

# Internal Revenue bulletin

Bulletin No. 2001-15  
April 9, 2001

## HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

### INCOME TAX

#### **Rev. Rul. 2001-17, page 1052.**

**Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate.** For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for April 2001.

#### **T.D. 8940, page 1016.**

Final regulations under sections 338 and 1060 of the Code revise the rules relating to deemed and actual asset acquisitions.

### EMPLOYMENT TAX

#### **Page 1054.**

**Railroad retirement; rate determination; quarterly.** The Railroad Retirement Board has determined that the rate of tax imposed by section 3221 of the Code shall be 26 cents for the quarter beginning April 1, 2001.

### EXCISE TAX

#### **REG-106892-00, page 1060.**

Proposed regulations under section 6302 of the Code relate to tax returns, payments, and deposits of excise tax.

### ADMINISTRATIVE

#### **T.D. 8943, page 1054.**

#### **REG-121109-00, page 1064.**

Temporary and proposed regulations under section 6103 of the Code authorize the IRS to disclose return information to the Bureau of the Census.

#### **REG-101520-97, page 1057.**

Proposed regulations under section 6343 of the Code provide circumstances under which levied upon property will be returned and the procedures for requesting a return of property.

#### **Announcement 2001-30, page 1065.**

This document contains a change of date for the public hearing on proposed regulations (REG-106030-98, 2001-11 I.R.B. 820) and extends the time to submit outlines of oral comments. A public hearing is scheduled for May 23, 2001.

Finding Lists begin on page ii.



Department of the Treasury  
Internal Revenue Service

# The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities

and by applying the tax law with integrity and fairness to all.

## Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and proce-

dures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

### **Part II.—Treaties and Tax Legislation.**

This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

### **Part III.—Administrative, Procedural, and Miscellaneous.**

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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# Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

## Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, page 1052.

## Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, page 1052.

## Section 338.—Certain Stock Purchases Treated as Asset Acquisitions

26 CFR 1.338-1: *General principles; status of old target and new target.*

### T.D. 8940

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

### Purchase Price Allocations in Deemed and Actual Asset Acquisitions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to deemed and actual asset acquisitions under sections 338 and 1060. The final regulations affect sellers and buyers of corporate stock that are eligible to elect to treat the transaction as a deemed asset acquisition. The final regulations also affect sellers and buyers of assets that constitute a trade or business.

DATES: *Effective Date:* These regulations are effective March 16, 2001.

*Applicability Dates:* For dates of applicability of these regulations, see §§1.338(i)-1 and 1.1060-1(a)(2).

FOR FURTHER INFORMATION CONTACT: Richard Starke of the Office of Associate Chief Counsel (Corporate), (202) 622-7790 (not a toll-free number).

## SUPPLEMENTARY INFORMATION:

### Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under the control number 1545-1658.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

The collections of information in these regulations are in §§1.338-2(d), 1.338-2(e)(4), 1.338-5(d)(3), 1.338-10(a)(4), 1.338(h)(10)-1(d)(2), and 1.1060-1(e)(ii)(A) and (B). The collections of information are necessary to make an election to treat a sale of stock as a sale of assets, to calculate and collect the appropriate amount of tax in a deemed or actual asset acquisition, and to determine the bases of assets acquired in a deemed or actual asset acquisition.

These collections of information are required to obtain a benefit. The likely respondents and/or recordkeepers are small businesses or organizations, businesses, or other for-profit institutions, and farms.

The regulations provide that a section 338 election is made by filing Form 8023. The burden for this requirement is reflected in the burden of Form 8023. The regulations also provide that both a seller and a purchaser must each file an asset acquisition statement on Form 8594. The burden for this requirement is reflected in the burden of Form 8594. With respect to Form 8023, the IRS estimated that 201 forms would be filed each year and that each taxpayer would require 12.98 hours to comply. With respect to Form 8594, the IRS estimated that 20,000 forms would be filed each year and that each taxpayer would require 12.25 hours to comply. These estimates have been made available for public comment and no public comments have been received.

The burden for the collection of information in §1.338-2(e)(4) is as follows:

Estimated total annual reporting/recordkeeping burden: 25 hours

Estimated average annual burden per respondent/recordkeeper: 0.56 hours

Estimated number of respondents/recordkeepers: 45

Estimated annual frequency of responses: On occasion

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

### Background

On August 10, 1999, the IRS and the Department of Treasury (Treasury) published a notice of proposed rulemaking in the **Federal Register** (REG-107069-97, 1999-2 C.B. 346 [64 FR 43462]) containing proposed regulations under sections 338 and 1060 of the Internal Revenue Code of 1986. On January 7, 2000, the IRS and Treasury published temporary regulations in the **Federal Register** (T. D. 8858, 2000-4 I.R.B. 333 [65 FR 1236]) that are virtually the same as the proposed regulations published on August 10, 1999. The preamble to the temporary regulations notes that the proposed regulations generally were favorably received and that the IRS and Treasury believe that the proposed regulations provided clearer guidance and better rules than the prior regulations under sections 338 and 1060. However, the preamble also notes that the comments received warranted further consideration.

### Explanation of Provisions

In general, the final regulations adopted herein are very similar to the proposed and temporary regulations in their organization and substance. However,

changes have been made in several areas, largely in response to the comments received. The principal changes are discussed below, in the order in which they appear in the regulations.

#### *Insurance Transactions*

Although section 338 treats a target as having sold all its assets in the deemed asset sale, proposed §1.338-1(a)(2) provides that other rules of law may characterize the transaction as something other than or in addition to a sale and purchase of assets. Proposed §1.338-1(a)(2) states: “[f]or example, if target is an insurance company for which a section 338 election is made, the deemed asset sale would be characterized and taxed as an assumption-reinsurance transaction under applicable Federal income tax law.” Several comments urged removal of the quoted sentence in the final regulations and recommended that the treatment of transactions involving insurance companies under section 338 be reserved pending more complete analysis and guidance. The IRS and Treasury believe that generally it is appropriate to view the deemed asset sale by an insurance company as involving an assumption-reinsurance transaction and, therefore, have retained the sentence in the final regulations. The IRS and Treasury, however, intend to provide additional guidance in a separate project.

#### *Residual Method Anti-abuse Rule*

The proposed regulations include a new anti-abuse rule intended to prevent taxpayers from changing the results of applying the residual method by engaging in transactions that have a transitory economic effect with respect to the ownership or use of assets. The anti-abuse rule is intended to apply only to an asset transfer exhibiting objective characteristics suggesting the transfer was engaged in to manipulate the operation of the residual method.

Notwithstanding the limited scope of the anti-abuse rule, several commentators suggested further limiting or eliminating the rule. After studying the comments, the IRS and Treasury continue to believe that the anti-abuse rule serves a useful purpose in protecting the operation of the residual method. Several changes have been made, however, to clarify the intended scope of the rule. Thus, the phrase

“to more than an insignificant extent” is changed in the final regulation to “primarily.” This change is meant to clarify that some continuing use in its original location of an asset transferred to or from the target is permitted.

A comment requested that the final regulations elaborate further on the statement that the Commissioner has the authority to make appropriate correlative adjustments and that the final regulations include an example. The final regulations do not do so, because the nature of any correlative adjustments would depend on the particular factual circumstances in which the rule is applied. Thus, any additional guidance would provide only limited assistance. However, the final regulations state that correlative adjustments should avoid duplication or omission of any item of income, gain, loss, deduction, or basis. See §1.338-1(c).

#### *Closing Date Issues*

Concerns have been raised about the possibility that buyers can effectuate transactions outside the ordinary course of business after acquiring target stock that, to the detriment of an unsuspecting seller, must be reported by the seller on its return, which normally covers the entire day on which the acquisition occurs. Some of these concerns derive from a reading of §1.1502-76(b) to preclude operation of the “next day rule” whenever a section 338 election is made for a target. The “next day rule” of §1.1502-76(b) provides that if, on the day of a group member’s change in status as a member, a transaction occurs that is properly allocable to the portion of the member’s day after the event resulting in the change, the member and all related persons must treat the transaction as occurring at the beginning of the following day.

Commentators have suggested that a purchaser acquiring stock of a subsidiary member of a consolidated group could, after acquiring the target stock, cause the target to sell all of its assets to another person later on the closing date and then make a unilateral section 338(g) election. It is suggested that the effect of the election is to preclude the operation of the next day rule, causing the results of the actual asset sale to fall onto the selling consolidated group’s tax return. The IRS and Treasury do not believe that

§1.1502-76(b), as written, automatically precludes the operation of the next day rule in a section 338 context, but nevertheless have provided a new rule in these final regulations that requires the application of the next day rule in a section 338 context where the target engages in a transaction outside the ordinary course of business on the acquisition date after the event resulting in the qualified stock purchase (QSP). See §1.338-1(d).

#### *Purchase Definition*

Proposed §1.338-3(b)(2) provides rules concerning the definition of a “purchase” that require more than a nominal amount to be paid for the stock of the target. Several comments requested reconsideration of the proposed rule. Accordingly, in the temporary regulations, at §1.338-3T(b)(2), a definition is given for the term *purchase of target affiliate*, while the definition of the term *purchase of target* is reserved. The final regulations include a single definition of *purchase* applicable to both targets and target affiliates, which definition generally conforms to the definition of *purchase of target affiliate* in the temporary regulations. Under this definition, stock in a target (or target affiliate) may be considered purchased if, under general principles of tax law, the purchasing corporation is considered to own stock of the target (or target affiliate) meeting the requirements of section 1504(a)(2), notwithstanding that no amount may be paid for (or allocated to) the stock.

#### *Transactions After QSPs*

Since 1995, the regulations under section 338 have provided special rules that apply, by virtue of section 338, to certain transfers of target assets following a QSP of the target’s stock if a section 338 election is not made for the target. These provisions modify the normal operation of the continuity of interest requirement under section 368 and the interpretation of the term shareholder for purposes of section 368(a)(1)(D), as applied to certain taxpayers. These rules were adopted to effectuate Congressional intent, in replacing former section 334(b)(2) with section 338, that the deemed sale results provided by section 338 not be available through transactions within the purchasing group after the acquisition. In the final regula-

tions, these rules are located at §1.338-3(d).

The 1995 amendments did not provide any special rule to modify the application of the statutory requirements for reorganizations under section 368(a)(1)(C). However, the considerations that justify the modified application of the continuity of interest rule and the shareholder definition for “D” reorganizations also justify an analogous modification of the “solely for voting stock” requirement for post-acquisition “C” reorganizations. Accordingly, the final regulations provide that consideration other than voting stock issued in connection with a QSP is ignored in determining whether a subsequent transfer of assets by the target corporation to a member of its new affiliated group satisfies the solely for voting stock requirement of a “C” reorganization. See §1.338-3(d)(4).

#### *Treatment of Liabilities*

The proposed regulations eliminate the prior distinction between “modified aggregate deemed sale price” (or MADSP) and “aggregate deemed sale price” (or ADSP), a distinction that appeared to have been based on the premise that the new target generally will not bear the tax liability for the deemed sale where a section 338(h)(10) election is made, but that it generally will bear the liability where a section 338 (but not section 338(h)(10)) election is made. However, these generalizations were not universally correct in either situation. Proposed §§1.338-4 and 1.338-5 clarify the treatment of taxes as liabilities in computing ADSP and “adjusted grossed-up basis” (or AGUB). Commentators asked for further clarification of the standards for taking certain taxes into account. Rather than providing more specific guidance, which would be inconsistent with the overall philosophy of deferring to general tax principles governing actual transactions, the final regulations further simplify the discussion of liabilities. Except for the fact that new target remains liable for old target’s tax liabilities (see §1.338-1(b)(3)(i)) and that a buyer’s assumption of a seller’s income tax liability with respect to the sale causes the consideration to “gross up” or “pyramid,” a tax liability is like any other type of liability and the status of any particular type of tax liability as a liability includi-

ble in ADSP or AGUB should be determined under general principles as applied to the facts relating to the incidence of the tax liability.

#### *Valuation Rules*

Proposed §1.338-6(a)(2)(iii) retains a statement from prior versions of the regulations that “[i]n certain cases the IRS may make an independent showing of the value of goodwill and going concern value as a means of calling into question the validity of the taxpayer’s valuation of other assets.” This authority was intended to provide a means of ensuring that taxpayers do not overvalue assets in higher classes that are allocated consideration before the residual class. As a factual matter, the IRS and Treasury understand that a low (or no) allocation to goodwill and going concern value may result from causes other than a taxpayer’s overvaluation of assets in higher classes. Moreover, the IRS and Treasury accept the soundness of the fundamental premise of the residual method — that goodwill and going concern value are the most difficult assets to value independently and that their value should be computed as the residue after all other assets are valued. The final regulations delete the sentence about valuing goodwill and going concern value. Under the final regulations, the IRS retains the ability to challenge a taxpayer’s valuation of assets in Classes I through VI, but will do so on grounds consistent with the residual method of allocation.

#### *Top-Down Allocation*

Changes to the rules for allocating purchase price to the stock and assets of lower tier subsidiaries were not proposed, although, as noted in the preamble to the proposed regulations, considerable study was given to alternative approaches. Comments were requested, but none was received, and the IRS and Treasury to date have been unable to develop a fully successful alternative. Accordingly, the final regulations continue to apply the “top-down” allocation system, under which the stock of a lower tier subsidiary is allocated purchase price in the general asset category (now Class V) and the deemed purchase price of its assets is in turn computed from that stock price and then allocated within the subsidiary.

In the final regulations, the scope of

Class II assets described in §1.338-6(b)(2)(ii) is modified to provide that Class II assets do not include stock of target affiliates, other than actively traded stock described in section 1504(a)(4) (certain preferred stock). Instead, stock of target affiliates is included in Class V. This would exclude target affiliate stock from Class II where the target holds an 80 percent or greater interest in the target affiliate but a minority interest in target affiliate stock of the same class is actively traded. It is not clear that the trading price for shares of a class of stock less than 20 percent of which is in the hands of the public, and which consequently may experience thinner trading volumes, necessarily is indicative of the fair market value of the 80 percent or greater majority interest.

#### *Class III Assets*

Proposed §1.338-6(b)(2) provides that Class III assets consist of “accounts receivable, mortgages, and credit card receivables from customers which arise in the ordinary course of business.” Comments suggested that these categories were too limited. Under the rationales expressed in the preamble to the proposed regulations, the IRS and Treasury believe that other types of debt instruments, and even other types of assets, should be included in Class III. As revised in the final regulations, Class III assets generally consist of assets that the taxpayer marks to market at least annually and debt instruments (including receivables). However, debt instruments issued by related parties, and certain contingent payment and convertible debt instruments, are not included in Class III.

#### *First Year Price Adjustments*

Proposed §1.338-7 provides rules for allocating the ADSP or AGUB when increases or decreases are required after the close of new target’s first taxable year. For increases or decreases required before the end of new target’s first taxable year, proposed §1.338-4(b)(2)(ii) provides that “[i]ncreases or decreases with respect to the elements of ADSP that are taken into account before the close of new target’s first taxable year are taken into account for purposes of determining ADSP and the deemed sale tax consequences as if they had been taken into account at the

beginning of the day after the acquisition date.” Proposed §1.338-5(b)(2)(ii) contains a similar rule for redeterminations of AGUB. These rules originated in predecessor versions of the regulations under section 338.

Although no commentator requested removal of these rules, one comment highlighted the difficulties posed for the seller in section 338(h)(10) transactions in applying a rule based on new target’s year-end, and requested relief. After reviewing this comment, the final regulations remove the rules providing special treatment for changes in ADSP or AGUB occurring before the close of new target’s first taxable year. Instead, the general rule in §1.338-7 governs the allocation of all changes in ADSP or AGUB after the acquisition date. This change is consistent with the IRS’s and Treasury’s expressed intent in drafting the proposed regulations to eliminate, to the extent possible, any special accounting rules in the section 338 regulations, as it should result in treatment more consistent with that of an actual asset sale.

#### *Like-kind Exchanges*

A commentator suggested that the final regulations should apply section 1031 to old target in its deemed asset sale if the purchaser pays for target stock with property of like kind to old target’s assets or with cash put in escrow for a successor to old target to designate for purchase of assets of like kind. This rule would be an exception to the requirement in §1.338-1(a)(2) that the transaction between old target and new target must be a taxable transaction, and inconsistent with the requirement of section 338(a)(1) that target “shall be treated as having sold all of its assets at the close of the acquisition date at fair market value . . . .” After considering the policy concerns and the administrative difficulties in creating and administering an exception for section 1031 exchanges, the IRS and Treasury have not adopted this suggestion.

#### *S Corporations*

A purchaser may agree to compensate the sellers of an S corporation target for adverse tax consequences resulting from a section 338(h)(10) election. When more than one shareholder in an S corporation sells stock in the same transaction, the

different shareholders may negotiate different prices for their stock based on varying Federal and state tax liabilities they will bear as a result of the transaction. Some commentators have noted that, in other cases, different prices may be paid for control premiums or other reasons. Under section 1361(b)(1)(D), an S corporation is permitted to have only one class of stock. A potential second class of stock issue arises because the fiction of a section 338(h)(10) election is that the target sells its assets to a new target and then liquidates. Applying that fiction, if the shareholders are treated as receiving differing amounts per share in the deemed liquidation, a second class of stock could result.

Some commentators have recommended that the final regulations clarify that the payment of varying amounts per share to S corporation shareholders will not cause the S corporation to violate the single class of stock requirement. The final regulations respond to these comments by including a statement in §1.1361-1(l)(2)(v) that the payment of varying amounts to S corporation shareholders in a transaction for which a section 338(h)(10) election is made will not cause the S corporation to violate the single class of stock requirement of section 1361(b)(1)(D) and §1.1361-1(l), provided that the varying amounts are negotiated in arm’s length negotiations with the purchaser.

