S corporation shareholder from another S corporation shareholder (or by a consolidated group member from another member) even though the acquisition is part of a QSD. That exclusion may mean that ADADP and AGUB do not accurately reflect the consideration paid for the target stock, and it may even make their computation impossible (*e.g.*, when an S corporation shareholder is the sole purchaser). To address those concerns, the definition of recently disposed target stock should be amended to include all stock acquired by a purchaser in the QSD if the purchaser held that stock on the disposition date. It should make no difference that the purchaser was an S corporation shareholder or a member of the seller's consolidated group.

Second, AGUB takes into account recently disposed stock if it is held by the purchasers on the day after the disposition date.¹⁴⁷ As defined, however, recently disposed stock may include stock acquired after the disposition date as long as it is acquired within the 12-month disposition period.¹⁴⁸ Although unlikely, it is possible that a purchaser could acquire target stock after the disposition date but within the 12-month disposition period. In that rare case, AGUB will be artificially reduced. To prevent that distortion, Regulation section 1.336-1(b)(17) should be amended to exclude from recently disposed stock any target stock acquired by a purchaser after the disposition date. Such an amendment would have to be coordinated with any change to the rules affecting creeping QSDs, described in Appendix, Part II.

3. Amount Deemed Distributed to Sellers

The section 336(e) regulations are not clear about the amount deemed to be received by the sellers in the deemed liquidation that results from the election at the end of the disposition date. Regulation section 1.336-2(b)(1)(iii)(A) describes the amount distributed as "the consideration deemed received from the new target." First, the reference to "consideration" normally would be considered to include liabilities assumed by the new target, and is therefore incorrect.¹⁴⁹ The technically correct reference for the aggregate distribution would be to the "grossed-up amount realized" on the sale of the recently disposed stock as described in Regulation section 1.336-3(c)(1)(i)(a).¹⁵⁰

¹⁴⁷ See Reg. §§ 1.336-4(a) (applying the principles of Regulation sections 1.338-5(b)-(g), 1.338-5(c)(1)).

¹⁴⁸ Reg. § 1.336-1(b)(17).

¹⁴⁹ Cf. Reg. § 1.338(h)(10)-1(d)(4)(i)-(ii), which describe the distribution as if the target "transferred all of its assets" to the selling shareholders." These assets are the deemed assets that would exist had the corporation sold its assets in the deemed disposition, and had cash to distribute in liquidation equal to the proceeds deemed realized in the sale.

¹⁵⁰ See Reg. § 1.336-2(b)(2)(iv) (specifying that the "fair market value" of all of the target stock that is used to determine the basis of retained target stock is the grossed-up amount realized under Regulation section 1.336-3(c)(1)(i)(a)).

Perhaps more important, to avoid confusion, the regulations should also state clearly that the deemed distribution may not be *pro rata* as to all sellers (including S corporation shareholders) who have disposed of stock in the QSD. Instead, the portion of grossed-up amount realized that is allocated to each such shareholder with respect to disposed stock should be the amount actually realized by such shareholder in the disposition, and in the case of nondisposed shares it should be the shareholder's ratable share of the grossed-up amount realized.

4. CERT

Section 172(b)(1)(E) limits the carryback of the portion of a net operating loss attributable to interest on debt allocable to a corporate equity reduction transaction (a CERT).¹⁵¹ A CERT includes a major stock acquisition, which generally occurs when a corporation under a plan acquires stock of another corporation with at least 50% of the vote or value of the corporation's outstanding stock.¹⁵² However, a CERT does not include a qualified stock purchase for which a section 338 election is made.¹⁵³

Applicable legislative history does not describe the justification for the section 338 exclusion.¹⁵⁴ It likely is justified because the target is treated as a new corporation for federal income tax purposes following the effective date of the election and cannot carry back any loss to offset its income in a pre-election period.

The CERT rules apparently were enacted to impede highly leveraged buyouts, including those in which a newly formed corporate purchaser buys the stock of a target, funds the purchase predominantly with debt and then merges into the target.¹⁵⁵ Because the target assumes the acquisition debt in the merger and the interest on the debt might generate or increase a net operating loss carryback, the target might carry back the loss to offset pre-acquisition target income, enjoying a tax refund. The refund might help fund the acquisition and in turn spur more highly leveraged target stock acquisitions. Likely to impede those transactions, Congress added the CERT rules.

