CHAPTER 9 - TAXABLE ACQUISITIONS

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9-1. In the aggregate, P has paid $1.4 million for the assets — cash of $1.2 million and the assumption of a $200,000 liability. T Corp. is treated as selling each asset separately (§1001), and the aggregate $1.4 million of consideration is allocated among the assets as provided under §1060. Because the total consideration paid exceeds the aggregate value of assets other than goodwill, the amount allocated to each asset other than goodwill equals its fair market value. The residual ($300,000) is allocated to goodwill. Thus, T Corp. recognizes $30,000 of capital gain income on the sale of the portfolio of marketable securities (Class II asset), $170,000 of ordinary income on the sale of inventory (Class IV asset), $50,000 of ordinary income resulting from the depreciation recapture on the sale of equipment (Class V asset), $150,000 of §1231 gain on the sale of the land (Class V asset), $165,000 of §1231 gain on the sale of the building (Class V asset), and $35,000 of §1231 gain (see Treas. Reg. §1.197-2(g)(8)) on the sale of the patent (Class VI asset). Under §1060, the excess ($300,000) is allocated to goodwill (Class VII asset) and results in §1231 gain to T (Treas. Reg. §1.197-2(g)(8)) to the extent that the goodwill was acquired by T or capital gain to the extent it was created by T (§197(b)(2)). (If T acquired goodwill in the past, how could T know to what extent its existing goodwill was created or acquired?) You may want to note that for corporations, both capital gains and ordinary income are typically taxed at a 35% rate, although its capital gains can only be offset by capital losses.

P takes a fair market value (i.e. cost) basis, pursuant to §1012, in all of the assets purchased, including the goodwill, which is amortizable over a 15-year period under §197. The aggregate consideration paid is allocated among the assets using the seven-tier residual method illustrated in the previous paragraph.

T Corp. does not recognize any gain or loss on its distribution of cash in liquidating. §336. However, T's shareholders, A, B, and C, recognize $300,000, $280,000, and $70,000 of gain, respectively, under §§331 and 1001. Each shareholder's gain is long- or short-term capital gain, depending on the shareholder's holding period for the stock.

The same results occur if P is a corporation. Note further that if P is a corporation and T merges into P under state law with T's shareholders receiving cash for their stock, the transaction is treated in the same manner as if T had transferred its assets to P and then liquidated. Rev. Rul. 69-6, 1969 C.B. 104.

9-2. The results to P and T are the same as in the answer to problem 9-1. Note that T recognizes its gain either on the sale (if the installment method does not apply) or on the distribution of the note under §336(a). *See also* §453B (for gain on the disposition of installment notes). Assuming that the sale occurs during the 12-month period beginning on the date of the adoption of the plan of liquidation and the liquidation is completed during that period, the shareholders can report their gain using the installment method. §453(h)(1)(A).

9-3. T recognizes no gain on this transaction, but retains its historic tax attributes, including its historic bases. *But see* §382 (for limitations on the use of any net operating loss carryovers). P takes a fair market value basis in the T Corp. stock. Under §1001, A has a total gain of $300,000; B has a total gain of $280,000; C has a total gain of $70,000. Each shareholder's gain is capital gain and its character depends on each shareholder's holding period for the stock. But what about the extra $300,000? It is possible that the excess $300,000 paid over the net value of stated assets of the corporation ($900,000) is a payment for a covenant not to compete (and not for goodwill). If the $300,000 is attributable to a covenant not to compete, then the shareholders have §1231 gain in proportion to their ownership and a reduced capital gain on the sale of stock. See Treas. Reg. §§1.197-2(b)(9) and -2(g)(8) If the $300,000 is for a covenant not to compete, P can amortize the $300,000 pursuant to §197.

9-4. T recognizes gain upon the liquidation. §336. T recognizes gain asset by asset pursuant to §1060; see problem 9-1 for the amount and character of the asset by asset gain. P recognizes no gain or loss on the liquidation, because P has a fair market value basis in the T stock. P's basis in each asset is its fair market value. §§331 and 334 (fair market value basis).

9-5. If P is a corporation, T does not recognize gain or loss on the liquidation. §337. Nor does P Corp. recognize gain or loss on the liquidation. §332. Further, P Corp. takes a transferred basis in the assets received. §334(b). P might want to make a §338 election to step up basis in the assets. (Note that if P makes a §338 election for the stock purchase, it will not be treated as a major stock acquisition (and thus not a "corporate equity reduction transaction") for purposes of §172(h), a provision discussed in more detail in the next paragraph. *See* §172(h)(3)(B)(ii).) To make a §338 election, P needs to purchase an affiliated interest in T stock over a 12-month period (e.g., no old and cold stock), and the §338 election must be made in a timely fashion. §338(g)(1). The benefit of §338 is that P does not need to liquidate T for the T assets to obtain a stepped up basis. If the election is made, T is treated as selling the assets to itself, and (disregarding any tax on the deemed sale) T will recognize gain as indicated in problem 9-1. T takes a fair market value basis in the assets under §338(b) with allocation of basis as indicated under Treas. Reg. §1.338-6 (*i.e.*, under the seven-tier residual method). If P liquidates T, neither T or P recognizes gain or loss.