One commentator requested clarification regarding the calculation and allocation of the purchaser’s AGUB for a target that was an S corporation that owned a qualified subchapter S subsidiary (QSub), where the QSub status does not continue after the acquisition date and the QSub is treated as becoming a separate subsidiary of new target. Although the regulations require allocation of the AGUB among the target’s assets held at the beginning of the day after the acquisition date, they also require results consistent with those that would occur if the parties had actually engaged in the transactions deemed to occur because of section 338(h)(10), and taking into account other transactions that actually occurred or are deemed to occur. See §1.338(h)(10)-1(d)(9). An actual sale of the assets of the S corporation target, including the stock of the QSub, to a corporation would be treated as a sale

by the S corporation of all of its assets, including those of the QSub. If the QSub status does not continue after the acquisition, the buyer would be treated as forming a new subsidiary containing the assets held by the former QSub. See §1.1361-5(b)(3) *Example 9*. Accordingly, the AGUB for the former S corporation target would be allocated among the assets of the former QSub as though they were assets of the target, and then the target would be treated as having formed a new subsidiary containing the assets of the former QSub.

Clarification was also requested regarding the possibility of making a section 338(h)(10) election for the sale by an S corporation of stock of a QSub. As noted above, *Example 9* of §1.1361-5(b)(3) indicates that the sale by an S corporation of all of the stock of a QSub is treated as an asset sale by the S corporation to the purchaser of the QSub stock. No further guidance is provided in these regulations. The sale of an 80 percent or greater (but less than 100 percent) interest in the stock of a QSub is not expected to be a common transaction because it generally will result in a taxable transaction with respect to all the assets of the QSub.

#### *Forms 8023 and 8594*

The current temporary regulations provide that a section 338(h)(10) election for an S corporation target must be made jointly by the purchaser and the S corporation shareholders. These regulations specifically require nonselling S corporation shareholders to consent to the election. See §1.338(h)(10)-1T(c)(2). However, the instructions for the election form (Form 8023) do not clearly require the nonselling shareholders to sign the election form. Moreover, the prior regulations were less clear in requiring nonselling S corporation shareholders to consent to the election. Commentators have requested that the IRS recognize the validity of section 338(h)(10) elections for S corporation targets even if not signed by nonselling shareholders. The IRS will revise Form 8023 to make clear that nonselling S corporation shareholders must also sign. The IRS will recognize the validity of otherwise valid elections made on the current version of the form even if not signed by the nonselling share-

holders, provided that the S corporation and all of its shareholders (including non-selling shareholders) report the tax consequences consistently with the results under section 338(h)(10). See §1.338(i)-1(b).

The preamble to the proposed regulations indicates that the IRS and Treasury were considering requiring that the information about the allocation of ADSP and AGUB currently submitted on the election form (Form 8023) instead be submitted by the purchaser and seller(s) separately on their income tax returns. Such a change will be effectuated when Form 8023 is revised. The information about ADSP and AGUB will be reported by each party separately on Form 8594, which also will be revised. With respect to a transaction subject to a section 338 election, Form 8594 will be filed with the income tax returns of the old and new target for the tax periods including the deemed sale and purchase. Where an election under section 338(g) is made for a controlled foreign corporation (CFC), the purchaser and seller (or their U.S. shareholder(s)) will be required to submit separately, on Form 8594, information about ADSP and AGUB. The Form 8594 will be required to be attached to the last Form 5471 filed by the seller for old target, and to the first Form 5471 filed by the purchaser for new target.

### Special Analyses

It has been determined that these final regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has been determined that a final regulatory flexibility analysis is required for the collection of information in this Treasury decision under 5 U.S.C. 604. This analysis is set forth below under the heading "Final Regulatory Flexibility Act Analysis." Pursuant to section 7805(f) of the Internal Revenue Code, these final regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Admin-

istration for comment on their impact on small business.

### Final Regulatory Flexibility Act Analysis

This analysis is required under the Regulatory Flexibility Act (5 U.S.C. chapter 6). This regulatory action is intended to simplify and clarify the current rules relating to both deemed and actual asset acquisitions. The current rules were developed over a long period of time and have been repeatedly amended. The IRS and Treasury believe these final regulations will significantly improve the clarity of the rules relating to both deemed and actual asset acquisitions.

The major objective of these final regulations is to modify the rules for allocating purchase price in both deemed and actual asset acquisitions. In addition, these final regulations replace the general rules for electing to treat a stock sale as an asset sale.

These collections of information may affect small businesses if the stock of a corporation which is a small entity is acquired in a qualified stock purchase or if a trade or business which is also a small business is transferred in a taxable transaction. Form 8023 (on which an election to treat a stock sale as an asset sale is filed) has been submitted to and approved by the Office of Management and Budget. With respect to Form 8023, the IRS estimated that 201 forms would be filed each year and that each taxpayer would require 12.98 hours to comply. Form 8594 (on which a sale or acquisition of assets constituting a trade or business is reported) has also been submitted to and approved by the Office of Management and Budget. With respect to Form 8594, the IRS estimated that 20,000 forms would be filed each year and that each taxpayer would require 12.25 hours to comply. These estimates have been made available for public comment and no public comments have been received. The regulations do not impose new requirements on small businesses and, in fact, should lessen any

difficulties associated with the existing reporting requirements by clarifying the rules associated with deemed and actual asset acquisitions.

The collections of information require taxpayers to file an election in order to treat a stock sale as an asset sale. In addition, taxpayers must file a statement regarding the amount of consideration allocated to each class of assets under the residual method. The professional skills that would be necessary to make the election or allocate the consideration would be the same as those required to prepare a return for the small business.

### Drafting Information

The principal author of these regulations is Richard Starke, Office of the Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated extensively in their development.

\* \* \* \* \*

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for Sections 1.338-6T, 1.338-7T, 1.338-10T and 1.1060-1T and by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.338-6 also issued under 26 U.S.C. 337(d), 338, and 1502.

Section 1.338-7 also issued under 26 U.S.C. 337(d), 338, and 1502.

Section 1.338-10 also issued under 26 U.S.C. 337(d), 338, and 1502.\* \* \*

Section 1.1060-1 also issued under 26 U.S.C. 1060.\* \* \*

Par. 2. In the list below, for each section indicated in the left column, remove the language in the middle column and add the language in the right column:

<i>Section</i>	<i>Remove</i>	<i>Add</i>
1.56(g)-1(k)(1), second sentence	of §1.338-6T(b), if otherwise	of §1.338-6(b), if otherwise
1.56(g)-1(k)(1), last sentence	of §1.338-6T(c)(1) and (2) also	of §1.338-6(c)(1) and (2) also
1.197-2(e)(1), second sentence	See §1.1060-1T(b)(2)	See §1.1060-1(b)(2)
1.197-2(k), <i>Example 6</i> , paragraph (i), last sentence	See §1.338-6T(b)	See §1.338-6(b)
1.197-2(k), <i>Example 6</i> , paragraph (ii), second sentence	Under §§1.1060-1T(c)(2) and 1.338-6T(c)(1),	Under §§1.1060-1(c)(2) and 1.338-6(c)(1)
1.197-2(k), <i>Example 6</i> , paragraph (ii), last sentence	See §§1.1060-1T(c)(2) and 1.338-6T(b)	See §§1.1060-1(c)(2) and 1.338-6(b)
1.197-2(k), <i>Example 23</i> paragraph (iv), first sentence	(as these terms are defined in §1.338-1(c)(13))	(as these terms are defined in §1.338-2(c)(17))
1.338-8(h)(1), last sentence	nomenclature of §1.338-1(b) and (c) and	nomenclature of §1.338-2(b) and (c) and
1.338-9(a), penultimate sentence	provided in §1.338-1(c)(14),	provided in §1.338-2(c)(18),
1.338-9(b)(1), first sentence	the deemed sale gain, as defined in §1.338-3(b)(4),	the deemed sale tax consequences, as defined in §1.338-2(c)(7),
1.338-9(b)(1), last sentence	the deemed sale gain.	the deemed sale tax consequences.
1.338-9(b)(3)(i)(B)	under §1.338(b)-1(e)(2).	under §1.338-5(d).
1.338-9(b)(3)(ii)	reflect deemed sale gain)	reflect deemed sale tax consequences)
1.338-9(b)(4)	under §1.338(b)-1(e)(2),	under §1.338-5(d),
1.338-9(f)(2), <i>Example 1</i> , paragraph (a), last sentence	and §1.338(b)-1(e)(2).	and §1.338-5(d).
1.368-1(a), third sentence	(k) and 1.338-3T(c)(3).	(k) and 1.338-3(d).
1.368-1(e)(6), <i>Example 4</i> , paragraph (ii), last sentence	see §1.338-3T(c)(3) (which	see §1.338-3(d) (which
1.597-2(d)(5)(iii)(B)	(see §1.338-7T)	(see §1.338-7)
1.597-5(c)(3)(i)	under §1.338-6T(b), (c)(1) and (2).	under §1.338-6(b), (c)(1) and (2).
1.597-5(d)(2)(i)	under §1.338-6T(b), (c)(1) and (2).	under §1.338-6(b), (c)(1) and (2).
1.921-1T(b)(1), A-1, immediately preceding the penultimate sentence	and §1.338-2T(d).	and §1.338-2(d).
1.1031(d)-1T last sentence	see §1.1060-1T(b), (c), and (d) <i>Example 1</i> .	see §1.1060-1(b), (c), and (d) <i>Example 1</i> .
1.1031(j)-1(b)(2)(iii), penultimate sentence	in §1.338-6T(b), to which reference is made by §1.1060-1T(c)(2).	in §1.338-6(b), to which reference is made by §1.1060-1(c)(2).
1.1361-4(d), <i>Example 3</i> , third sentence	Under section 338(a) and §1.338(h)(10)-1T(d)(3)	Under section 338(a) and §1.338(h)(10)-1(d)(3)
1.1502-75(k)	See §1.338(h)(10)-1T(d)(7) for	See §1.338(h)(10)-1(d)(7) for
1.1502-76(b)(1)(ii)(A)(I), last sentence	See §1.338-10T(a)(5) (deemed	See §1.338-10(a)(5) (deemed



Par. 3. Sections 1.338–0 through 1.338–7 are added to read as follows:

*§1.338–0 Outline of topics.*

This section lists the captions contained in the regulations under section 338 as follows:

*§1.338–1 General principles; status of old target and new target.*

- (a) In general.
  - (1) Deemed transaction.
  - (2) Application of other rules of law.
  - (3) Overview.
- (b) Treatment of target under other provisions of the Internal Revenue Code.
  - (1) General rule for subtitle A.
  - (2) Exceptions for subtitle A.
  - (3) General rule for other provisions of the Internal Revenue Code.
- (c) Anti-abuse rule.
  - (1) In general.
  - (2) Examples.
- (d) Next day rule for post-closing transactions.

*§1.338–2 Nomenclature and definitions; mechanics of the section 338 election.*

- (a) Scope.
- (b) Nomenclature.
- (c) Definitions.
  - (1) Acquisition date.
  - (2) Acquisition date assets.
  - (3) Affiliated group.
  - (4) Common parent.
  - (5) Consistency period.
  - (6) Deemed asset sale.
  - (7) Deemed sale tax consequences.
  - (8) Deemed sale return.
  - (9) Domestic corporation.
  - (10) Old target's final return.
  - (11) Purchasing corporation.
  - (12) Qualified stock purchase.
  - (13) Related persons.
  - (14) Section 338 election.
  - (15) Section 338(h)(10) election.
  - (16) Selling group.
  - (17) Target; old target; new target.
  - (18) Target affiliate.
  - (19) 12-month acquisition period.
- (d) Time and manner of making election.
- (e) Special rules for foreign corporations or DISCs.
  - (1) Elections by certain foreign purchasing corporations.
    - (i) General rule.
    - (ii) Qualifying foreign purchasing corporation.

- (iii) Qualifying foreign target.
- (iv) Triggering event.
- (v) Subject to United States tax.
  - (2) Acquisition period.
  - (3) Statement of section 338 may be filed by United States shareholders in certain cases.
  - (4) Notice requirement for U.S. persons holding stock in foreign target.
    - (i) General rule.
    - (ii) Limitation.
    - (iii) Form of notice.
    - (iv) Timing of notice.
    - (v) Consequence of failure to comply.
    - (vi) Good faith effort to comply.

*§1.338–3 Qualification for the section 338 election.*

- (a) Scope.
- (b) Rules relating to qualified stock purchases.
  - (1) Purchasing corporation requirement.
  - (2) Purchase.
  - (3) Acquisitions of stock from related corporations.
    - (i) In general.
    - (ii) Time for testing relationship.
    - (iii) Cases where section 338(h)(3)(C) applies—acquisitions treated as purchases.
    - (iv) Examples.
  - (4) Acquisition date for tiered targets.
    - (i) Stock sold in deemed asset sale.
    - (ii) Examples.
    - (5) Effect of redemptions.
      - (i) General rule.
      - (ii) Redemptions from persons unrelated to the purchasing corporation.
      - (iii) Redemptions from the purchasing corporation or related persons during 12-month acquisition period.
        - (A) General rule.
        - (B) Exception for certain redemptions from related corporations.
    - (iv) Examples.
  - (c) Effect of post-acquisition events on eligibility for section 338 election.
    - (1) Post-acquisition elimination of target.
    - (2) Post-acquisition elimination of the purchasing corporation.
    - (d) Consequences of post-acquisition elimination of target where section 338 election not made.
      - (1) Scope.
      - (2) Continuity of interest.
      - (3) Control requirement.
      - (4) Solely for voting stock requirement.

- (5) Example.

*§1.338–4 Aggregate deemed sale price; various aspects of taxation of the deemed asset sale.*

- (a) Scope.
- (b) Determination of ADSP.
  - (1) General rule.
  - (2) Time and amount of ADSP.
    - (i) Original determination.
    - (ii) Redetermination of ADSP.
    - (iii) Example.
  - (c) Grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock.
    - (1) Determination of amount.
    - (2) Example.
    - (d) Liabilities of old target.
      - (1) In general.
      - (2) Time and amount of liabilities.
    - (e) Deemed sale tax consequences.
    - (f) Other rules apply in determining ADSP.
    - (g) Examples.
    - (h) Deemed sale of target affiliate stock.
      - (1) Scope.
      - (2) In general.
      - (3) Deemed sale of foreign target affiliate by a domestic target.
      - (4) Deemed sale producing effectively connected income.
      - (5) Deemed sale of insurance company target affiliate electing under section 953(d).
      - (6) Deemed sale of DISC target affiliate.
      - (7) Anti-stuffing rule.
      - (8) Examples.

*§1.338–5 Adjusted grossed-up basis.*

- (a) Scope.
- (b) Determination of AGUB.
  - (1) General rule.
  - (2) Time and amount of AGUB.
    - (i) Original determination.
    - (ii) Redetermination of AGUB.
    - (iii) Examples.
  - (c) Grossed-up basis of recently purchased stock.
  - (d) Basis of nonrecently purchased stock; gain recognition election.
    - (1) No gain recognition election.
    - (2) Procedure for making gain recognition election.
    - (3) Effect of gain recognition election.
      - (i) In general.
      - (ii) Basis amount.
      - (iii) Losses not recognized.

- (iv) Stock subject to election.
- (e) Liabilities of new target.
  - (1) In general.
  - (2) Time and amount of liabilities.
  - (3) Interaction with deemed sale tax consequences.
- (f) Adjustments by the Internal Revenue Service.
- (g) Examples.

*§1.338-6 Allocation of ADSP and AGUB among target assets.*

- (a) Scope.
  - (1) In general.
  - (2) Fair market value.
    - (i) In general.
    - (ii) Transaction costs.
  - (iii) Internal Revenue Service authority.
- (b) General rule for allocating ADSP and AGUB.
  - (1) Reduction in the amount of consideration for Class I assets.
  - (2) Other assets.
    - (i) In general.
    - (ii) Class II assets.
    - (iii) Class III assets.
    - (iv) Class IV assets.
    - (v) Class V assets.
    - (vi) Class VI assets.
    - (vii) Class VII assets.
  - (3) Other items designated by the Internal Revenue Service.
  - (c) Certain limitations and other rules for allocation to an asset.
    - (1) Allocation not to exceed fair market value.
    - (2) Allocation subject to other rules.
    - (3) Special rule for allocating AGUB when purchasing corporation has non-recently purchased stock.
      - (i) Scope.
      - (ii) Determination of hypothetical purchase price.
      - (iii) Allocation of AGUB.
    - (4) Liabilities taken into account in determining amount realized on subsequent disposition.
  - (d) Examples.

*§1.338-7 Allocation of redetermined ADSP and AGUB among target assets.*

- (a) Scope.
- (b) Allocation of redetermined ADSP and AGUB.
- (c) Special rules for ADSP.
  - (1) Increases or decreases in deemed sale tax consequences taxable notwithstanding old target ceases to exist.

- (2) Procedure for transactions in which section 338(h)(10) is not elected.
- (i) Deemed sale tax consequences included in new target's return.
  - (ii) Carryovers and carrybacks.
    - (A) Loss carryovers to new target taxable years.
    - (B) Loss carrybacks to taxable years of old target.
    - (C) Credit carryovers and carrybacks.
- (3) Procedure for transactions in which section 338(h)(10) is elected.
  - (d) Special rules for AGUB.
    - (1) Effect of disposition or depreciation of acquisition date assets.
    - (2) Section 38 property.
  - (e) Examples.