Those rules did not have to apply if a section 338 election was made for a target stock acquisition for the following reason: the target would be treated as a new corporation for federal income tax purposes beginning on

¹⁵¹I.R.C. § 172(b)(1)(E).

¹⁵²§ 172(h)(3)(A)(i), (B)(i).

¹⁵³§ 172(h)(3)(B) (excluding section 338 transactions as major stock acquisitions).

¹⁵⁴H.R. REP. No. 101-247, at 1250-53 (1989).

¹⁵⁵STAFF OF THE JOINT COMM. ON TAX'N, 101ST CONG., JCS-1-89, FEDERAL INCOME TAX ASPECTS OF CORPORATE FINANCIAL STRUCTURES, at 46-47 (Jt. Comm. Print 1989). See also Martin T. Ginsberg, Jack S. Levin, William R. Welke & Richard A. Wolfe, *CERTs: The New Limitations on NOL Carrybacks*, 46 TAX NOTES (TA) 1315 (Mar. 12, 1990) (noting Congressional concern with "the recent and rapid increase of corporate indebtedness generated by highly leveraged buyouts and recapitalizations").

the acquisition date, and it could not carry any post-acquisition loss back to offset pre-acquisition target income.¹⁵⁶

Under the same rationale, the CERT rules should not apply to a target stock acquisition for which a general section 336(e) election is made, because the target is treated as a new corporation for federal income tax purposes after the disposition date, and any target loss generated after that date cannot be carried back to offset pre-disposition date target income. The section 336(e) regulations should be amended to make this point.¹⁵⁷

This rationale does not support a CERT exclusion when a section 336(e) election is made for a target distributed in a section 355(d) or (e) transaction. In that case, the target is *not* treated as a new corporation after the disposition date, and its post-disposition losses may be carried back.

L. *Technical–Editorial Corrections*

No analysis is needed for corrections in the nature of minor clerical errors in the regulations. These items are listed in the Appendix, Parts XII.A.1–3.

1. *Revision to Definition of “Disposition”*

In defining a disposition, Regulation section 1.336-1(b)(5)(i)(A) provides that stock is not disposed of if the “purchaser” takes a basis in the stock determined by reference to the transferor’s basis or determined under section 1014. However, a “purchaser” is a person who receives stock in a disposition. To avoid circularity, the regulation should refer to a “transferee,” not a “purchaser.”

2. *Accounting for Tiered Targets*

Regulation section 1.336-2(b)(1)(i)(C) provides that, if section 336(e) elections are made for a parent–subsidiary chain, the deemed asset disposition of a higher-tier subsidiary is considered to precede the deemed asset disposition of a lower-tier subsidiary. This provision should be amended to make clear that a higher-tier subsidiary includes the parent in that chain.¹⁵⁸ Similarly, regulation section 1.336-2(b)(1)(iii)(B) provides that, if section 336(e) elections are made for a parent–subsidiary chain of corporations, the deemed liquidation of a lower-tier subsidiary is considered to precede the deemed

¹⁵⁶ Ginsburg, *supra* note 155 at 1317, n.15 (noting this effect).

¹⁵⁷ Further, even though the target generally is treated as a new corporation following a section 336(e) election, the election should not result in the substitution of a new obligor for purposes of Regulation section 1.1001-3. See Reg. § 1.1001-3(e)(4) (for a comparable rule for a QSP for which a section 338 election is made).

¹⁵⁸ Cf. Reg. § 1.338(h)(10)-1(d)(3)(ii) (stating that in the case of section 338(h)(10) elections for a parent–subsidiary chain, the deemed asset sale of a parent is deemed to precede that of its subsidiary).

liquidation of a higher-tier subsidiary. This provision too should be amended to make clear that a higher-tier subsidiary includes the parent in that chain.¹⁵⁹

3. *Clarification of Overlaps Between QSP and QSD*

The overlap rule (Regulation section 1.336-1(b)(6)(ii)(A)) provides that, if “a” transaction satisfies the definitions of both a QSD and a QSP, it generally is not treated as a QSD. Because a QSD or a QSP may result from more than one transaction, this rule should be amended, for example, to refer to “a transaction *or series* of transactions” or to “one or more transactions.” For example, suppose P owns all the T stock and sells that stock to X, an unrelated corporation, within a 12-month period, selling one-half of T’s only class of stock in one transaction and the other half in a separate transaction. The overlap rule does not apply, because neither sale, by itself, would be a QSD or QSP. However, the sales together would satisfy both definitions, and as the regulation now reads, either a section 336(e) or section 338 election could be made. This revision should be made regardless of whether creeping QSDs continue to be allowed.