If P does not make a §338 election and has excess interest deductions that create an NOL, P might attempt to carryback the NOL in accordance with §172, generating a tax refund for prior years under §172(a)(1). However, if the interest deduction is generated by a "corporate equity reduction transaction" (CERT) then under §§172(h) and 172(b)(1)(E), the NOL cannot be carried back although it can be carried forward. In this problem, the interest is not subject to the CERT rule (assuming that it is the only interest to which that rule may apply), because it is less than the $1 million de minimis amount. §172(h)(1)(D).

9-6. Generally, a §338(g) election is not attractive because there is no advantage to recognizing income now for a step-up in basis that leads to higher depreciation deductions or less gain (or greater loss) later. However, if T has an NOL that is about to

expire, P has the opportunity to step-up the basis of the T assets at no immediate tax cost, so that it may make sense to make the §338(g) election.

9-7. If P is a corporation, T does not recognize gain or loss on the liquidation. §337. Nor does P Corp. recognize gain or loss on the liquidation. §332. Because P recognizes no gain or loss, it takes transferred bases in the assets received. §334(b).

9-8. This problem raises the consistency concerns addressed in §§338(e) and (f). P Corp. may want to acquire a stepped-up basis in some of the assets but not all of them. Here, by purchasing the land and building, P may hope to step-up the basis of the §1231 assets but not of the assets that produce ordinary income. Section 338(e) deems P to have made a §338 election when it purchases the T assets during the consistency period. §338(h)(4). Notwithstanding the statutory requirement of a deemed §338 election, the regulations take a completely different approach. Treas. Regs. §1.338-8(d). Instead, no election is deemed made, but rather, the purchasing corporation takes transferred bases in the purchased, appreciated assets if the target is a subsidiary member of a consolidated group (or a corporate shareholder of the target receives a 100% dividends received deduction in conjunction with the asset disposition). Treas. Regs. §1.338-8(a)(2) and (4). (In fact, the regulations no longer permit the Service to impose a deemed §338 election.) Because T was not a member of a consolidated group before its stock was purchased and no T shareholder was eligible for a 100% dividends received deduction, the consistency rules do not apply to P's purchase of the land and building and P takes a stepped up (*i.e.*, cost) basis in those assets.

9-9. On the sale, T recognizes gain in the same manner as problem 9-1. P Corp. takes a stepped-up basis under §1012 and §1060 as in problem 9-1. On the liquidation of T, neither T nor H recognizes gain or loss. §§337 and 332. On liquidation of H Corp., H Corp. does not recognize gain but A, B, and C recognize gain on the difference between their stock bases and the amount received as discussed in problem 9-1. §§331 and 336. In sum, there is one corporate-level and one shareholder-level tax.

9-10. When T liquidates, neither T nor H recognizes gain. §§337 and 332. H takes transferred bases in the T assets. §334(b). When H liquidates, H recognizes gain on the assets in the same manner as in problem 9-1. §336. A, B, and C are taxable under §§331 and 1001 and take fair market value bases in the distributed assets. When the shareholders sell their assets to P Corp., they recognize no gain or loss, because they have fair market value bases in the assets sold. P Corp. takes a cost basis in the assets purchased. §1012; §1060. In total, there is one corporate-level and one shareholder-level tax.

9-11. In absence of relief, H would recognize a gain of $1million on the sale of the T stock. P Corp. takes a cost basis in the purchased T Corp. stock. §1012. T Corp. is now a subsidiary of P Corp., but it retains its historic asset bases. On liquidation of H Corp., H Corp. recognizes no gain (§336), but A, B, and C recognize gain as in problem 9-1 (§331).

If P Corp. wants to have the bases of the T assets stepped up, P Corp. could make a §338(g) election, or P Corp. and H Corp. could join in making a §338(h)(10) election. A §338(g) election would result in three levels of tax — one on the sale by H Corp. of the T

stock, one on the liquidation of H (*i.e.* shareholders are taxed), and one on the deemed sale by T of its assets. In the previous two problems, the same economic result was achieved with only two levels of tax.

However, a §338(h)(10) election allows T to take a stepped-up basis in its assets with only two levels of tax, just as in the previous two problems. Under this election, H Corp. is deemed to receive the sales proceeds in liquidation of T. Treas. Reg. §1.338(h)(10)-1. Because §332 would apply to that deemed liquidation, H Corp. would recognize no gain. On H Corp's liquidation, the H shareholders recognize gain and on T's deemed sale of its assets, T also recognizes gain.

An election under §338(h)(10) preserves the target's tax attributes (e.g. loss carryovers) to the benefit of the selling parent corporation, which inherits those attributes in the deemed §332 liquidation of the target-subsidiary. Further, if the parent and target are members of the same consolidated group, the §338(h)(10) election, unlike the §338(g) election, allows the target corporation to be treated as a member of that group in accounting for the target's deemed asset sale. Then, the target's gain, if any, on the deemed sale can be offset by other members' losses.

Section 336(e) performs a similar function in some situations where the requirements of §338(h)(10) are not met (e.g., 80% control requirement of §1504).