*§1.338-8 Asset and stock consistency.*

- (a) Introduction.
  - (1) Overview.
  - (2) General application.
  - (3) Extension of the general rules.
  - (4) Application where certain dividends are paid.
  - (5) Application to foreign target affiliates.
  - (6) Stock consistency.
- (b) Consistency for direct acquisitions.
  - (1) General rule.
  - (2) Section 338(h)(10) elections.
- (c) Gain from disposition reflected in basis of target stock.
  - (1) General rule.
  - (2) Gain not reflected if section 338 election made for target.
  - (3) Gain reflected by reason of distributions.
  - (4) Controlled foreign corporations.
  - (5) Gain recognized outside the consolidated group.
- (d) Basis of acquired assets.
  - (1) Carryover basis rule.
  - (2) Exceptions to carryover basis rule for certain assets.
  - (3) Exception to carryover basis rule for *de minimis* assets.
  - (4) Mitigation rule.
    - (i) General rule.
    - (ii) Time for transfer.
- (e) Examples.
  - (1) In general.
  - (2) Direct acquisitions.
- (f) Extension of consistency to indirect acquisitions.
  - (1) Introduction.
  - (2) General rule.
  - (3) Basis of acquired assets.
  - (4) Examples.

- (g) Extension of consistency if dividends qualifying for 100 percent dividends received deduction are paid.
  - (1) General rule for direct acquisitions from target.
  - (2) Other direct acquisitions having same effect.
  - (3) Indirect acquisitions.
  - (4) Examples.
  - (h) Consistency for target affiliates that are controlled foreign corporations.
    - (1) In general.
    - (2) Income or gain resulting from asset dispositions.
      - (i) General rule.
      - (ii) Basis of controlled foreign corporation stock.
        - (iii) Operating rule.
    - (iv) Increase in asset or stock basis.
  - (3) Stock issued by target affiliate that is a controlled foreign corporation.
    - (4) Certain distributions.
      - (i) General rule.
      - (ii) Basis of controlled foreign corporation stock.
        - (iii) Increase in asset or stock basis.
    - (5) Examples.
      - (i) [Reserved]
      - (j) Anti-avoidance rules.
        - (1) Extension of consistency period.
        - (2) Qualified stock purchase and 12-month acquisition period.
        - (3) Acquisitions by conduits.
          - (i) Asset ownership.
            - (A) General rule.
            - (B) Application of carryover basis rule.
          - (ii) Stock acquisitions.
            - (A) Purchase by conduit.
            - (B) Purchase of conduit by corporation.
            - (C) Purchase of conduit by conduit.
        - (4) Conduit.
        - (5) Existence of arrangement.
        - (6) Predecessor and successor.
          - (i) Persons.
          - (ii) Assets.
      - (7) Examples.

*§1.338-9 International aspects of section 338.*

- (a) Scope.
- (b) Application of section 338 to foreign targets.
  - (1) In general.
  - (2) Ownership of FT stock on the acquisition date.
  - (3) Carryover FT stock.
    - (i) Definition.
    - (ii) Carryover of earnings and profits.

- (iii) Cap on carryover of earnings and profits.
- (iv) Post-acquisition date distribution of old FT earnings and profits.
- (v) Old FT earnings and profits unaffected by post-acquisition date deficits.
- (vi) Character of FT stock as carryover FT stock eliminated upon disposition.
- (4) Passive foreign investment company stock.
- (c) Dividend treatment under section 1248(e).
- (d) Allocation of foreign taxes.
- (e) Operation of section 338(h)(16). [Reserved]
- (f) Examples.

*§1.338-10 Filing of returns.*

- (a) Returns including tax liability from deemed asset sale.
  - (1) In general.
  - (2) Old target's final taxable year otherwise included in consolidated return of selling group.
    - (i) General rule.
    - (ii) Separate taxable year.
  - (iii) Carryover and carryback of tax attributes.
  - (iv) Old target is a component member of purchasing corporation's controlled group.
  - (3) Old target is an S corporation.
  - (4) Combined deemed sale return.
    - (i) General rule.
    - (ii) Gain and loss offsets.
    - (iii) Procedure for filing a combined return.
    - (iv) Consequences of filing a combined return.
  - (5) Deemed sale excluded from purchasing corporation's consolidated return.
  - (6) Due date for old target's final return.
    - (i) General rule.
    - (ii) Application of §1.1502-76(c).
      - (A) In general.
      - (B) Deemed extension.
      - (C) Erroneous filing of deemed sale return.
      - (D) Erroneous filing of return for regular tax year.
      - (E) Last date for payment of tax.
  - (7) Examples.
    - (b) Waiver.
      - (1) Certain additions to tax.
      - (2) Notification.
      - (3) Elections or other actions required to be specified on a timely filed return.
        - (i) In general.
        - (ii) New target in purchasing corpora-

- tion's consolidated return.
- (4) Examples.

*§1.338(h)(10)-1 Deemed asset sale and liquidation.*

- (a) Scope.
- (b) Definitions.
  - (1) Consolidated target.
  - (2) Selling consolidated group.
  - (3) Selling affiliate; affiliated target.
  - (4) S corporation target.
  - (5) S corporation shareholders.
  - (6) Liquidation.
- (c) Section 338(h)(10) election.
  - (1) In general.
  - (2) Simultaneous joint election requirement.
  - (3) Irrevocability.
  - (4) Effect of invalid election.
  - (d) Certain consequences of section 338(h)(10) election.
    - (1) P.
    - (2) New T.
    - (3) Old T—deemed sale.
      - (i) In general.
      - (ii) Tiered targets.
    - (4) Old T and selling consolidated group, selling affiliate, or S corporation shareholders—deemed liquidation; tax characterization.
      - (i) In general.
      - (ii) Tiered targets.
    - (5) Selling consolidated group, selling affiliate, or S corporation shareholders.
      - (i) In general.
      - (ii) Basis and holding period of T stock not acquired.
      - (iii) T stock sale.
    - (6) Nonselling minority shareholders other than nonselling S corporation shareholders.
      - (i) In general.
      - (ii) T stock sale.
      - (iii) T stock not acquired.
    - (7) Consolidated return of selling consolidated group.
    - (8) Availability of the section 453 installment method.
      - (i) In deemed asset sale.
      - (ii) In deemed liquidation.
    - (9) Treatment consistent with an actual asset sale.
  - (e) Examples.
  - (f) Inapplicability of provisions.
  - (g) Required information.

*§1.338(i)-1 Effective dates.*

*§1.338-1 General principles; status of old target and new target.*

(a) *In general*—(1) *Deemed transaction.* Elections are available under section 338 when a purchasing corporation acquires the stock of another corporation (the target) in a qualified stock purchase. One type of election, under section 338(g), is available to the purchasing corporation. Another type of election, under section 338(h)(10), is, in more limited circumstances, available jointly to the purchasing corporation and the sellers of the stock. (Rules concerning eligibility for these elections are contained in §§1.338-2, 1.338-3, and 1.338(h)(10)-1.) Although target is a single corporation under corporate law, if a section 338 election is made, then two separate corporations, old target and new target, generally are considered to exist for purposes of subtitle A of the Internal Revenue Code. Old target is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities (see §1.1001-2(a)), and new target is treated as acquiring all of its assets from an unrelated person in exchange for consideration that includes the assumption of those liabilities. (Such transaction is, without regard to its characterization for Federal income tax purposes, referred to as the deemed asset sale and the income tax consequences thereof as the deemed sale tax consequences.) If a section 338(h)(10) election is made, old target is deemed to liquidate following the deemed asset sale.

(2) *Application of other rules of law.* Other rules of law apply to determine the tax consequences to the parties as if they had actually engaged in the transactions deemed to occur under section 338 and the regulations thereunder except to the extent otherwise provided in those regulations. See also §1.338-6(c)(2). Other rules of law may characterize the transaction as something other than or in addition to a sale and purchase of assets; however, the transaction between old and new target must be a taxable transaction. For example, if target is an insurance company for which a section 338 election is made, the deemed asset sale would be characterized and taxed as an assumption-reinsurance transaction under applicable Federal income tax law. See §1.817-4(d).

(3) *Overview.* Definitions and special nomenclature and rules for making the section 338 election are provided in

§1.338-2. Qualification for the section 338 election is addressed in §1.338-3. The amount for which old target is treated as selling all of its assets (the aggregate deemed sale price, or ADSP) is addressed in §1.338-4. The amount for which new target is deemed to have purchased all its assets (the adjusted grossed-up basis, or AGUB) is addressed in §1.338-5. Section 1.338-6 addresses allocation both of ADSP among the assets old target is deemed to have sold and of AGUB among the assets new target is deemed to have purchased. Section 1.338-7 addresses allocation of ADSP or AGUB when those amounts subsequently change. Asset and stock consistency are addressed in §1.338-8. International aspects of section 338 are covered in §1.338-9. Rules for the filing of returns are provided in §1.338-10. Eligibility for and treatment of section 338(h)(10) elections is addressed in §1.338(h)(10)-1.

(b) *Treatment of target under other provisions of the Internal Revenue Code*—(1) *General rule for subtitle A.* Except as provided in this section, new target is treated as a new corporation that is unrelated to old target for purposes of subtitle A of the Internal Revenue Code. Thus—

(i) New target is not considered related to old target for purposes of section 168 and may make new elections under section 168 without taking into account the elections made by old target; and

(ii) New target may adopt, without obtaining prior approval from the Commissioner, any taxable year that meets the requirements of section 441 and any method of accounting that meets the requirements of section 446. Notwithstanding §1.441-1T(b)(2), a new target may adopt a taxable year on or before the last day for making the election under section 338 by filing its first return for the desired taxable year on or before that date.

(2) *Exceptions for subtitle A.* New target and old target are treated as the same corporation for purposes of—

(i) The rules applicable to employee benefit plans (including those plans described in sections 79, 104, 105, 106, 125, 127, 129, 132, 137, and 220), qualified pension, profit-sharing, stock bonus and annuity plans (sections 401(a) and 403(a)), simplified employee pensions (section 408(k)), tax qualified stock option plans (sections 422 and 423), welfare

benefit funds (sections 419, 419A, 512(a)(3), and 4976), and voluntary employee benefit associations (section 501(c)(9) and the regulations thereunder);

(ii) Sections 1311 through 1314 (relating to the mitigation of the effect of limitations), if a section 338(h)(10) election is not made for target;

(iii) Section 108(e)(5) (relating to the reduction of purchase money debt);

(iv) Section 45A (relating to the Indian Employment Credit), section 51 (relating to the Work Opportunity Credit), section 51A (relating to the Welfare to Work Credit), and section 1396 (relating to the Empowerment Zone Act);

(v) Sections 401(h) and 420 (relating to medical benefits for retirees);

(vi) Section 414 (relating to definitions and special rules); and

(vii) Any other provision designated in the Internal Revenue Bulletin by the Internal Revenue Service. See §601.601(d)(2)(ii) of this chapter. See, for example, §1.1001-3(e)(4)(i)(F) providing that an election under section 338 does not result in the substitution of a new obligor on target's debt.

(3) *General rule for other provisions of the Internal Revenue Code.* Except as provided in the regulations under section 338 or in the Internal Revenue Bulletin by the Internal Revenue Service (see §601.601(d)(2)(ii) of this chapter), new target is treated as a continuation of old target for purposes other than subtitle A of the Internal Revenue Code. For example—

(i) New target is liable for old target's Federal income tax liabilities, including the tax liability for the deemed sale tax consequences and those tax liabilities of the other members of any consolidated group that included old target that are attributable to taxable years in which those corporations and old target joined in the same consolidated return (see §1.1502-6(a));

(ii) Wages earned by the employees of old target are considered wages earned by such employees from new target for purposes of sections 3101 and 3111 (Federal Insurance Contributions Act) and section 3301 (Federal Unemployment Tax Act); and

(iii) Old target and new target must use the same employer identification number

(c) *Anti-abuse rule*—(1) *In general.* The rules of this paragraph (c) apply for

purposes of applying the residual method as provided for under the regulations under sections 338 and 1060. The Commissioner is authorized to treat any property (including cash) transferred by old target in connection with the transactions resulting in the application of the residual method (and not held by target at the close of the acquisition date) as, nonetheless, property of target at the close of the acquisition date if the property so transferred is, within 24 months after the deemed asset sale, owned by new target, or is owned, directly or indirectly, by a member of the affiliated group of which new target is a member and continues after the acquisition date to be held or used primarily in connection with one or more of the activities of new target. In addition, the Commissioner is authorized to treat any property (including cash) transferred to old target in connection with the transactions resulting in the application of the residual method (and held by target at the close of the acquisition date) as, nonetheless, not being property of target at the close of the acquisition date if the property so transferred is, within 24 months after the deemed asset sale, not owned by new target but owned, directly or indirectly, by a member of the affiliated group of which new target is a member, or owned by new target but held or used primarily in connection with an activity conducted, directly or indirectly, by another member of the affiliated group of which new target is a member in combination with other property retained by or acquired, directly or indirectly, from the transferor of the property (or a member of the same affiliated group) to old target. For purposes of this paragraph (c)(1), an interest in an entity is considered held or used in connection with an activity if property of the entity is so held or used. The authority of the Commissioner under this paragraph (c)(1) includes the making of any appropriate correlative adjustments (avoiding, to the extent possible, the duplication or omission of any item of income, gain, loss, deduction, or basis).

(2) *Examples.* The following examples illustrate this paragraph (c):

*Example 1.* Prior to a qualified stock purchase under section 338, target transfers one of its assets to a related party. The purchasing corporation then purchases the target stock and also purchases the transferred asset from the related party. After its purchase of target, the purchasing corporation and

target are members of the same affiliated group. A section 338 election is made. Under an arrangement with the purchaser, the separately transferred asset is used primarily in connection with target's activities. Applying the anti-abuse rule of this paragraph (c), the Commissioner may consider target to own the transferred asset for purposes of applying the residual method under section 338.

*Example 2.* T owns all the stock of T1. T1 leases intellectual property to T, which T uses in connection with its own activities. P, a purchasing corporation, wishes to buy the T-T1 chain of corporations. P, in connection with its planned purchase of the T stock, contracts to consummate a purchase of all the stock of T1 on March 1 and of all the stock of T on March 2. Section 338 elections are thereafter made for both T and T1. Immediately after the purchases, P, T and T1 are members of the same affiliated group. T continues to lease the intellectual property from T1 and that is the primary use of the intellectual property. Thus, an asset of T, the T1 stock, was removed from T's own assets prior to the qualified stock purchase of the T stock, T1's own assets are used after the deemed asset sale in connection with T's own activities, and the T1 stock is after the deemed asset sale owned by P, a member of the same affiliated group of which T is a member. Applying the anti-abuse rule of this paragraph (c), the Commissioner may, for purposes of application of the residual method under section 338 both to T and to T1, consider P to have bought only the stock of T, with T at the time of the qualified stock purchases of both T and T1 (the qualified stock purchase of T1 being triggered by the deemed sale under section 338 of T's assets) owning T1. The Commissioner accordingly would allocate consideration to T's assets as though the T1 stock were one of those assets, and then allocate consideration within T1 based on the amount allocated to the T1 stock at the T level.

(d) *Next day rule for post-closing transactions.* If a target corporation for which an election under section 338 is made engages in a transaction outside the ordinary course of business on the acquisition date after the event resulting in the qualified stock purchase of the target or a higher tier corporation, the target and all persons related thereto (either before or after the qualified stock purchase) under section 267(b) or section 707 must treat the transaction for all Federal income tax purposes as occurring at the beginning of the day following the transaction and after the deemed purchase by new target.

### *§1.338-2 Nomenclature and definitions; mechanics of the section 338 election.*

(a) *Scope.* This section prescribes rules relating to elections under section 338.

(b) *Nomenclature.* For purposes of the regulations under section 338 (except as otherwise provided):

(1) T is a domestic target corporation that has only one class of stock outstand-

ing. Old T refers to T for periods ending on or before the close of T's acquisition date; new T refers to T for subsequent periods.

(2) P is the purchasing corporation.

(3) The P group is an affiliated group of which P is a member.

(4) P1, P2, etc., are domestic corporations that are members of the P group.

(5) T1, T2, etc., are domestic corporations that are target affiliates of T. These corporations (T1, T2, etc.) have only one class of stock outstanding and may also be targets.

(6) S is a domestic corporation (unrelated to P and B) that owns T prior to the purchase of T by P. (S is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by a domestic corporation.)

(7) A, a U.S. citizen or resident, is an individual (unrelated to P and B) who owns T prior to the purchase of T by P. (A is referred to in cases in which it is appropriate to consider the effects of having all of the outstanding stock of T owned by an individual who is a U.S. citizen or resident. Ownership of T by A and ownership of T by S are mutually exclusive circumstances.)

(8) B, a U.S. citizen or resident, is an individual (unrelated to T, S, and A) who owns the stock of P.

(9) F, used as a prefix with the other terms in this paragraph (b), connotes foreign, rather than domestic, status. For example, FT is a foreign corporation (as defined in section 7701(a)(5)) and FA is an individual other than a U.S. citizen or resident.

(10) CFC, used as a prefix with the other terms in this paragraph (b) referring to a corporation, connotes a controlled foreign corporation (as defined in section 957, taking into account section 953(c)). A corporation identified with the prefix F may be a controlled foreign corporation. (The prefix CFC is used when the corporation's status as a controlled foreign corporation is significant.)

(c) *Definitions.* For purposes of the regulations under section 338 (except as otherwise provided)

(1) *Acquisition date.* The term *acquisition date* has the same meaning as in section 338(h)(2).

(2) *Acquisition date assets.* *Acquisition date assets* are the assets of the target held

at the beginning of the day after the acquisition date (but see §1.338-1(d) (regarding certain transactions on the acquisition date)).

(3) *Affiliated group.* The term *affiliated group* has the same meaning as in section 338(h)(5). Corporations are affiliated on any day they are members of the same affiliated group.

(4) *Common parent.* The term *common parent* has the same meaning as in section 1504.

(5) *Consistency period.* The *consistency period* is the period described in section 338(h)(4)(A) unless extended pursuant to §1.338-8(j)(1).

(6) *Deemed asset sale.* The *deemed asset sale* is the transaction described in §1.338-1(a)(1) that is deemed to occur for purposes of subtitle A of the Internal Revenue Code if a section 338 election is made.