APPENDIX

Recommendations List

The Comments focus on recommended simplifications to the regulations and additional guidance to clarify the regulations in a number of areas. Our recommendations are divided into two categories—recommendations for the current project to revise the regulations and recommendations for future guidance projects.

- **Current Project.** These recommendations are made for consideration by Treasury and the Service in the current section 336(e) regulation project. We believe that adoption of these recommendations would improve the section 336(e) regime significantly in practice, even though some of the recommendations may not implement the best possible rules as a technical or policy matter.
- These recommendations are divided into subcategories based on our consensus opinion as to degree of urgency—“Priority 1” and “Priority 2.”
- The recommendations in Part III.L. (Technical–Editorial Recommendations) should be simple to draft and should not be controversial. Thus, even though they may not be urgent, they are

¹⁵⁹ Cf. Reg. § 1.338(h)(10)-1(d)(3)(ii) (stating that in the case of section 338(h)(10) elections for a parent-subsidiary chain, the deemed liquidation of a subsidiary is deemed to precede that of its parent).

included in the “Current Project” category, and they are not assigned a priority within that category.

- **Future Project.** These recommendations are made for consideration in future guidance projects. In some instances, these recommendations are broader in scope than Current Project recommendations on the same subject, and they embody our consensus views as to the best possible solutions to the problems addressed. Considering these recommendations and drafting language to implement them, however, would likely require more time and effort than the Current Project recommendations.

I. Related Person

A. Current Project

We recommend that the following changes to the related person rule be considered in the Current Project. These changes would solve immediate problems but are relatively narrow. Broader changes are recommended in Part I.B., below, for consideration in a Future Project.

1. **Priority 1.** For purposes of determining whether a seller of target stock and a partnership that purchases such stock are related persons, attribution of stock ownership between the partnership and its partners should be limited to partners with a 50%-or-greater partnership interest, or in any event a much larger interest than the 5% interest provided in the current rule. This recommendation would apply to both sales and distributions of target stock and to both C corporation and S corporation targets.
2. **Priority 1.** A taxable intercompany distribution of C corporation target stock by a subsidiary to its parent should qualify as a disposition of the stock, if the distribution is part of a series of related transactions that includes a distribution of the target stock by the parent to shareholders that are not related persons to the distributing subsidiary.
3. **Priority 2.** Under Regulation section 1.336-1(b)(12), the related person rule applies both where stock owned by the transferor is attributed to the transferee (as under section 338(h)(3)(C)) and where stock owned by the transferee is attributed to the transferor. We recommend that the section 336(e) rule be conformed to the section 338(h)(3)(C) rule.

B. Future Project

1. We believe that a section 336(e) election should be available with respect to transfers between related persons if all realized gain is recognized. Thus, we recommend that a new approach be considered in a Future Project.
 - a. A stock sale would be excluded from disposition status only in the following situations:

- i. The stock sale, if taken into account (*i.e.*, no section 336(e) election), either—
 - Would be subject to section 304(a), with any proceeds being subject to section 301, or
 - Would qualify for tax-free treatment, *e.g.*, as a type-B reorganization or under section 351.
 - ii. The deemed asset transfer resulting from a section 336(e) election would qualify as a tax-free exchange, *e.g.*, an acquisitive type-D or other reorganization or under section 351.
- b. A stock distribution that is taxable (either fully taxable or taxable to the distributing corporation under section 355(d) or (e)) would be treated as a disposition in all cases, including intercompany distributions within consolidated groups. Adoption of this approach in its comprehensive form would constitute a repeal of the separate related person rule. Thus, adjustments should be considered to prevent abuse, for example, where direct or indirect participation of a passthrough entity otherwise could make “disposition” treatment available by avoiding sections 304, 351 and 368. Also, we note that, if this recommendation were adopted, a sale of target stock not qualifying as a “purchase” under section 338(h)(3)(C) could qualify as a “disposition” under the regulations. The appropriateness of this result would need to be considered.
2. As a more narrow change, we recommend consideration of a rule that a sale or distribution of target stock to a related person would qualify as a disposition if, after a series of related transactions, the owner of the target stock is not a related person to the seller in all instances, a recommendation in addition to the one for intragroup distributions that would be addressed in Part I.A.2., above.

II. Creeping QSD

The regulations allow a qualified stock disposition (QSD) to include sales and distributions of target stock over a period as long as 12 months. These “creeping QSDs” offer advantages (flexibility in planning and execution of dispositions, as well as consistency with the section 338(h)(10) model). In our view, however, the complications more than offset the advantages. Although detailed rules could be adopted to resolve the issues, we believe such refinements would not be worth the effort and added complexity. Thus, we recommend simplified rules.

A. Current Project

1. **Priority 1.** For S corporation targets, QSDs should be limited to situations in which one or more dispositions of target stock comprising the QSD occur on a single day.
2. **Priority 1.** For C corporation targets—

- a. QSDs should be limited to the following situations:
 - i. At the beginning of the disposition date, the target is a member of the selling affiliated group (whether or not consolidated).
 - ii. On the date the target otherwise would leave the selling affiliated group (whether or not consolidated), binding contracts are in place for all remaining dispositions of target stock necessary to a QSD.
- b. For “binding contract” situations, rules would have to be adopted to govern a consolidated target’s membership in the selling group and a purchasing group. We recommend the following:
 - i. If no section 336(e) election is made, the target should leave the selling consolidated group under existing consolidated return rules.
 - ii. If the binding contract or contracts provide for a section 336(e) election, and the election is made, the target should leave the selling consolidated group on the date of the first stock sale that qualifies as a disposition and is included in the QSD.
 - iii. The timing of the target’s joining a new consolidated group would be coordinated with its leaving the selling consolidated group.

B. Future Project

1. Consider exceptions to the single-day rule for S corporation targets, described in Part II.A.1., above, for public offerings, dispositions subject to binding contracts on the date of the first disposition, related transactions and the like.
2. Consider allowing an election to postpone the target’s departure from a selling consolidated group (or joining a new consolidated group) in a “binding contract” situation, described in Part II.A.2.a.ii., above.

III. Consistency Rule

A. Current Project

We recommend the following changes to the consistency rule in the Current Project to solve immediate problems. Broader changes are recommended for consideration in a Future Project. *See* Part III.B., below.

1. **Priority 1.** The regulations should state explicitly that neither the consistency rule nor its “principles” apply to an S corporation target in a QSD or to a disposition of stock of a C corporation target by an S corporation.
2. **Priority 2.** The stock ownership threshold for asset purchasers subject to the consistency rule should be changed to a 25% threshold

or in any event to a much higher threshold than in the current 5% rule.

- 3. Priority 2.** For purposes of determining whether the consistency rule's stock ownership threshold is met, attribution of stock ownership between a partnership and its partners should be limited to partners with a 50%-or-greater partnership interest (or in any event a much larger interest than in the current rule), that is, conformed to the recommended partner-partnership stock ownership attribution for purposes of the related person rule, described in Part I.A.1., above.

B. Future Project

1. We agree with the New York State Bar Association that application of the consistency rule, under both section 338 and section 336(e), should result in reduction to the seller's basis in the target stock, not carryover basis to the asset purchaser.
2. We believe that the consistency rule under section 336(e) should apply only if, after the QSD, the purchaser of the asset is a corporation that is a member of the same affiliated group as the target.

IV. Disallowance of Net Loss Recognized in Target Stock Distribution

A. Current Project

- 1. Priority 1.** In a stock distribution, if section 336(e) elections are made for the target and its subsidiaries, any net loss should be computed by aggregating the gains and losses of the target and its electing subsidiaries.
- 2. Priority 2.** An exception to loss disallowance should be adopted for a QSD that includes one or more distributions of target stock in complete liquidation of the target's parent corporation.
- 3. Priority 2.** The fraction that determines the proportion of loss disallowed should be revised to include all target stock sold during the disposition period, regardless of whether the stock is included in the QSD as recently disposed stock, and regardless of whether the sale takes place before, on or after the disposition date.

V. Kimbell-Diamond Doctrine and Step Transaction

A. Current Project

- 1. Priority 2.** The regulations should state that the *Kimbell-Diamond* doctrine will not apply if a QSD with no section 336(e) election is followed by a pre-planned liquidation or merger of the target, unless the integrated series of transactions that includes the QSD qualifies as a reorganization.

VI. Excess Loss Accounts

A. Current Project

1. **Priority 1.** The regulations should provide that, if a distribution of target stock is taxable to the distributing corporation under section 355(d) or (e) and is subject to a section 336(e) election, no excess loss account (ELA) in the stock of the target or its electing subsidiaries is triggered, and any such ELA is eliminated.
2. **Priority 2.** The regulations should confirm that, if a sale or distribution of target stock is fully taxable and is subject to a section 336(e) election, again no ELA in the stock of the target or its electing subsidiaries is triggered, and any such ELA is eliminated.