(7) *Deemed sale tax consequences.* *Deemed sale tax consequences* refers to, in the aggregate, the Federal income tax consequences (generally, the income, gain, deduction, and loss) of the deemed asset sale. Deemed sale tax consequences also refers to the Federal income tax consequences of the transfer of a particular asset in the deemed asset sale.

(8) *Deemed sale return.* The *deemed sale return* is the return on which target's deemed sale tax consequences are reported that does not include any other items of target. Target files a deemed sale return when a section 338 election (but not a section 338(h)(10) election) is filed for target and target is a member of a selling group (defined in paragraph (c)(16) of this section) that files a consolidated return for the period that includes the acquisition date. See §1.338-10. If target is an S corporation for the period that ends on the day before the acquisition date and a section 338 election (but not a section 338(h)(10) election) is filed for target, see §1.338-10(a)(3).

(9) *Domestic corporation.* A *domestic corporation* is a corporation—

(i) That is domestic within the meaning of section 7701(a)(4) or that is treated as domestic for purposes of subtitle A of the Internal Revenue Code (e.g., to which an election under section 953(d) or 1504(d) applies); and

(ii) That is not a DISC, a corporation described in section 1248(e), or a corpo-

ration to which an election under section 936 applies.

(10) *Old target's final return.* *Old target's final return* is the income tax return of old target for the taxable year ending at the close of the acquisition date that includes the deemed sale tax consequences. However, if a deemed sale return is filed for old target, the deemed sale return is considered old target's final return.

(11) *Purchasing corporation.* The term *purchasing corporation* has the same meaning as in section 338(d)(1). The purchasing corporation may also be referred to as purchaser. Unless otherwise provided, any reference to the purchasing corporation is a reference to all members of the affiliated group of which the purchasing corporation is a member. See sections 338(h)(5) and (8). Also, unless otherwise provided, any reference to the purchasing corporation is, with respect to a deemed purchase of stock under section 338(a)(2), a reference to new target with respect to its own deemed purchase of stock in another target.

(12) *Qualified stock purchase.* The term *qualified stock purchase* has the same meaning as in section 338(d)(3).

(13) *Related persons.* Two persons are related if stock in a corporation owned by one of the persons would be attributed under section 318(a) (other than section 318(a)(4)) to the other.

(14) *Section 338 election.* A *section 338 election* is an election to apply section 338(a) to target. A section 338 election is made by filing a statement of section 338 election pursuant to paragraph (d) of this section. The form on which this statement is filed is referred to in the regulations under section 338 as the Form 8023, "Elections Under Section 338 for Corporations Making Qualified Stock Purchases."

(15) *Section 338(h)(10) election.* A *section 338(h)(10) election* is an election to apply section 338(h)(10) to target. A section 338(h)(10) election is made by making a joint election for target under §1.338(h)(10)-1 on Form 8023.

(16) *Selling group.* The *selling group* is the affiliated group (as defined in section 1504) eligible to file a consolidated return that includes target for the taxable period in which the acquisition date occurs. However, a selling group is not an affiliated group of which target is the

common parent on the acquisition date.

(17) *Target; old target; new target.* *Target* is the target corporation as defined in section 338(d)(2). *Old target* refers to target for periods ending on or before the close of target's acquisition date. *New target* refers to target for subsequent periods.

(18) *Target affiliate.* The term *target affiliate* has the same meaning as in section 338(h)(6) (applied without section 338(h)(6)(B)(i)). Thus, a corporation described in section 338(h)(6)(B)(i) is considered a target affiliate for all purposes of section 338. If a target affiliate is acquired in a qualified stock purchase, it is also a target.

(19) *12-month acquisition period.* The *12-month acquisition period* is the period described in section 338(h)(1), unless extended pursuant to §1.338-8(j)(2).

(d) *Time and manner of making election.* The purchasing corporation makes a section 338 election for target by filing a statement of section 338 election on Form 8023 in accordance with the instructions to the form. The section 338 election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. A section 338 election is irrevocable. See §1.338(h)(10)-1(c)(2) for section 338(h)(10) elections.

(e) *Special rules for foreign corporations or DISCs—(1) Elections by certain foreign purchasing corporations—(i) General rule.* A qualifying foreign purchasing corporation is not required to file a statement of section 338 election for a qualifying foreign target before the earlier of 3 years after the acquisition date and the 180th day after the close of the purchasing corporation's taxable year within which a triggering event occurs.

(ii) *Qualifying foreign purchasing corporation.* A purchasing corporation is a *qualifying foreign purchasing corporation* only if, during the acquisition period of a qualifying foreign target, all the corporations in the purchasing corporation's affiliated group are foreign corporations that are not subject to United States tax.

(iii) *Qualifying foreign target.* A target is a *qualifying foreign target* only if target and its target affiliates are foreign corporations that, during target's acquisition period, are not subject to United States tax (and will not become subject to United

States tax during such period because of a section 338 election). A target affiliate is taken into account for purposes of the preceding sentence only if, during target's 12-month acquisition period, it is or becomes a member of the affiliated group that includes the purchasing corporation.

(iv) *Triggering event.* A *triggering event* occurs in the taxable year of the qualifying foreign purchasing corporation in which either that corporation or any corporation in its affiliated group becomes subject to United States tax.

(v) *Subject to United States tax.* For purposes of this paragraph (e)(1), a foreign corporation is considered subject to United States tax—

(A) For the taxable year for which that corporation is required under §1.6012-2(g) (other than §1.6012-2(g)(2)(i)(B)(2)) to file a United States income tax return; or

(B) For the period during which that corporation is a controlled foreign corporation, a passive foreign investment company for which an election under section 1295 is in effect, a foreign investment company, or a foreign corporation the stock ownership of which is described in section 552(a)(2).

(2) *Acquisition period.* For purposes of this paragraph (e), the term *acquisition period* means the period beginning on the first day of the 12-month acquisition period and ending on the acquisition date.

(3) *Statement of section 338 election may be filed by United States shareholders in certain cases.* The United States shareholders (as defined in section 951(b)) of a foreign purchasing corporation that is a controlled foreign corporation (as defined in section 957 (taking into account section 953(c))) may file a statement of section 338 election on behalf of the purchasing corporation if the purchasing corporation is not required under §1.6012-2(g) (other than §1.6012-2(g)(2)(i)(B)(2)) to file a United States income tax return for its taxable year that includes the acquisition date. Form 8023 must be filed as described in the form and its instructions and also must be attached to the Form 5471, "Information Return of U.S. Persons With Respect To Certain Foreign Corporations," filed with respect to the purchasing corporation by each United States shareholder for the purchasing corporation's taxable year that in-

cludes the acquisition date (or, if paragraph (e)(1)(i) of this section applies to the election, for the purchasing corporation's taxable year within which it becomes a controlled foreign corporation). The provisions of §1.964-1(c) (including §1.964-1(c)(7)) do not apply to an election made by the United States shareholders.

(4) *Notice requirement for U.S. persons holding stock in foreign target*—(i) *General rule.* If a target subject to a section 338 election was a controlled foreign corporation, a passive foreign investment company, or a foreign personal holding company at any time during the portion of its taxable year that ends on its acquisition date, the purchasing corporation must deliver written notice of the election (and a copy of Form 8023, its attachments and instructions) to—

(A) Each U.S. person (other than a member of the affiliated group of which the purchasing corporation is a member (the purchasing group member)) that, on the acquisition date of the foreign target, holds stock in the foreign target; and

(B) Each U.S. person (other than a purchasing group member) that sells stock in the foreign target to a purchasing group member during the foreign target's 12-month acquisition period.

(ii) *Limitation.* The notice requirement of this paragraph (e)(4) applies only where the section 338 election for the foreign target affects income, gain, loss, deduction, or credit of the U.S. person described in paragraph (e)(4)(i) of this section under section 551, 951, 1248, or 1293.

(iii) *Form of notice.* The notice to U.S. persons must be identified prominently as a notice of section 338 election and must—

(A) Contain the name, address, and employer identification number (if any) of, and the country (and, if relevant, the lesser political subdivision) under the laws of which are organized the purchasing corporation and the relevant target (i.e., the target the stock of which the particular U.S. person held or sold under the circumstances described in paragraph (e)(4)(i) of this section);

(B) Identify those corporations as the purchasing corporation and the foreign target, respectively; and

(C) Contain the following declaration (or a substantially similar declaration):

THIS DOCUMENT SERVES AS NOTICE OF AN ELECTION UNDER SECTION 338 FOR THE ABOVE CITED FOREIGN TARGET THE STOCK OF WHICH YOU EITHER HELD OR SOLD UNDER THE CIRCUMSTANCES DESCRIBED IN TREASURY REGULATIONS SECTION 1.338-2(e)(4). FOR POSSIBLE UNITED STATES FEDERAL INCOME TAX CONSEQUENCES UNDER SECTION 551, 951, 1248, OR 1293 OF THE INTERNAL REVENUE CODE OF 1986 THAT MAY APPLY TO YOU, SEE TREASURY REGULATIONS SECTION 1.338-9(b). YOU MAY BE REQUIRED TO ATTACH THE INFORMATION ATTACHED TO THIS NOTICE TO CERTAIN RETURNS.

(iv) *Timing of notice.* The notice required by this paragraph (e)(4) must be delivered to the U.S. person on or before the later of the 120th day after the acquisition date of the particular target or the day on which Form 8023 is filed. The notice is considered delivered on the date it is mailed to the proper address (or an address similar enough to complete delivery), unless the date it is mailed cannot be reasonably determined. The date of mailing will be determined under the rules of section 7502. For example, the date of mailing is the date of U.S. postmark or the applicable date recorded or marked by a designated delivery service.

(v) *Consequence of failure to comply.* A statement of section 338 election is not valid if timely notice is not given to one or more U.S. persons described in this paragraph (e)(4). If the form of notice fails to comply with all requirements of this paragraph (e)(4), the section 338 election is valid, but the waiver rule of §1.338-10(b)(1) does not apply.

(vi) *Good faith effort to comply.* The purchasing corporation will be considered to have complied with this paragraph (e)(4), even though it failed to provide notice or provide timely notice to each person described in this paragraph (e)(4), if the Commissioner determines that the purchasing corporation made a good faith effort to identify and provide timely notice to those U.S. persons.

§1.338-3 *Qualification for the section 338 election.*

(a) *Scope.* This section provides rules on whether certain acquisitions of stock are qualified stock purchases and on other miscellaneous issues under section 338.

(b) *Rules relating to qualified stock purchases*—(1) *Purchasing corporation requirement.* An individual cannot make a qualified stock purchase of target. Section 338(d)(3) requires, as a condition of a qualified stock purchase, that a corporation purchase the stock of target. If an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include new P's merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase.

(2) *Purchase.* The term *purchase* has the same meaning as in section 338(h)(3). Stock in a target (or target affiliate) may be considered purchased if, under general principles of tax law, the purchasing corporation is considered to own stock of the target (or target affiliate) meeting the requirements of section 1504(a)(2), notwithstanding that no amount may be paid for (or allocated to) the stock.

(3) *Acquisitions of stock from related corporations*—(i) *In general.* Stock acquired by a purchasing corporation from a related corporation (R) is generally not considered acquired by purchase. See section 338(h)(3)(A)(iii).

(ii) *Time for testing relationship.* For purposes of section 338(h)(3)(A)(iii), a purchasing corporation is treated as related to another person if the relationship specified in section 338(h)(3)(A)(iii) exists—

(A) In the case of a single transaction, immediately after the purchase of target stock;

(B) In the case of a series of acquisitions otherwise constituting a qualified stock purchase within the meaning of section 338(d)(3), immediately after the last acquisition in such series; and

(C) In the case of a series of transactions effected pursuant to an integrated plan to dispose of target stock, immediately after the last transaction in such series.

(iii) *Cases where section 338(h)(3)(C) applies—acquisitions treated as pur-*

chases. If section 338(h)(3)(C) applies and the purchasing corporation is treated as acquiring stock by purchase from R, solely for purposes of determining when the stock is considered acquired, target stock acquired from R is considered to have been acquired by the purchasing corporation on the day on which the purchasing corporation is first considered to own that stock under section 318(a) (other than section 318(a)(4)).

(iv) *Examples.* The following examples illustrate this paragraph (b)(3):

*Example 1.* (i) S is the parent of a group of corporations that are engaged in various businesses. Prior to January 1, Year 1, S decided to discontinue its involvement in one line of business. To accomplish this, S forms a new corporation, Newco, with a nominal amount of cash. Shortly thereafter, on January 1, Year 1, S transfers all the stock of the subsidiary conducting the unwanted business (T) to Newco in exchange for 100 shares of Newco common stock and a Newco promissory note. Prior to January 1, Year 1, S and Underwriter (U) had entered into a binding agreement pursuant to which U would purchase 60 shares of Newco common stock from S and then sell those shares in an Initial Public Offering (IPO). On January 6, Year 1, the IPO closes.

(ii) Newco's acquisition of T stock is one of a series of transactions undertaken pursuant to one integrated plan. The series of transactions ends with the closing of the IPO and the transfer of all the shares of stock in accordance with the agreements. Immediately after the last transaction effected pursuant to the plan, S owns 40 percent of Newco, which does not give rise to a relationship described in section 338(h)(3)(A)(iii). See §1.338-3(b)(3)(ii)(C). Accordingly, S and Newco are not related for purposes of section 338(h)(3)(A)(iii).

(iii) Further, because Newco's basis in the T stock is not determined by reference to S's basis in the T stock and because the transaction is not an exchange to which section 351, 354, 355, or 356 applies, Newco's acquisition of the T stock is a purchase within the meaning of section 338(h)(3).

*Example 2.* (i) On January 1 of Year 1, P purchases 75 percent in value of the R stock. On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, R acquires an additional 16 shares of T stock. On December 1 of Year 1, P purchases 70 shares of T stock from an unrelated person and 12 of the 20 shares of T stock held by R.

(ii) Of the 12 shares of T stock purchased by P from R on December 1 of Year 1, 3 of those shares are deemed to have been acquired by P on January 1 of Year 1, the date on which 3 of the 4 shares of T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e.,  $4 \times .75$ ). The remaining 9 shares of T stock purchased by P from R on December 1 of Year 1 are deemed to have been acquired by P on June 1 of Year 1, the date on which an additional 12 of the 20 shares of T stock owned by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e.,  $(20 \times .75) - 3$ ). Because stock acquisitions by P sufficient for a qualified stock purchase of T occur within a

12-month period (i.e., 3 shares constructively on January 1 of Year 1, 9 shares constructively on June 1 of Year 1, and 70 shares actually on December 1 of Year 1), a qualified stock purchase is made on December 1 of Year 1.

*Example 3.* (i) On February 1 of Year 1, P acquires 25 percent in value of the R stock from B (the sole shareholder of P). That R stock is not acquired by purchase. See section 338(h)(3)(A)(iii). On that date, R owns 4 of the 100 shares of T stock. On June 1 of Year 1, P purchases an additional 25 percent in value of the R stock, and on January 1 of Year 2, P purchases another 25 percent in value of the R stock. On June 1 of Year 2, R acquires an additional 16 shares of the T stock. On December 1 of Year 2, P purchases 68 shares of the T stock from an unrelated person and 12 of the 20 shares of the T stock held by R.

(ii) Of the 12 shares of the T stock purchased by P from R on December 1 of Year 2, 2 of those shares are deemed to have been acquired by P on June 1 of Year 1, the date on which 2 of the 4 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e.,  $4 \times .5$ ). For purposes of this attribution, the R stock need not be acquired by P by purchase. See section 338(h)(1). (By contrast, the acquisition of the T stock by P from R does not qualify as a purchase unless P has acquired at least 50 percent in value of the R stock by purchase. Section 338(h)(3)(C)(i). Of the remaining 10 shares of the T stock purchased by P from R on December 1 of Year 2, 1 of those shares is deemed to have been acquired by P on January 1 of Year 2, the date on which an additional 1 share of the 4 shares of the T stock held by R on that date was first considered owned by P under section 318(a)(2)(C) (i.e.,  $(4 \times .75) - 2$ ). The remaining 9 shares of the T stock purchased by P from R on December 1 of Year 2, are deemed to have been acquired by P on June 1 of Year 2, the date on which an additional 12 shares of the T stock held by R on that date were first considered owned by P under section 318(a)(2)(C) (i.e.,  $(20 \times .75) - 3$ ). Because a qualified stock purchase of T by P is made on December 1 of Year 2 only if all 12 shares of the T stock purchased by P from R on that date are considered acquired during a 12-month period ending on that date (so that, in conjunction with the 68 shares of the T stock P purchased on that date from the unrelated person, 80 of T's 100 shares are acquired by P during a 12-month period) and because 2 of those 12 shares are considered to have been acquired by P more than 12 months before December 1 of Year 2 (i.e., on June 1 of Year 1), a qualified stock purchase is not made. (Under §1.338-8(j)(2), for purposes of applying the consistency rules, P is treated as making a qualified stock purchase of T if, pursuant to an arrangement, P purchases T stock satisfying the requirements of section 1504(a)(2) over a period of more than 12 months.)

*Example 4.* Assume the same facts as in *Example 3*, except that on February 1 of Year 1, P acquires 25 percent in value of the R stock by purchase. The result is the same as in *Example 3*.

(4) *Acquisition date for tiered targets—*  
(i) *Stock sold in deemed asset sale.* If an election under section 338 is made for target, old target is deemed to sell target's assets and new target is deemed to acquire

those assets. Under section 338(h)(3)(B), new target's deemed purchase of stock of another corporation is a purchase for purposes of section 338(d)(3) on the acquisition date of target. If new target's deemed purchase causes a qualified stock purchase of the other corporation and if a section 338 election is made for the other corporation, the acquisition date for the other corporation is the same as the acquisition date of target. However, the deemed sale and purchase of the other corporation's assets is considered to take place after the deemed sale and purchase of target's assets.

(ii) *Example.* The following example illustrates this paragraph (b)(4):

*Example.* A owns all of the T stock. T owns 50 of the 100 shares of X stock. The other 50 shares of X stock are owned by corporation Y, which is unrelated to A, T, or P. On January 1 of Year 1, P makes a qualified stock purchase of T from A and makes a section 338 election for T. On December 1 of Year 1, P purchases the 50 shares of X stock held by Y. A qualified stock purchase of X is made on December 1 of Year 1, because the deemed purchase of 50 shares of X stock by new T because of the section 338 election for T and the actual purchase of 50 shares of X stock by P are treated as purchases made by one corporation. Section 338(h)(8). For purposes of determining whether those purchases occur within a 12-month acquisition period as required by section 338(d)(3), T is deemed to purchase its X stock on T's acquisition date, i.e., January 1 of Year 1.

(5) *Effect of redemptions—*(i) *General rule.* Except as provided in this paragraph (b)(5), a qualified stock purchase is made on the first day on which the percentage ownership requirements of section 338(d)(3) are satisfied by reference to target stock that is both—

(A) Held on that day by the purchasing corporation; and

(B) Purchased by the purchasing corporation during the 12-month period ending on that day.

(ii) *Redemptions from persons unrelated to the purchasing corporation.* Target stock redemptions from persons unrelated to the purchasing corporation that occur during the 12-month acquisition period are taken into account as reductions in target's outstanding stock for purposes of determining whether target stock purchased by the purchasing corporation in the 12-month acquisition period satisfies the percentage ownership requirements of section 338(d)(3).

(iii) *Redemptions from the purchasing corporation or related persons during 12-month acquisition period—*(A) *General*



*rule.* For purposes of the percentage ownership requirements of section 338(d)(3), a redemption of target stock during the 12-month acquisition period from the purchasing corporation or from any person related to the purchasing corporation is not taken into account as a reduction in target's outstanding stock.

(B) *Exception for certain redemptions from related corporations.* A redemption of target stock during the 12-month acquisition period from a corporation related to the purchasing corporation is taken into account as a reduction in target's outstanding stock to the extent that the redeemed stock would have been considered purchased by the purchasing corporation (because of section 338(h)(3)(C)) during the 12-month acquisition period if the redeemed stock had been acquired by the purchasing corporation from the related corporation on the day of the redemption. See paragraph (b)(3) of this section.

(iv) *Examples.* The following examples illustrate this paragraph (b)(5):

*Example 1. QSP on stock purchase date; redemption from unrelated person during 12-month period.* A owns all 100 shares of T stock. On January 1 of Year 1, P purchases 40 shares of the T stock from A. On July 1 of Year 1, T redeems 25 shares from A. On December 1 of Year 1, P purchases 20 shares of the T stock from A. P makes a qualified stock purchase of T on December 1 of Year 1, because the 60 shares of T stock purchased by P within the 12-month period ending on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

*Example 2. QSP on stock redemption date; redemption from unrelated person during 12-month period.* The facts are the same as in *Example 1*, except that P purchases 60 shares of T stock on January 1 of Year 1 and none on December 1 of Year 1. P makes a qualified stock purchase of T on July 1 of Year 1, because that is the first day on which the T stock purchased by P within the preceding 12-month period satisfies the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/75 shares), determined by taking into account the redemption of 25 shares.

*Example 3. Redemption from purchasing corporation not taken into account.* On December 15 of Year 1, T redeems 30 percent of its stock from P. The redeemed stock was held by P for several years and constituted P's total interest in T. On December 1 of Year 2, P purchases the remaining T stock from A. P does not make a qualified stock purchase of T on December 1 of Year 2. For purposes of the 80-percent ownership requirements of section 338(d)(3), the redemption of P's T stock on December 15 of Year 1 is not taken into account as a reduction in T's outstanding stock.

*Example 4. Redemption from related person taken into account.* On January 1 of Year 1, P pur-

chases 60 of the 100 shares of X stock. On that date, X owns 40 of the 100 shares of T stock. On April 1 of Year 1, T redeems X's T stock and P purchases the remaining 60 shares of T stock from an unrelated person. For purposes of the 80-percent ownership requirements of section 338(d)(3), the redemption of the T stock from X (a person related to P) is taken into account as a reduction in T's outstanding stock. If P had purchased the 40 redeemed shares from X on April 1 of Year 1, all 40 of the shares would have been considered purchased (because of section 338(h)(3)(C)(i)) during the 12-month period ending on April 1 of Year 1 (24 of the 40 shares would have been considered purchased by P on January 1 of Year 1 and the remaining 16 shares would have been considered purchased by P on April 1 of Year 1). See paragraph (b)(3) of this section. Accordingly, P makes a qualified stock purchase of T on April 1 of Year 1, because the 60 shares of T stock purchased by P on that date satisfy the 80-percent ownership requirements of section 338(d)(3) (i.e., 60/60 shares), determined by taking into account the redemption of 40 shares.

(c) *Effect of post-acquisition events on eligibility for section 338 election—(1) Post-acquisition elimination of target.* (i) The purchasing corporation may make an election under section 338 for target even though target is liquidated on or after the acquisition date. If target liquidates on the acquisition date, the liquidation is considered to occur on the following day and immediately after new target's deemed purchase of assets. The purchasing corporation may also make an election under section 338 for target even though target is merged into another corporation, or otherwise disposed of by the purchasing corporation provided that, under the facts and circumstances, the purchasing corporation is considered for tax purposes as the purchaser of the target stock.

(ii) The following examples illustrate this paragraph (c)(1):

*Example 1.* On January 1 of Year 1, P purchases 100 percent of the outstanding common stock of T. On June 1 of Year 1, P sells the T stock to an unrelated person. Assuming that P is considered for tax purposes as the purchaser of the T stock, P remains eligible, after June 1 of Year 1, to make a section 338 election for T that results in a deemed asset sale of T's assets on January 1 of Year 1.

*Example 2.* On January 1 of Year 1, P makes a qualified stock purchase of T. On that date, T owns the stock of T1. On March 1 of Year 1, T sells the T1 stock to an unrelated person. On April 1 of Year 1, P makes a section 338 election for T. Notwithstanding that the T1 stock was sold on March 1 of Year 1, the section 338 election for T on April 1 of Year 1 results in a qualified stock purchase by T of T1 on January 1 of Year 1. See paragraph (b)(4)(i) of this section.

(2) *Post-acquisition elimination of the purchasing corporation.* An election

under section 338 may be made for target after the acquisition of assets of the purchasing corporation by another corporation in a transaction described in section 381(a), provided that the purchasing corporation is considered for tax purposes as the purchaser of the target stock. The acquiring corporation in the section 381(a) transaction may make an election under section 338 for target.

(d) *Consequences of post-acquisition elimination of target where section 338 election not made—(1) Scope.* The rules of this paragraph (d) apply to the transfer of target assets to the purchasing corporation (or another member of the same affiliated group as the purchasing corporation) (the transferee) following a qualified stock purchase of target stock, if the purchasing corporation does not make a section 338 election for target. Notwithstanding the rules of this paragraph (d), section 354(a) (and so much of section 356 as relates to section 354) cannot apply to any person other than the purchasing corporation or another member of the same affiliated group as the purchasing corporation unless the transfer of target assets is pursuant to a reorganization as determined without regard to this paragraph (d).

(2) *Continuity of interest.* By virtue of section 338, in determining whether the continuity of interest requirement of §1.368-1(b) is satisfied on the transfer of assets from target to the transferee, the purchasing corporation's target stock acquired in the qualified stock purchase represents an interest on the part of a person who was an owner of the target's business enterprise prior to the transfer that can be continued in a reorganization.

(3) *Control requirement.* By virtue of section 338, the acquisition of target stock in the qualified stock purchase will not prevent the purchasing corporation from qualifying as a shareholder of the target transferor for the purpose of determining whether, immediately after the transfer of target assets, a shareholder of the transferor is in control of the corporation to which the assets are transferred within the meaning of section 368(a)(1)(D).

(4) *Solely for voting stock requirement.* By virtue of section 338, the acquisition of target stock in the qualified stock purchase for consideration other than voting stock will not prevent the subsequent

transfer of target assets from satisfying the solely for voting stock requirement for purposes of determining if the transfer of target assets qualifies as a reorganization under section 368(a)(1)(C).

(5) *Example.* The following example illustrates this paragraph (d):

*Example. (i) Facts.* P, T, and X are domestic corporations. T and X each operate a trade or business. A and K, individuals unrelated to P, own 85 and 15 percent, respectively, of the stock of T. P owns all of the stock of X. The total adjusted basis of T's property exceeds the sum of T's liabilities plus the amount of liabilities to which T's property is subject. P purchases all of A's T stock for cash in a qualified stock purchase. P does not make an election under section 338(g) with respect to its acquisition of T stock. Shortly after the acquisition date, and as part of the same plan, T merges under applicable state law into X in a transaction that, but for the question of continuity of interest, satisfies all the requirements of section 368(a)(1)(A). In the merger, all of T's assets are transferred to X. P and K receive X stock in exchange for their T stock. P intends to retain the stock of X indefinitely.

(ii) *Status of transfer as a reorganization.* By virtue of section 338, for the purpose of determining whether the continuity of interest requirement of §1.368-1(b) is satisfied, P's T stock acquired in the qualified stock purchase represents an interest on the part of a person who was an owner of T's business enterprise prior to the transfer that can be continued in a reorganization through P's continuing ownership of X. Thus, the continuity of interest requirement is satisfied and the merger of T into X is a reorganization within the meaning of section 368(a)(1)(A). Moreover, by virtue of section 338, the requirement of section 368(a)(1)(D) that a target shareholder control the transferee immediately after the transfer is satisfied because P controls X immediately after the transfer. In addition, all of T's assets are transferred to X in the merger and P and K receive the X stock exchanged therefor in pursuance of the plan of reorganization. Thus, the merger of T into X is also a reorganization within the meaning of section 368(a)(1)(D).

(iii) *Treatment of T and X.* Under section 361(a), T recognizes no gain or loss in the merger. Under section 362(b), X's basis in the assets received in the merger is the same as the basis of the assets in T's hands. X succeeds to and takes into account the items of T as provided in section 381.

(iv) *Treatment of P.* By virtue of section 338, the transfer of T assets to X is a reorganization. Pursuant to that reorganization, P exchanges its T stock solely for stock of X, a party to the reorganization. Because P is the purchasing corporation, section 354 applies to P's exchange of T stock for X stock in the merger of T into X. Thus, P recognizes no gain or loss on the exchange. Under section 358, P's basis in the X stock received in the exchange is the same as the basis of P's T stock exchanged therefor.

(v) *Treatment of K.* Because K is not the purchasing corporation (or an affiliate thereof), section 354 cannot apply to K's exchange of T stock for X stock in the merger of T into X unless the transfer of T's assets is pursuant to a reorganization as determined without regard to this paragraph (d). Under general principles of tax law applicable to reorgani-

zations, the continuity of interest requirement is not satisfied because P's stock purchase and the merger of T into X are pursuant to an integrated transaction in which A, the owner of 85 percent of the stock of T, received solely cash in exchange for A's T stock. See, e.g., §1.368-1(e)(1)(i); *Yoc Heating v. Commissioner*, 61 T.C. 168 (1973); *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd, 491 F.2d 749 (3d Cir. 1974). Thus, the requisite continuity of interest under §1.368-1(b) is lacking and section 354 does not apply to K's exchange of T stock for X stock. K recognizes gain or loss, if any, pursuant to section 1001(c) with respect to its T stock.

#### *§1.338-4 Aggregate deemed sale price; various aspects of taxation of the deemed asset sale.*

(a) *Scope.* This section provides rules under section 338(a)(1) to determine the aggregate deemed sale price (ADSP) for target. ADSP is the amount for which old target is deemed to have sold all of its assets in the deemed asset sale. ADSP is allocated among target's assets in accordance with §1.338-6 to determine the amount for which each asset is deemed to have been sold. When a subsequent increase or decrease is required under general principles of tax law with respect to an element of ADSP, the redetermined ADSP is allocated among target's assets in accordance with §1.338-7. This §1.338-4 also provides rules regarding the recognition of gain or loss on the deemed sale of target affiliate stock. Notwithstanding section 338(h)(6)(B)(ii), stock held by a target affiliate in a foreign corporation or in a corporation that is a DISC or that is described in section 1248(e) is not excluded from the operation of section 338.

(b) *Determination of ADSP—(1) General rule.* ADSP is the sum of—

(i) The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock (as defined in section 338(b)(6)(A)); and

(ii) The liabilities of old target.

(2) *Time and amount of ADSP—(i) Original determination.* ADSP is initially determined at the beginning of the day after the acquisition date of target. General principles of tax law apply in determining the timing and amount of the elements of ADSP.

(ii) *Redetermination of ADSP.* ADSP is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of

tax law, for the elements of ADSP. For example, ADSP is redetermined because of an increase or decrease in the amount realized for recently purchased stock or because liabilities not originally taken into account in determining ADSP are subsequently taken into account. Increases or decreases with respect to the elements of ADSP result in the reallocation of ADSP among target's assets under §1.338-7.

(iii) *Example.* The following example illustrates this paragraph (b)(2):

*Example.* In Year 1, T, a manufacturer, purchases a customized delivery truck from X with purchase money indebtedness having a stated principal amount of \$100,000. P acquires all of the stock of T in Year 3 for \$700,000 and makes a section 338 election for T. Assume T has no liabilities other than its purchase money indebtedness to X. In Year 4, when T is neither insolvent nor in a title 11 case, T and X agree to reduce the amount of the purchase money indebtedness to \$80,000. Assume further that the reduction would be a purchase price reduction under section 108(e)(5). T and X's agreement to reduce the amount of the purchase money indebtedness would not, under general principles of tax law that would apply if the deemed asset sale had actually occurred, change the amount of liabilities of old target taken into account in determining its amount realized. Accordingly, ADSP is not redetermined at the time of the reduction. See §1.338-5(b)(2)(iii) *Example 1* for the effect on AGUB.

(c) *Grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock—(1) Determination of amount.* The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock is an amount equal to—

(i) The amount realized on the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock determined as if the selling shareholder(s) were required to use old target's accounting methods and characteristics and the installment method were not available and determined without regard to the selling costs taken into account under paragraph (c)(1)(iii) of this section;

(ii) Divided by the percentage of target stock (by value, determined on the acquisition date) attributable to that recently purchased target stock;

(iii) Less the selling costs incurred by the selling shareholders in connection with the sale to the purchasing corporation of the purchasing corporation's recently purchased target stock that reduce

their amount realized on the sale of the stock (e.g., brokerage commissions and any similar costs to sell the stock).

(2) *Example.* The following example illustrates this paragraph (c):

*Example.* T has two classes of stock outstanding, voting common stock and preferred stock described in section 1504(a)(4). On March 1 of Year 1, P purchases 40 percent of the outstanding T stock from S1 for \$500, 20 percent of the outstanding T stock from S2 for \$225, and 20 percent of the outstanding T stock from S3 for \$275. On that date, the fair market value of all the T voting common stock is \$1,250 and the preferred stock \$750. S1, S2, and S3 incur \$40, \$35, and \$25 respectively of selling costs. S1 continues to own the remaining 20 percent of the outstanding T stock. The grossed-up amount realized on the sale to P of P's recently purchased T stock is calculated as follows: The total amount realized (without regard to selling costs) is \$1,000 (500 + 225 + 275). The percentage of T stock by value on the acquisition date attributable to the recently purchased T stock is 50% (1,000/(1,250 + 750)). The selling costs are \$100 (40 + 35 + 25). The grossed-up amount realized is \$1,900 (1,000/.5 - 100).

(d) *Liabilities of old target—(1) In general.* In general, the liabilities of old target are measured as of the beginning of the day after the acquisition date. (But see §1.338-1(d) (regarding certain transactions on the acquisition date).) In order to be taken into account in ADSP, a liability must be a liability of target that is properly taken into account in amount realized under general principles of tax law that would apply if old target had sold its assets to an unrelated person for consideration that included the discharge of its liabilities. See §1.1001-2(a). Such liabilities may include liabilities for the tax consequences resulting from the deemed sale.

(2) *Time and amount of liabilities.* The time for taking into account liabilities of old target in determining ADSP and the amount of the liabilities taken into account is determined as if old target had sold its assets to an unrelated person for consideration that included the discharge of the liabilities by the unrelated person.

For example, if no amount of a target liability is properly taken into account in amount realized as of the beginning of the day after the acquisition date, the liability is not initially taken into account in determining ADSP (although it may be taken into account at some later date).

(e) *Deemed sale tax consequences.* Gain or loss on each asset in the deemed sale is computed by reference to the ADSP allocated to that asset. ADSP is allocated under the rules of §1.338-6. Though deemed sale tax consequences may increase or decrease ADSP by creating or reducing a tax liability, the amount of the tax liability itself may be a function of the size of the deemed sale tax consequences. Thus, these determinations may require trial and error computations.

(f) *Other rules apply in determining ADSP.* ADSP may not be applied in such a way as to contravene other applicable rules. For example, a capital loss cannot be applied to reduce ordinary income in calculating the tax liability on the deemed sale for purposes of determining ADSP.

(g) *Examples.* The following examples illustrate this section. For purposes of the examples in this paragraph (g), unless otherwise stated, T is a calendar year taxpayer that files separate returns and that has no loss, tax credit, or other carryovers to Year 1. Depreciation for Year 1 is not taken into account. T has no liabilities other than the Federal income tax liability resulting from the deemed asset sale, and the T shareholders have no selling costs. Assume that T's tax rate for any ordinary income or net capital gain resulting from the deemed sale of assets is 34 percent and that any capital loss is offset by capital gain. On July 1 of Year 1, P purchases all of the stock of T and makes a section 338 election for T. The examples are as follows:

*Example 1. One class.* (i) On July 1 of Year 1, T's only asset is an item of section 1245 property with an adjusted basis to T of \$50,400, a recomputed

basis of \$80,000, and a fair market value of \$100,000. P purchases all of the T stock for \$75,000, which also equals the amount realized for the stock determined as if the selling shareholder(s) were required to use old target's accounting methods and characteristics.