VII. Other S Corporation Matters

A. Current Project

1. **Priority 1.** For S corporation targets, the regulations should state clearly the date on which shareholder status is determined, in order to identify the shareholders who must join in a section 336(e) election agreement and (if the QSD does not arise from dispositions occurring on a single day) the shareholders to whom gain or loss on the deemed asset sale is allocated.
 - a. Gain or loss from the deemed asset sale should be allocated to all “affected shareholders,” and the same shareholders should be required to agree to the section 336(e) election.
 - b. Affected shareholders should include the following shareholders:
 - i. All target shareholders on the disposition date other than those who acquire stock on that date (*but see* Part VII.A.1.c., below).
 - ii. If the QSD does not consist entirely of dispositions occurring on a single day (*i.e.*, if the recommendation in Part II.A.1., above, is not adopted)—
 - All shareholders who dispose of target stock in the QSD.
 - Shareholders who transfer target stock before the disposition date (whether or not the transfer is a disposition) during the taxable year of the target in which a QSD occurs, other than such shareholders who elect the closing of the books method under section 1377(a)(2).
 - c. If a QSD does not consist entirely of dispositions occurring on a single day (*i.e.*, if the recommendation in Part II.A.1., above, is not adopted), purchasers of disposed-of stock before the disposition date should be treated as if they had acquired their stock on the disposition date. They should not, by reason of holding the purchased stock, be treated as affected shareholders.

2. **Priority 1.** The regulations under either section 336(e) or section 1361(b)(3) should be amended to clarify that distributions by an S corporation of the stock of a QSub to which either section 311 or section 355(d) or (e) applies will be treated as a “sale” of the QSub stock by the S corporation for purposes of section 1361(b)(3)(C)(ii). As a result, the S corporation would be deemed to distribute assets rather than stock, and a protective section 336(e) election would be unnecessary for a distribution of stock of a QSub that fails to qualify for nonrecognition at the corporate level.
3. **Priority 2.** If a QSD does not consist entirely of dispositions occurring on a single day (*i.e.*, if the recommendation in Part II.A.1., above, is not adopted), any distribution on stock of an S corporation target during the disposition period, but before the disposition date, should be deemed distributed to the selling shareholder(s) and then paid over to the purchaser(s) as a purchase price adjustment (or other appropriate characterization depending on the nature of the stock sale itself), with conforming adjustments made to the ADADP and AGUB.
4. **Priority 2.** The regulations should clarify that the written agreement required to make a section 336(e) election may be satisfied for a shareholder of an S corporation target by either—
 - a. An agreement to which the target is a party, and in which the shareholder agrees to a section 336(e) election for any QSD, either under specified conditions or as the target determines, or
 - b. An agreement entered into on behalf of a shareholder by the target or any other person under a power of attorney granted to such person to make a section 336(e) election.
5. **Priority 2.** A protective section 336(e) election should be deemed made in any transaction reported on an S corporation’s original return as a fully tax-free section 355 distribution, unless the distributing corporation (or any affected S corporation shareholder) affirmatively elects non-application of section 336(e).

B. Future Project

1. A separate set of provisions dealing exclusively with S corporation targets, illustrated by examples dealing with S corporations, should be drafted to reduce complexity for small businesses and their advisers.

VIII. AGUB, Gain Recognition Election and Nonrecently Disposed Stock

A. Current Project

1. **Priority 1.**
 - a. The regulations should clarify that the AGUB is a collective computation, should explicitly set out that computation, and

should provide an example in the regulations that involves the computation.

- b. The computation of basis amount unnecessarily involves two formulas. Those formulas should be combined and restated as one formula for the regulations under both section 336(e) and section 338.
 - c. If the gain recognition election is deemed made by a person who actually owns no recently disposed stock, the proposed gain recognition election requires a division by zero. To avoid that concern, that holder should take into account relevant attributes of the related person whose gain recognition election forced the holder's election.
2. **Priority 2.** Nonrecently disposed stock should be limited to stock that is not recently disposed stock and that is owned by a corporate purchaser affiliated with the target after the QSD.
 3. **Priority 2.** If nonrecently disposed stock is limited as we recommend, the gain recognition election should be required and a holder of nonrecently disposed stock should recognize loss as well as gain.

B. Future Project

1. Even if the regulations are amended to adopt the suggested changes to both the definition of nonrecently disposed stock and the operation of the gain recognition election, AGUB, ADADP and the gain recognition election could operate to create non-economic loss. To address that concern, we recommend that the gain recognition election take into account all recently disposed stock, not just the purchaser's recently disposed stock.

IX. Target Stock Redemptions

A. Future Project

1. Consider whether redemptions of target stock should continue to be treated in the same manner as under section 338 (redeemed stock disregarded in determining whether a QSP occurs and in computing ADSP and AGUB), or whether instead some redemptions should qualify as dispositions of the redeemed stock.
2. If the section 338 rule relating to stock redemptions is retained for purposes of section 336(e), add a specific statement or cross-reference to this effect.

X. Target Stock Issuances

A. Future Project

1. Consider adding a rule to state explicitly whether a stock issuance by the target qualifies as a "disposition" of outstanding stock. A

rule that treats a stock issuance as a disposition would have to be coordinated with the related person or similar rules. *See* Part I.B.1., above.

XI. Miscellaneous Matters

A. Current Project

1. **Priority 2.** The definition of recently disposed stock in Regulation section 1.336-1(b)(17) should be revised to include stock acquired by a person during the disposition period, only to the extent of such person's net increase in target stock ownership during the disposition period.
2. **Priority 2.** Regulation section 1.336-2(b)(1)(iii)(A) provides that the amount deemed transferred by the target to the seller(s) is "all of the consideration deemed received from the new target in the deemed asset disposition." This language could be read to mean ADADP, which would include the target's liabilities deemed assumed by the new target. We recommend the following changes:
 - a. The regulations should provide instead that the amount deemed transferred by the target to the seller(s) is the "grossed-up amount realized" by the target, as defined in Regulation section 1.336-3(c)(1).
 - b. The amount treated as distributed to each S corporation shareholder with respect to disposed target stock should be the amount actually received by that shareholder on the disposition of such stock.

B. Future Project

1. Regulation section 1.336-1(b)(5)(v), which disregards dispositions of stock of a target if the disposing shareholder "reacquires" the disposed of stock, should be revised to clarify that the rule is intended to cause only net dispositions to be counted toward a QSD.
2. If shares of target stock are sold at differing prices or are distributed at differing values, the computation of AGUB allows a deduction for a noneconomic loss to be created in some situations. The computation should be revised to prevent this deduction.
3. Section 172(h)(3)(B)(ii) provides that a QSP in which a section 338 election is made is excluded from treatment as a "major stock acquisition" and therefore cannot be a corporate equity reduction transaction (CERT). The regulations should be revised to include an explicit exclusion of QSDs from the CERT rules.
4. Consider a deemed protective section 336(e) election to be made by default for any distribution reported on a C corporation's original return as a fully tax-free under section 355, unless the distributing corporation elects non-application of section 336(e). *See* Part VII.A.5., above.

XII. Technical–Editorial Corrections

A. Current Project

1. Correct Regulation section 1.336-0 outline to show sublevels under sections 1.336-2(h)(1)(i)-(iv) and sections 1.336-2(h)(6)(i)-(xiii).
2. Correct Regulation section 1.336-2(h)(1)(iv) (incorrectly numbered as (ii)).
3. Regulation section 1.336-3(g) Example 3(iv) assumes in the computation of ADADP that a capital loss on publicly traded stock can offset ordinary income on stock in trade. The example should be changed to avoid that implication.¹⁶⁰
4. To eliminate circularity in the definition of “disposition” in Regulation section 1.336-1(b)(5)(i)(a), the reference to “the purchaser” in the exclusion for stock with basis determined under section 1014(a) should be to “the transferee.”
5. Regulation sections 1.336-2(b)(1)(i)(C) and 1.336-2(b)(1)(iii)(B) provide the order in which a target and its tiered subsidiaries are deemed to sell their assets and liquidate if they all elect under section 336(e). Both provisions should be amended to clarify that these ordering rules apply to the parent in the chain as well as to its subsidiaries.
6. The rule governing overlap between a QSP and a QSD (in Regulation section 1.336-1(b)(6)(ii)(a)) refers to “a” transaction. Because a QSD may be composed of more than one transaction, this reference should be to “a transaction or series of transactions” or similar language.

¹⁶⁰See Reg. § 1.336-3(f).