(ii) ADSP is determined as follows (for purposes of this section (g), G is the grossed-up amount realized on the sale to P of P's recently purchased T stock, L is T's liabilities other than T's tax liability for the deemed sale tax consequences,  $T_R$  is the applicable tax rate, and B is the adjusted basis of the asset deemed sold):

$$\begin{aligned} \text{ADSP} &= G + L + T_R \times (\text{ADSP} - B) \\ \text{ADSP} &= (\$75,000/1) + \$0 + .34 \times (\text{ADSP} - \$50,400) \\ \text{ADSP} &= \$75,000 + .34\text{ADSP} - \$17,136 \\ .66\text{ADSP} &= \$57,864 \\ \text{ADSP} &= \$87,672.72 \end{aligned}$$

(iii) Because ADSP for T (\$87,672.72) does not exceed the fair market value of T's asset (\$100,000), a Class V asset, T's entire ADSP is allocated to that asset. Thus, T's deemed sale results in \$37,272.72 of taxable income (consisting of \$29,600 of ordinary income and \$7,672.72 of capital gain).

(iv) The facts are the same as in paragraph (i) of this *Example 1*, except that on July 1 of Year 1, P purchases only 80 of the 100 shares of T stock for \$60,000. The grossed-up amount realized on the sale to P of P's recently purchased T stock (G) is \$75,000 (\$60,000/.8). Consequently, ADSP and the deemed sale tax consequences are the same as in paragraphs (ii) and (iii) of this *Example 1*.

(v) The facts are the same as in paragraph (i) of this *Example 1*, except that T also has goodwill (a Class VII asset) with an appraised value of \$10,000. The results are the same as in paragraphs (ii) and (iii) of this *Example 1*. Because ADSP does not exceed the fair market value of the Class V asset, no amount is allocated to the Class VII asset (goodwill).

*Example 2. More than one class.* (i) P purchases all of the T stock for \$140,000, which also equals the amount realized for the stock determined as if the selling shareholder(s) were required to use old target's accounting methods and characteristics. On July 1 of Year 1, T has liabilities (not including the tax liability for the deemed sale tax consequences) of \$50,000, cash (a Class I asset) of \$10,000, actively traded securities (a Class II asset) with a basis of \$4,000 and a fair market value of \$10,000, goodwill (a Class VII asset) with a basis of \$3,000, and the following Class V assets:

Asset	Basis	FMV	Ratio of asset FMV to total Class V FMV
Land .....	\$ 5,000	\$ 35,000	.14
Building .....	10,000	50,000	.20
Equipment A (Recomputed basis \$80,000) .....	5,000	90,000	.36
Equipment B (Recomputed basis \$20,000) .....	10,000	75,000	.30
Totals .....	\$ 30,000	\$ 250,000	1.00

(ii) ADSP exceeds \$20,000. Thus, \$10,000 of ADSP is allocated to the cash and \$10,000 to the actively traded securities. The amount allocated to an asset (other than a Class VII asset) cannot exceed its fair market value (however, the fair market value of any property subject to nonrecourse indebtedness is treated as being not less than the amount of such indebtedness; see §1.338-6(a)(2)). See §1.338-6(c)(1) (relating to fair market value limitation).

(iii) The portion of ADSP allocable to the Class V assets is preliminarily determined as follows (in the formula, the amount allocated to the Class I assets is referred to as I and the amount allocated to the Class II assets as II):

$$\begin{aligned} \text{ADSP}_V &= (G - (I + II)) + L + T_R \times [(II - B_{II}) + (\text{ADSP}_V - B_V)] \\ \text{ADSP}_V &= (\$140,000 - (\$10,000 + \$10,000)) + \$50,000 + .34 \times [(\$10,000 - \$4,000) + (\text{ADSP}_V - (\$5,000 + \$10,000 + \$5,000 + \$10,000))] \\ \text{ADSP}_V &= \$161,840 + .34 \text{ADSP}_V \\ .66 \text{ADSP}_V &= \$161,840 \\ \text{ADSP}_V &= \$245,212.12 \end{aligned}$$

(iv) Because, under the preliminary calculations of ADSP, the amount to be allocated to the Class I, II, III, IV, V, and VI assets does not exceed their aggregate fair market value, no ADSP amount is allocated to goodwill. Accordingly, the deemed sale of the goodwill results in a capital loss of \$3,000. The

portion of ADSP allocable to the Class V assets is finally determined by taking into account this loss as follows:

$$\begin{aligned} \text{ADSP}_V &= (G - (I + II)) + L + T_R \times [(II - B_{II}) + (\text{ADSP}_V - B_V) + (\text{ADSP}_{VII} - B_{VII})] \\ \text{ADSP}_V &= (\$140,000 - (\$10,000 + \$10,000)) + \$50,000 + .34 \times [(\$10,000 - \$4,000) + (\text{ADSP}_V - \$30,000) + (\$0 - \$3,000)] \\ \text{ADSP}_V &= \$160,820 + .34 \text{ADSP}_V \\ .66 \text{ADSP}_V &= \$160,820 \\ \text{ADSP}_V &= \$243,666.67 \end{aligned}$$

(v) The allocation of ADSP<sub>V</sub> among the Class V assets is in proportion to their fair market values, as follows:

Asset	ADSP	Gain
Land .....	\$ 34,113.33	\$ 29,113.33 (capital gain)
Building .....	48,733.34	38,733.34 (capital gain)
Equipment A .....	87,720.00	82,720.00 (75,000 ordinary income 7,720 capital gain)
Equipment B .....	73,100.00	63,100.00 (10,000 ordinary income 53,100 capital gain)
Totals .....	\$ 243,666.67	\$ 213,666.67

*Example 3. More than one class.* (i) The facts are the same as in *Example 2*, except that P purchases the T stock for \$150,000, rather than \$140,000. The amount realized for the stock determined as if the selling shareholder(s) were required to use old target's accounting methods and characteristics is also \$150,000.

(ii) As in *Example 2*, ADSP exceeds \$20,000. Thus, \$10,000 of ADSP is allocated to the cash and \$10,000 to the actively traded securities.

(iii) The portion of ADSP allocable to the Class V assets as preliminarily determined under the formula set forth in paragraph (iii) of *Example 2* is \$260,363.64. The amount allocated to the Class V assets cannot exceed their aggregate fair market value (\$250,000). Thus, preliminarily, the ADSP amount allocated to Class V assets is \$250,000.

(iv) Based on the preliminary allocation, the ADSP is determined as follows (in the formula, the amount allocated to the Class I assets is referred to as I, the amount allocated to the Class II assets as II, and the amount allocated to the Class V assets as V):

$$\begin{aligned} \text{ADSP} &= G + L + T_R \times [(II - B_{II}) + (V - B_V) + (\text{ADSP} - (I + II + V + B_{VII}))] \\ \text{ADSP} &= \$150,000 + \$50,000 + .34 \times [(\$10,000 - \$4,000) + (\$250,000 - \$30,000) + (\text{ADSP} - (\$10,000 + \$10,000 + \$250,000 + \$3,000))] \\ \text{ADSP} &= \$200,000 + .34 \text{ADSP} - \$15,980 \\ .66 \text{ADSP} &= \$184,020 \\ \text{ADSP} &= \$278,818.18 \end{aligned}$$

(v) Because ADSP as determined exceeds the aggregate fair market value of the Class I, II, III, IV, V, and VI assets, the \$250,000 amount preliminarily allocated to the Class V assets is appropriate. Thus, the amount of ADSP allocated to Class V assets equals their aggregate fair market value (\$250,000), and the allocated ADSP amount for each Class V

asset is its fair market value. Further, because there are no Class VI assets, the allocable ADSP amount for the Class VII asset (goodwill) is \$8,818.18 (the excess of ADSP over the aggregate ADSP amounts for the Class I, II, III, IV, V and VI assets).

*Example 4. Amount allocated to T1 stock.* (i) The facts are the same as in *Example 2*, except that T owns all of the T1 stock (instead of the building), and T1's only asset is the building. The T1 stock and the building each have a fair market value of \$50,000, and the building has a basis of \$10,000. A section 338 election is made for T1 (as well as T), and T1 has no liabilities other than the tax liability for the deemed sale tax consequences. T is the common parent of a consolidated group filing a final consolidated return described in §1.338-10(a)(1).

(ii) ADSP exceeds \$20,000. Thus, \$10,000 of ADSP is allocated to the cash and \$10,000 to the actively traded securities.

(iii) Because T does not recognize any gain on the deemed sale of the T1 stock under paragraph (h)(2) of this section, appropriate adjustments must be made to reflect accurately the fair market value of the T and T1 assets in determining the allocation of ADSP among T's Class V assets (including the T1 stock). In preliminarily calculating ADSP<sub>V</sub> in this case, the T1 stock can be disregarded and, because T owns all of the T1 stock, the T1 asset can be treated as a T asset. Under this assumption, ADSP<sub>V</sub> is \$243,666.67. See paragraph (iv) of *Example 2*.

(iv) Because the portion of the preliminary ADSP allocable to Class V assets (\$243,666.67) does not exceed their fair market value (\$250,000), no amount is allocated to Class VII assets for T. Further, this amount (\$243,666.67) is allocated among T's Class V assets in proportion to their fair market values. See paragraph (v) of *Example 2*. Tentatively, \$48,733.34 of this amount is allocated to the T1 stock.

(v) The amount tentatively allocated to the T1 stock, however, reflects the tax incurred on the deemed sale of the T1 asset equal to \$13,169.34 (.34 x (\$48,733.34 - \$10,000)). Thus, the ADSP allocable to the Class V assets of T, and the ADSP allocable to the T1 stock, as preliminarily calculated, each must be reduced by \$13,169.34. Consequently, these amounts, respectively, are \$230,497.33 and \$35,564.00. In determining ADSP for T1, the grossed-up amount realized on the deemed sale to new T of new T's recently purchased T1 stock is \$35,564.00.

(vi) The facts are the same as in paragraph (i) of this *Example 4*, except that the T1 building has a \$12,500 basis and a \$62,500 value, all of the outstanding T1 stock has a \$62,500 value, and T owns 80 percent of the T1 stock. In preliminarily calculating ADSP<sub>V</sub>, the T1 stock can be disregarded but, because T owns only 80 percent of the T1 stock, only 80 percent of T1 asset basis and value should be taken into account in calculating T's ADSP. By taking into account 80 percent of these amounts, the remaining calculations and results are the same as in paragraphs (ii), (iii), (iv), and (v) of this *Example 4*, except that the grossed-up amount realized on the sale of the recently purchased T1 stock is \$44,455.00 (\$35,564.00/0.8).

(h) *Deemed sale of target affiliate stock—(1) Scope.* This paragraph (h) prescribes rules relating to the treatment of gain or loss realized on the deemed sale of stock of a target affiliate when a section 338 election (but not a section 338(h)(10) election) is made for the target affiliate. For purposes of this paragraph (h), the definition of domestic corporation in §1.338-2(c)(9) is ap-

plied without the exclusion therein for DISCs, corporations described in section 1248(e), and corporations to which an election under section 936 applies.

(2) *In general.* Except as otherwise provided in this paragraph (h), if a section 338 election is made for target, target recognizes no gain or loss on the deemed sale of stock of a target affiliate having the same acquisition date and for which a section 338 election is made if—

(i) Target directly owns stock in the target affiliate satisfying the requirements of section 1504(a)(2);

(ii) Target and the target affiliate are members of a consolidated group filing a final consolidated return described in §1.338-10(a)(1); or

(iii) Target and the target affiliate file a combined return under §1.338-10(a)(4).

(3) *Deemed sale of foreign target affiliate by a domestic target.* A domestic target recognizes gain or loss on the deemed sale of stock of a foreign target affiliate. For the proper treatment of such gain or loss, see, e.g., sections 1246, 1248, 1291 *et seq.*, and 338(h)(16) and §1.338-9.

(4) *Deemed sale producing effectively connected income.* A foreign target recognizes gain or loss on the deemed sale of stock of a foreign target affiliate to the extent that such gain or loss is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

(5) *Deemed sale of insurance company target affiliate electing under section 953(d).* A domestic target recognizes gain (but not loss) on the deemed sale of stock of a target affiliate that has in effect an election under section 953(d) in an amount equal to the lesser of the gain realized or the earnings and profits described in section 953(d)(4)(B).

(6) *Deemed sale of DISC target affiliate.* A foreign or domestic target recognizes gain (but not loss) on the deemed sale of stock of a target affiliate that is a DISC or a former DISC (as defined in section 992(a)) in an amount equal to the lesser of the gain realized or the amount of accumulated DISC income determined with respect to such stock under section 995(c). Such gain is included in gross income as a dividend as provided in sections 995(c)(2) and 996(g).

(7) *Anti-stuffing rule.* If an asset the adjusted basis of which exceeds its fair

market value is contributed or transferred to a target affiliate as transferred basis property (within the meaning of section 7701(a)(43)) and a purpose of such transaction is to reduce the gain (or increase the loss) recognized on the deemed sale of such target affiliate's stock, the gain or loss recognized by target on the deemed sale of stock of the target affiliate is determined as if such asset had not been contributed or transferred.

(8) *Examples.* The following examples illustrate this paragraph (h):

*Example 1.* (i) P makes a qualified stock purchase of T and makes a section 338 election for T. T's sole asset, all of the T1 stock, has a basis of \$50 and a fair market value of \$150. T's deemed purchase of the T1 stock results in a qualified stock purchase of T1 and a section 338 election is made for T1. T1's assets have a basis of \$50 and a fair market value of \$150.

(ii) T realizes \$100 of gain on the deemed sale of the T1 stock, but the gain is not recognized because T directly owns stock in T1 satisfying the requirements of section 1504(a)(2) and a section 338 election is made for T1.

(iii) T1 recognizes gain of \$100 on the deemed sale of its assets.

*Example 2.* The facts are the same as in *Example 1*, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the \$100 gain realized by T on the deemed sale of the T1 stock is recognized.

*Example 3.* (i) P makes a qualified stock purchase of T and makes a section 338 election for T. T owns all of the stock of T1 and T2. T's deemed purchase of the T1 and T2 stock results in a qualified stock purchase of T1 and T2 and section 338 elections are made for T1 and T2. T1 and T2 each own 50 percent of the vote and value of T3 stock. The deemed purchases by T1 and T2 of the T3 stock result in a qualified stock purchase of T3 and a section 338 election is made for T3. T is the common parent of a consolidated group and all of the deemed asset sales are reported on the T group's final consolidated return. See §1.338-10(a)(1).

(ii) Because T, T1, T2 and T3 are members of a consolidated group filing a final consolidated return, no gain or loss is recognized by T, T1 or T2 on their respective deemed sales of target affiliate stock.

*Example 4.* (i) T's sole asset, all of the FT1 stock, has a basis of \$25 and a fair market value of \$150. FT1's sole asset, all of the FT2 stock, has a basis of \$75 and a fair market value of \$150. FT1 and FT2 each have \$50 of accumulated earnings and profits for purposes of section 1248(c) and (d). FT2's assets have a basis of \$125 and a fair market value of \$150, and their sale would not generate subpart F income under section 951. The sale of the FT2 stock or assets would not generate income effectively connected with the conduct of a trade or business within the United States. FT1 does not have an election in effect under section 953(d) and neither FT1 nor FT2 is a passive foreign investment company.

(ii) P makes a qualified stock purchase of T and makes a section 338 election for T. T's deemed purchase of the FT1 stock results in a qualified stock

purchase of FT1 and a section 338 election is made for FT1. Similarly, FT1's deemed purchase of the FT2 stock results in a qualified stock purchase of FT2 and a section 338 election is made for FT2.

(iii) T recognizes \$125 of gain on the deemed sale of the FT1 stock under paragraph (h)(3) of this section. FT1 does not recognize \$75 of gain on the deemed sale of the FT2 stock under paragraph (h)(2) of this section. FT2 recognizes \$25 of gain on the deemed sale of its assets. The \$125 gain T recognizes on the deemed sale of the FT1 stock is included in T's income as a dividend under section 1248, because FT1 and FT2 have sufficient earnings and profits for full recharacterization (\$50 of accumulated earnings and profits in FT1, \$50 of accumulated earnings and profits in FT2, and \$25 of deemed sale earnings and profits in FT2). Section 1.338-9(b). For purposes of sections 901 through 908, the source and foreign tax credit limitation basket of \$25 of the recharacterized gain on the deemed sale of the FT1 stock is determined under section 338(h)(16).

#### §1.338-5 Adjusted grossed-up basis.

(a) *Scope.* This section provides rules under section 338(b) to determine the adjusted grossed-up basis (AGUB) for target. AGUB is the amount for which new target is deemed to have purchased all of its assets in the deemed purchase under section 338(a)(2). AGUB is allocated among target's assets in accordance with §1.338-6 to determine the price at which the assets are deemed to have been purchased. When a subsequent increase or decrease with respect to an element of AGUB is required under general principles of tax law, redetermined AGUB is allocated among target's assets in accordance with §1.338-7.

(b) *Determination of AGUB—(1) General rule.* AGUB is the sum of—

(i) The grossed-up basis in the purchasing corporation's recently purchased target stock;

(ii) The purchasing corporation's basis in nonrecently purchased target stock; and

(iii) The liabilities of new target.

(2) *Time and amount of AGUB—(i) Original determination.* AGUB is initially determined at the beginning of the day after the acquisition date of target. General principles of tax law apply in determining the timing and amount of the elements of AGUB.

(ii) *Redetermination of AGUB.* AGUB is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, with respect to an element of AGUB. For example, AGUB is redetermined because of an increase or decrease

in the amount paid or incurred for recently purchased stock or nonrecently purchased stock or because liabilities not originally taken into account in determining AGUB are subsequently taken into account. An increase or decrease to one element of AGUB also may cause an increase or decrease to another element of AGUB. For example, if there is an increase in the amount paid or incurred for recently purchased stock after the acquisition date, any increase in the basis of nonrecently purchased stock because a gain recognition election was made is also taken into account when AGUB is redetermined. Increases or decreases with respect to the elements of AGUB result in the reallocation of AGUB among target's assets under §1.338-7.

(iii) *Examples.* The following examples illustrate this paragraph (b)(2):

*Example 1.* In Year 1, T, a manufacturer, purchases a customized delivery truck from X with purchase money indebtedness having a stated principal amount of \$100,000. P acquires all of the stock of T in Year 3 for \$700,000 and makes a section 338 election for T. Assume T has no liabilities other than its purchase money indebtedness to X. In Year 4, when T is neither insolvent nor in a title 11 case, T and X agree to reduce the amount of the purchase money indebtedness to \$80,000. Assume that the reduction would be a purchase price reduction under section 108(e)(5). T and X's agreement to reduce the amount of the purchase money indebtedness would, under general principles of tax law that would apply if the deemed asset sale had actually occurred, change the amount of liabilities of old target taken into account in determining its basis. Accordingly, AGUB is redetermined at the time of the reduction. See paragraph (e)(2) of this section. Thus the purchase price reduction affects the basis of the truck only indirectly, through the mechanism of §§1.338-6 and 1.338-7. See §1.338-4(b)(2)(iii) *Example* for the effect on ADSP.

*Example 2.* T, an accrual basis taxpayer, is a chemical manufacturer. In Year 1, T is obligated to remediate environmental contamination at the site of one of its plants. Assume that all the events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy but economic performance has not occurred with respect to the liability within the meaning of section 461(h). P acquires all of the stock of T in Year 1 and makes a section 338 election for T. Assume that, if a corporation unrelated to T had actually purchased T's assets and assumed T's obligation to remediate the contamination, the corporation would not satisfy the economic performance requirements until Year 5. Under section 461(h), the assumed liability would not be treated as incurred and taken into account in basis until that time. The incurrence of the liability in Year 5 under the economic performance rules is an increase in the amount of liabilities properly taken into account in basis and results in the redetermination of AGUB. (Respecting ADSP, compare §1.461-4(d)(5), which provides that economic performance occurs for old T as the amount of the liability is properly taken into account in amount realized on the deemed asset sale. Thus ADSP is not redetermined when new T satisfies the economic performance requirements.)

(c) *Grossed-up basis of recently purchased stock.* The purchasing corporation's grossed-up basis of recently purchased target stock (as defined in section 338(b)(6)(A)) is an amount equal to—

(1) The purchasing corporation's basis in recently purchased target stock at the beginning of the day after the acquisition date determined without regard to the acquisition costs taken into account in paragraph (c)(3) of this section;

(2) Multiplied by a fraction, the numerator of which is 100 minus the number that is the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's nonrecently purchased target stock, and the denominator of which is the number equal to the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's recently purchased target stock;

(3) Plus the acquisition costs the purchasing corporation incurred in connection with its purchase of the recently purchased stock that are capitalized in the basis of such stock (e.g., brokerage commissions and any similar costs incurred by the purchasing corporation to acquire the stock).

(d) *Basis of nonrecently purchased stock; gain recognition election—(1) No gain recognition election.* In the absence of a gain recognition election under section 338(b)(3) and this section, the purchasing corporation retains its basis in the nonrecently purchased stock.

(2) *Procedure for making gain recognition election.* A gain recognition election may be made for nonrecently purchased stock of target (or a target affiliate) only if a section 338 election is made for target (or the target affiliate). The gain recognition election is made by attaching a gain recognition statement to a timely filed Form 8023 for target. The gain recognition statement must contain the information specified in the form and its instructions. The gain recognition election is irrevocable. If a section 338(h)(10) election is made for target, see §1.338(h)(10)-1(d)(1) (providing that the purchasing corporation is automatically deemed to have made a gain recognition election for its nonrecently purchased T stock).

(3) *Effect of gain recognition election—(i) In general.* If the purchasing corporation makes a gain recognition

election, then for all purposes of the Internal Revenue Code—

(A) The purchasing corporation is treated as if it sold on the acquisition date the nonrecently purchased target stock for the basis amount determined under paragraph (d)(3)(ii) of this section; and

(B) The purchasing corporation's basis on the acquisition date in nonrecently purchased target stock immediately following the deemed sale in paragraph (d)(3)(i)(A) of this section is the basis amount.

(ii) *Basis amount.* The basis amount is equal to the amount in paragraph (c)(1) of this section (the purchasing corporation's basis in recently purchased target stock at the beginning of the day after the acquisition date determined without regard to the acquisition costs taken into account in paragraph (c)(3) of this section) multiplied by a fraction the numerator of which is the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation's nonrecently purchased target stock and the denominator of which is 100 percent minus the numerator amount. Thus, if target has a single class of outstanding stock, the purchasing corporation's basis in each share of nonrecently purchased target stock after the gain recognition election is equal to the average price per share of the purchasing corporation's recently purchased target stock.

(iii) *Losses not recognized.* Only gains (unreduced by losses) on the nonrecently purchased target stock are recognized.

(iv) *Stock subject to election.* The gain recognition election applies to—

(A) All nonrecently purchased target stock; and

(B) Any nonrecently purchased stock in a target affiliate having the same acquisition date as target if such target affiliate stock is held by the purchasing corporation on such date.

(e) *Liabilities of new target—(1) In general.* The liabilities of new target are the liabilities of target as of the beginning of the day after the acquisition date (but see §1.338-1(d) (regarding certain transactions on the acquisition date)). In order to be taken into account in AGUB, a liability must be a liability of target that is properly taken into account in basis under general principles of tax law that would apply if new target had acquired its assets

from an unrelated person for consideration that included discharge of the liabilities of that unrelated person. Such liabilities may include liabilities for the tax consequences resulting from the deemed sale.

(2) *Time and amount of liabilities.* The time for taking into account liabilities of old target in determining AGUB and the amount of the liabilities taken into account is determined as if new target had acquired its assets from an unrelated person for consideration that included the discharge of its liabilities.

(3) *Interaction with deemed sale tax consequences.* In general, see §1.338-4(e). Although ADSP and AGUB are not necessarily linked, if an increase in the amount realized for recently purchased stock of target is taken into account after the acquisition date, and if the tax on the deemed sale tax consequences is a liability of target, any increase in that liability is also taken into account in re-determining AGUB.

(f) *Adjustments by the Internal Revenue Service.* In connection with the examination of a return, the Commissioner may increase (or decrease) AGUB under the authority of section 338(b)(2) and allocate such amounts to target's assets under the authority of section 338(b)(5) so that AGUB and the basis of target's assets properly reflect the cost to the purchasing corporation of its interest in target's assets. Such items may include distributions from target to the purchasing corporation, capital contributions from the purchasing corporation to target during the 12-month acquisition period, or acquisitions of target stock by the purchasing corporation after the acquisition date from minority shareholders. See also §1.338-1(d) (regarding certain transactions on the acquisition date).

(g) *Examples.* The following examples illustrate this section. For purposes of the examples in this paragraph (g), T has no liabilities other than the tax liability for the deemed sale tax consequences, T shareholders incur no costs in selling the T stock, and P incurs no costs in acquiring the T stock. The examples are as follows:

*Example 1.* (i) Before July 1 of Year 1, P purchases 10 of the 100 shares of T stock for \$5,000. On July 1 of Year 2, P purchases 80 shares of T stock for \$60,000 and makes a section 338 election for T. As of July 1 of Year 2, T's only asset is raw land with an adjusted basis to T of \$50,400 and a fair market value of

\$100,000. T has no loss or tax credit carryovers to Year 2. T's marginal tax rate for any ordinary income or net capital gain resulting from the deemed asset sale is 34 percent. The 10 shares purchased before July 1 of Year 1 constitute nonrecently purchased T stock with respect to P's qualified stock purchase of T stock on July 1 of Year 2.

(ii) The ADSP formula as applied to these facts is the same as in §1.338-4(g) *Example 1*. Accordingly, the ADSP for T is \$87,672.72. The existence of nonrecently purchased T stock is irrelevant for purposes of the ADSP formula, because that formula treats P's nonrecently purchased T stock in the same manner as T stock not held by P.

(iii) The total tax liability resulting from T's deemed asset sale, as calculated under the ADSP formula, is \$12,672.72.

(iv) If P does not make a gain recognition election, the AGUB of new T's assets is \$85,172.72, determined as follows (In the following formula below, GRP is the grossed-up basis in P's recently purchased T stock, BNP is P's basis in nonrecently purchased T stock, L is T's liabilities, and X is P's acquisition costs for the recently purchased T stock):

$$\begin{aligned} \text{AGUB} &= \text{GRP} + \text{BNP} + \text{L} + \text{X} \\ \text{AGUB} &= \$60,000 \times [(1 - .1)/.8] + \$5,000 + \\ &\quad \$12,672.72 + 0 \\ \text{AGUB} &= \$85,172.72 \end{aligned}$$

(v) If P makes a gain recognition election, the AGUB of new T's assets is \$87,672.72, determined as follows:

$$\begin{aligned} \text{AGUB} &= \$60,000 \times [(1 - .1)/.8] + \$60,000 \times [(1 - \\ &\quad .1)/.8] \times [.1/(1 - .1)] + \$12,672.72 \\ \text{AGUB} &= \$87,672.72 \end{aligned}$$

(vi) The calculation of AGUB if P makes a gain recognition election may be simplified as follows:

$$\begin{aligned} \text{AGUB} &= \$60,000/.8 + \$12,672.72 \\ \text{AGUB} &= \$87,672.72 \end{aligned}$$

(vii) As a result of the gain recognition election, P's basis in its nonrecently purchased T stock is increased from \$5,000 to \$7,500 (i.e., \$60,000 x [(1 - .1)/.8] x [.1/(1 - .1)]). Thus, P recognizes a gain in Year 2 with respect to its nonrecently purchased T stock of \$2,500 (i.e., \$7,500 - \$5,000).

*Example 2.* On January 1 of Year 1, P purchases one-third of the T stock. On March 1 of Year 1, T distributes a dividend to all of its shareholders. On April 15 of Year 1, P purchases the remaining T stock and makes a section 338 election for T. In appropriate circumstances, the Commissioner may decrease the AGUB of T to take into account the payment of the dividend and properly reflect the fair market value of T's assets deemed purchased.

*Example 3.* (i) T's sole asset is a building worth \$100,000. At this time, T has 100 shares of stock outstanding. On August 1 of Year 1, P purchases 10 of the 100 shares of T stock for \$8,000. On June 1 of Year 2, P purchases 50 shares of T stock for \$50,000. On June 15 of Year 2, P contributes a tract of land to the capital of T and receives 10 additional shares of T stock as a result of the contribution. Both the basis and fair market value of the land at that time are \$10,800. On June 30 of Year 2, P purchases the remaining 40 shares of T stock for \$40,000 and makes a section 338 election for T. The AGUB of T is \$108,800.

(ii) To prevent the shifting of basis from the contributed property to other assets of T, the Commissioner may allocate \$10,800 of the AGUB to the land, leaving \$98,000 to be allocated to the building. See paragraph (f) of this section. Otherwise, applying the allocation rules of §1.338-6 would, on these facts, result in an allocation to the recently contributed land of an amount less than its value of \$10,800, with the difference being allocated to the building already held by T.

### §1.338-6 Allocation of ADSP and AGUB among target assets.

(a) *Scope—(1) In general.* This section prescribes rules for allocating ADSP and AGUB among the acquisition date assets of a target for which a section 338 election is made.

(2) *Fair market value—(i) In general.* Generally, the fair market value of an asset is its gross fair market value (i.e., fair market value determined without regard to mortgages, liens, pledges, or other liabilities). However, for purposes of determining the amount of old target's deemed sale tax consequences, the fair market value of any property subject to a nonrecourse indebtedness will be treated as being not less than the amount of such indebtedness. (For purposes of the preceding sentence, a liability that was incurred because of the acquisition of the property is disregarded to the extent that such liability was not taken into account in determining old target's basis in such property.)

(ii) *Transaction costs.* Transaction costs are not taken into account in allocating ADSP or AGUB to assets in the deemed sale (except indirectly through their effect on the total ADSP or AGUB to be allocated).

(iii) *Internal Revenue Service authority.* In connection with the examination of a return, the Internal Revenue Service may challenge the taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties.

(b) *General rule for allocating ADSP and AGUB—(1) Reduction in the amount of consideration for Class I assets.* Both ADSP and AGUB, in the respective allocation of each, are first reduced by the amount of Class I assets. Class I assets are cash and general deposit accounts (including savings and checking accounts)

other than certificates of deposit held in banks, savings and loan associations, and other depository institutions. If the amount of Class I assets exceeds AGUB, new target will immediately realize ordinary income in an amount equal to such excess. The amount of ADSP or AGUB remaining after the reduction is to be allocated to the remaining acquisition date assets.

(2) *Other assets*—(i) *In general*. Subject to the limitations and other rules of paragraph (c) of this section, ADSP and AGUB (as reduced by the amount of Class I assets) are allocated among Class II acquisition date assets of target in proportion to the fair market values of such Class II assets at such time, then among Class III assets so held in such proportion, then among Class IV assets so held in such proportion, then among Class V assets so held in such proportion, then among Class VI assets so held in such proportion, and finally to Class VII assets. If an asset is described below as includible in more than one class, then it is included in such class with the lower or lowest class number (for instance, Class III has a lower class number than Class IV).

(ii) *Class II assets*. Class II assets are actively traded personal property within the meaning of section 1092(d)(1) and §1.1092(d)-1 (determined without regard to section 1092(d)(3)). In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Class II assets do not include stock of target affiliates, whether or not of a class that is actively traded, other than actively traded stock described in section 1504(a)(4). Examples of Class II assets include U.S. government securities and publicly traded stock.

(iii) *Class III assets*. Class III assets are assets that the taxpayer marks to market at least annually for Federal income tax purposes and debt instruments (including accounts receivable). However, Class III assets do not include —

(A) Debt instruments issued by persons related at the beginning of the day following the acquisition date to the target under section 267(b) or 707;

(B) Contingent debt instruments subject to §1.1275-4, §1.483-4, or section 988, unless the instrument is subject to

the non-contingent bond method of §1.1275-4(b) or is described in §1.988-2(b)(2)(i)(B)(2); and

(C) Debt instruments convertible into the stock of the issuer or other property.

(iv) *Class IV assets*. Class IV assets are stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

(v) *Class V assets*. Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets.

(vi) *Class VI assets*. Class VI assets are all section 197 intangibles, as defined in section 197, except goodwill and going concern value.

(vii) *Class VII assets*. Class VII assets are goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

(3) *Other items designated by the Internal Revenue Service*. Similar items may be added to any class described in this paragraph (b) by designation in the Internal Revenue Bulletin by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

(c) *Certain limitations and other rules for allocation to an asset*—(1) *Allocation not to exceed fair market value*. The amount of ADSP or AGUB allocated to an asset (other than Class VII assets) cannot exceed the fair market value of that asset at the beginning of the day after the acquisition date.

(2) *Allocation subject to other rules*. The amount of ADSP or AGUB allocated to an asset is subject to other provisions of the Internal Revenue Code or general principles of tax law in the same manner as if such asset were transferred to or acquired from an unrelated person in a sale or exchange. For example, if the deemed asset sale is a transaction described in section 1056(a) (relating to basis limitation for player contracts transferred in connection with the sale of a franchise), the amount of AGUB allocated to a contract for the services of an athlete cannot exceed the limitation imposed by that section. As another example, section 197(f)(5) applies in determining the amount of AGUB allocated to an amortiz-

able section 197 intangible resulting from an assumption-reinsurance transaction.

(3) *Special rule for allocating AGUB when purchasing corporation has nonrecently purchased stock*—(i) *Scope*. This paragraph (c)(3) applies if at the beginning of the day after the acquisition date—

(A) The purchasing corporation holds nonrecently purchased stock for which a gain recognition election under section 338(b)(3) and §1.338-5(d) is not made; and

(B) The hypothetical purchase price determined under paragraph (c)(3)(ii) of this section exceeds the AGUB determined under §1.338-5(b).

(ii) *Determination of hypothetical purchase price*. Hypothetical purchase price is the AGUB that would result if a gain recognition election were made.

(iii) *Allocation of AGUB*. Subject to the limitations in paragraphs (c)(1) and (2) of this section, the portion of AGUB (after reduction by the amount of Class I assets) to be allocated to each Class II, III, IV, V, VI, and VII asset of target held at the beginning of the day after the acquisition date is determined by multiplying—

(A) The amount that would be allocated to such asset under the general rules of this section were AGUB equal to the hypothetical purchase price; by

(B) A fraction, the numerator of which is actual AGUB (after reduction by the amount of Class I assets) and the denominator of which is the hypothetical purchase price (after reduction by the amount of Class I assets).

(4) *Liabilities taken into account in determining amount realized on subsequent disposition*. In determining the amount realized on a subsequent sale or other disposition of property deemed purchased by new target, §1.1001-2(a)(3) shall not apply to any liability that was taken into account in AGUB.

(d) *Examples*. The following examples illustrate §§1.338-4, 1.338-5, and this section:

*Example 1.* (i) T owns 90 percent of the outstanding T1 stock. P purchases 100 percent of the outstanding T stock for \$2,000. There are no acquisition costs. P makes a section 338 election for T and, as a result, T1 is considered acquired in a qualified stock purchase. A section 338 election is made for T1. The grossed-up basis of the T stock is \$2,000 (i.e., \$2,000 x 1/1).

(ii) The liabilities of T as of the beginning of the day after the acquisition date (including the tax lia-



bility for the deemed sale tax consequences) that would, under general principles of tax law, properly be taken into account at that time, are as follows:

Liabilities (nonrecourse mortgage plus unsecured liabilities) . . . . .	\$ 700
Taxes Payable . . . . .	<u>300</u>
Total . . . . .	\$ 1,000

(iii) The AGUB of T is determined as follows:

Grossed-up basis . . . . .	\$2,000
Total liabilities . . . . .	<u>1,000</u>
AGUB . . . . .	\$ 3,000

(iv) Assume that ADSP is also \$3,000.

(v) Assume that, at the beginning of the day after the acquisition date, T's cash and the fair market values of T's Class II, III, IV, and V assets are as follows:

Asset Class	Asset	Fair market value
I	Cash . . . . .	\$ 200*
II	Portfolio of actively traded securities . . . . .	300
III	Accounts receivable . . . . .	600
IV	Inventory . . . . .	300
V	Building . . . . .	800
V	Land . . . . .	200
V	Investment in T1 . . . . .	<u>450</u>
	Total . . . . .	\$ 2,850

\*Amount.

(vi) Under paragraph (b)(1) of this section, the amount of ADSP and AGUB allocable to T's Class II, III, IV, and V assets is reduced by the amount of cash to \$2,800, i.e., \$3,000 - \$200. \$300 of ADSP and of AGUB is then allocated to actively traded securities.

\$600 of ADSP and of AGUB is then allocated to accounts receivable. \$300 of ADSP and of AGUB is then allocated to the inventory. Since the remaining amount of ADSP and of AGUB is \$1,600 (i.e., \$3,000 - (\$200 + \$300 + \$600 + \$300)), an amount which exceeds the sum of the fair market values of T's Class V assets, the amount of ADSP and of AGUB allocated to each Class V asset is its fair market value:

Building . . . . .	800
Land . . . . .	200
Investment in T1 . . . . .	<u>450</u>
Total . . . . .	\$ 1,450

(vii) T has no Class VI assets. The amount of ADSP and of AGUB allocated to T's Class VII assets (goodwill and going concern value) is \$150, i.e., \$1,600 - \$1,450.

(viii) The grossed-up basis of the T1 stock is \$500, i.e., \$450 x 1/9.

(ix) The liabilities of T1 as of the beginning of the day after the acquisition date (including the tax liability for the deemed sale tax consequences) that would, under general principles of tax law, properly be taken into account at that time, are as follows:

General Liabilities . . . . .	\$ 100
Taxes Payable . . . . .	<u>20</u>
Total . . . . .	\$ 120

(x) The AGUB of T1 is determined as follows:

Grossed-up basis of T1 Stock . . . . .	\$ 500
Liabilities . . . . .	<u>120</u>
AGUB . . . . .	\$ 620

(xi) Assume that ADSP is also \$620.

(xii) Assume that at the beginning of the day after the acquisition date, T1's cash and the fair market values of its Class IV and VI assets are as follows:

Asset Class	Asset	Fair Market Value
I	Cash . . . . .	\$ 50*
IV	Inventory . . . . .	200
VI	Patent . . . . .	<u>350</u>
	Total . . . . .	\$ 600

\* Amount.

(xiii) The amount of ADSP and of AGUB allocable to T1's Class IV and VI assets is first reduced by the \$50 of cash.

(xiv) Because the remaining amount of ADSP and of AGUB (\$570) is an amount which exceeds the fair market value of T1's only Class IV asset, the inventory, the amount allocated to the inventory is its fair market value (\$200). After that, the remaining amount of ADSP and of AGUB (\$370) exceeds the fair market value of T1's only Class VI asset, the patent. Thus, the amount of ADSP and of AGUB allocated to the patent is its fair market value (\$350).

(xv) The amount of ADSP and of AGUB allocated to T1's Class VII assets (goodwill and going concern value) is \$20, i.e., \$570 - \$550.

*Example 2.* (i) Assume that the facts are the same as in *Example 1* except that P has, for five years, owned 20 percent of T's stock, which has a basis in P's hands at the beginning of the day after the acquisition date of \$100, and P purchases the remaining 80 percent of T's stock for \$1,600. P does not make a gain recognition election under section 338(b)(3).

(ii) Under §1.338-5(c), the grossed-up basis of recently purchased T stock is \$1,600, i.e., \$1,600 x (1 - .2)/.8.

(iii) The AGUB of T is determined as follows:

Grossed-up basis of recently purchased stock as determined under §1.338-5(c) (\$1,600 x (1 - .2)/.8) . . . . .	\$ 1,600
Basis of nonrecently purchased stock . . . . .	100
Liabilities . . . . .	<u>1,000</u>
AGUB . . . . .	\$ 2,700

(iv) Since P holds nonrecently purchased stock, the hypothetical purchase price of the T stock must be computed and is determined as follows:

Grossed-up basis of recently purchased stock as determined under §1.338-5(c) (\$1,600 x (1 - .2)/.8) . . . . .	\$ 1,600
Basis of nonrecently purchased stock as if the gain recognition election under §1.338-5(d)(2) had been made (\$1,600 x .2/(1 - .2)) . . . . .	400
Liabilities . . . . .	<u>1,000</u>
Total . . . . .	\$ 3,000

(v) Since the hypothetical purchase price (\$3,000) exceeds the AGUB (\$2,700) and no gain recognition election is made under section 338(b)(3), AGUB is allocated under paragraph (c)(3) of this section.

(vi) First, an AGUB amount equal to the hypothetical purchase price (\$3,000) is allocated among

the assets under the general rules of this section. The allocation is set forth in the column below entitled *Original Allocation*. Next, the allocation to each asset in Class II through Class VII is multiplied by a fraction having a numerator equal to the actual AGUB reduced by the amount of Class I assets

(\$2,700 - \$200 = \$2,500) and a denominator equal to the hypothetical purchase price reduced by the amount of Class I assets (\$3,000 - \$200 = \$2,800), or 2,500/2,800. This produces the *Final Allocation*:

<i>Class</i>	<i>Asset</i>	<i>Original Allocation</i>	<i>Final Allocation</i>
I	Cash . . . . .	\$ 200	\$ 200
II	Portfolio of actively traded securities . . . . .	300	268*
III	Accounts receivable . . . . .	600	536
IV	Inventory . . . . .	300	268
V	Building . . . . .	800	714
V	Land . . . . .	200	178
V	Investment in T1 . . . . .	450	402
VII	Goodwill and going concern value . . . . .	<u>150</u>	<u>134</u>
	Total . . . . .	\$ 3,000	\$ 2,700

\* All numbers rounded for convenience.

*§1.338-7 Allocation of redetermined ADSP and AGUB among target assets.*

(a) *Scope.* ADSP and AGUB are redetermined at such time and in such amount as an increase or decrease would be required under general principles of tax law for the elements of ADSP or AGUB. This section provides rules for allocating redetermined ADSP or AGUB.

(b) *Allocation of redetermined ADSP and AGUB.* When ADSP or AGUB is redetermined, a new allocation of ADSP or AGUB is made by allocating the redetermined ADSP or AGUB amount under the rules of §1.338-6. If the allocation of the redetermined ADSP or AGUB amount under §1.338-6 to a given asset is different from the original allocation to it, the difference is added to or subtracted from the original allocation to the asset, as appropriate. (See paragraph (d) of this section for new target's treatment of the amount so allocated.) Amounts allocable to an acquisition date asset (or with respect to a disposed-of acquisition date asset) are subject to all the asset allocation rules (for example, the fair market value limitation in §1.338-6(c)(1)) as if the redetermined ADSP or AGUB were the ADSP or AGUB on the acquisition date.

(c) *Special rules for ADSP—(1) Increases or decreases in deemed sale tax consequences taxable notwithstanding old target ceases to exist.* To the extent general principles of tax law would require a seller in an actual asset sale to account for events relating to the sale that occur after the sale date, target must make such an accounting. Target is not precluded from realizing additional deemed sale tax consequences because the target is treated as a new corporation after the acquisition date.

(2) *Procedure for transactions in which section 338(h)(10) is not elected—(i)*

*Deemed sale tax consequences included in new target's return.* If an election under section 338(h)(10) is not made, any additional deemed sale tax consequences of old target resulting from an increase or decrease in the ADSP are included in new target's income tax return for new target's taxable year in which the increase or decrease is taken into account. For example, if after the acquisition date there is an increase in the allocable ADSP of section 1245 property for which the recomputed basis (but not the adjusted basis) exceeds the portion of the ADSP allocable to that particular asset on the acquisition date, the additional gain is treated as ordinary income to the extent it does not exceed such excess amount. See paragraph (c)(2)(ii) of this section for the special treatment of old target's carryovers and carrybacks. Although included in new target's income tax return, the deemed sale tax consequences are separately accounted for as an item of old target and may not be offset by income, gain, deduction, loss, credit, or other amount of new target. The amount of tax on income of old target resulting from an increase or decrease in the ADSP is determined as if such deemed sale tax consequences had been recognized in old target's taxable year ending at the close of the acquisition date. However, because the income resulting from the increase or decrease in ADSP is reportable in new target's taxable year of the increase or decrease, not in old target's taxable year ending at the close of the acquisition date, there is not a resulting underpayment of tax in that past taxable year of old target for purposes of calculation of interest due.

(ii) *Carryovers and carrybacks—(A) Loss carryovers to new target taxable years.* A net operating loss or net capital loss of old target may be carried forward to a taxable year of new target, under the

principles of section 172 or 1212, as applicable, but is allowed as a deduction only to the extent of any recognized income of old target for such taxable year, as described in paragraph (c)(2)(i) of this section. For this purpose, however, taxable years of new target are not taken into account in applying the limitations in section 172(b)(1) or 1212(a)(1)(B) (or other similar limitations). In applying sections 172(b) and 1212(a)(1), only income, gain, loss, deduction, credit, and other amounts of old target are taken into account. Thus, if old target has an unexpired net operating loss at the close of its taxable year in which the deemed asset sale occurred that could be carried forward to a subsequent taxable year, such loss may be carried forward until it is absorbed by old target's income.

(B) *Loss carrybacks to taxable years of old target.* An ordinary loss or capital loss accounted for as a separate item of old target under paragraph (c)(2)(i) of this section may be carried back to a taxable year of old target under the principles of section 172 or 1212, as applicable. For this purpose, taxable years of new target are not taken into account in applying the limitations in section 172(b) or 1212(a) (or other similar limitations).

(C) *Credit carryovers and carrybacks.* The principles described in paragraphs (c)(2)(ii)(A) and (B) of this section apply to carryovers and carrybacks of amounts for purposes of determining the amount of a credit allowable under part IV, subchapter A, chapter 1 of the Internal Revenue Code. Thus, for example, credit carryovers of old target may offset only income tax attributable to items described in paragraph (c)(2)(i) of this section.

(3) *Procedure for transactions in which section 338(h)(10) is elected.* If an election under section 338(h)(10) is made, any changes in the deemed sale tax conse-

quences caused by an increase or decrease in the ADSP are accounted for in determining the taxable income (or other amount) of the member of the selling consolidated group, the selling affiliate, or the S corporation shareholders to which such income, loss, or other amount is attributable for the taxable year in which such increase or decrease is taken into account.

(d) *Special rules for AGUB*—(1) *Effect of disposition or depreciation of acquisition date assets.* If an acquisition date asset has been disposed of, depreciated, amortized, or depleted by new target before an amount is added to the original allocation to the asset, the increased amount otherwise allocable to such asset is taken into account under general principles of tax law that apply when part of the cost of an asset not previously taken into account in basis is paid or incurred after the asset has been disposed of, depreciated, amortized, or depleted. A similar rule applies when an amount is subtracted from the original allocation to the asset. For purposes of the preceding sentence, an asset is considered to have been disposed of to the extent that its allocable portion of the decrease in AGUB would reduce its basis below zero.

(2) *Section 38 property.* Section 1.47-2(c) applies to a reduction in basis of section 38 property under this section.

(e) *Examples.* The following examples illustrate this section. Any amount described in the following examples is exclusive of interest. For rules characterizing deferred contingent payments as principal or interest, see §§ 1.483-4, 1.1274-2(g), and 1.1275-4(c). The examples are as follows:

*Example 1.* (i)(A) T's assets other than goodwill and going concern value, and their fair market values at the beginning of the day after the acquisition date, are as follows:

Asset Class	Asset	Fair Market Value
V	Building . . . . .	\$ 100
V	Stock of X (not a target) . . . . .	<u>200</u>
	Total . . . . .	\$ 300

(B) T has no liabilities other than a contingent liability that would not be taken into account under general principles of tax law in an asset sale between unrelated parties when the buyer assumed the liability or took property subject to it.

(ii)(A) On September 1, 2000, P purchases all of the outstanding stock of T for \$270 and makes a section 338 election for T. The grossed-up basis of the T stock and T's AGUB are both \$270. The AGUB is ratably allocated among T's Class V assets in proportion to their fair market values as follows:

Asset	Basis
Building (\$270 x 100/300) . . . . .	\$ 90
Stock (\$270 x 200/300) . . . . .	<u>180</u>
Total . . . . .	\$270

(B) No amount is allocated to the Class VII assets. New T is a calendar year taxpayer. Assume that the X stock is a capital asset in the hands of new T.

(iii) On January 1, 2001, new T sells the X stock and uses the proceeds to purchase inventory.

(iv) Pursuant to events on June 30, 2002, the contingent liability of old T is at that time properly taken into account under general principles of tax law. The amount of the liability is \$60.

(v) T's AGUB increases by \$60 from \$270 to \$330. This \$60 increase in AGUB is first allocated among T's acquisition date assets in accordance with the provisions of § 1.338-6. Because the redetermined AGUB for T (\$330) exceeds the sum of the fair market values at the beginning of the day after the acquisition date of the Class V acquisition date assets (\$300), AGUB allocated to those assets is limited to those fair market values under § 1.338-6(c)(1). As there are no Class VI assets, the remaining AGUB of \$30 is allocated to goodwill and going concern value (Class VII assets). The amount of increase in AGUB allocated to each acquisition date asset is determined as follows:

Asset	Original AGUB	Redetermined AGUB	Increase
Building . . . . .	\$ 90	\$ 100	\$ 10
X Stock . . . . .	180	200	20
Goodwill and going concern value . . . . .	<u>0</u>	<u>30</u>	<u>30</u>
Total . . . . .	\$ 270	\$ 330	\$ 60

(vi) Since the X stock was disposed of before the contingent liability was properly taken into account for tax purposes, no amount of the increase in AGUB attributable to such stock may be allocated to any T asset. Rather, such amount (\$20) is allowed as a capital loss to T for the taxable year 2002 under the principles of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). In addition, the \$10 increase in AGUB allocated to the building and the \$30 increase in AGUB allocated to the goodwill and going concern value are treated as basis redeterminations in 2002. See paragraph (d)(1) of this section.

*Example 2.* (i) On January 1, 2002, P purchases all of the outstanding stock of T and makes a section 338 election for T. Assume that ADSP and AGUB of T are both \$500 and are allocated among T's acquisition date assets as follows:

Asset Class	Asset	Basis
V	Machinery . . . . .	\$ 150
V	Land . . . . .	250
VII	Goodwill and going concern value . . . . .	<u>100</u>
	Total . . . . .	\$ 500

(ii) On September 30, 2004, P filed a claim against the selling shareholders of T in a court of appropriate jurisdiction alleging fraud in the sale of the T stock.

(iii) On January 1, 2007, the former shareholders refund \$140 of the purchase price to P in a settlement of the lawsuit. Assume that, under general principles of tax law, both the seller and the buyer properly take into account such refund when paid. Assume also that the refund has no effect on the tax liability for the deemed sale tax consequences. This refund results in a decrease of T's ADSP and AGUB of \$140, from \$500 to \$360.

(iv) The redetermined ADSP and AGUB of \$360 is allocated among T's acquisition date assets. Because ADSP and AGUB do not exceed the fair market value of the Class V assets, the ADSP and AGUB amounts are allocated to the Class V assets in proportion to their fair market values at the beginning of the day after the acquisition date. Thus, \$135 ( $\$150 \times (\$360/(\$150 + \$250))$ ) is allocated to the machinery and \$225 ( $\$250 \times (\$360/(\$150 + \$250))$ ) is allocated to the land. Accordingly, the basis of the machinery is reduced by \$15 (\$150 original allocation - \$135 redetermined allocation) and

the basis of the land is reduced by \$25 (\$250 original allocation - \$225 redetermined allocation). No amount is allocated to the Class VII assets. Accordingly, the basis of the goodwill and going concern value is reduced by \$100 (\$100 original allocation - \$0 redetermined allocation).

(v) Assume that, as a result of deductions under section 168, the adjusted basis of the machinery immediately before the decrease in AGUB is zero. The machinery is treated as if it were disposed of before the decrease is taken into account. In 2007, T recognizes income of \$15, the character of which is determined under the principles of *Arrowsmith v. Commissioner* and the tax benefit rule. No adjustment to the basis of T's assets is made for any tax paid on this amount. Assume also that, as a result of amortization deductions, the adjusted basis of the goodwill and going concern value immediately before the decrease in AGUB is \$40. A similar adjustment to income is made in 2007 with respect to the \$60 of previously amortized goodwill and going concern value.

(vi) In summary, the basis of T's acquisition date assets, as of January 1, 2007, is as follows:

Asset	Basis	Class	Asset	Final Allocation
Machinery	\$ 0	I	Cash	\$ 200
Land	225	II	Portfolio of actively traded securities	268*
Goodwill and going concern value	0	III	Accounts receivable	536
		IV	Inventory	268
		V	Building	714
		V	Land	178
		V	Investment in T1	402
		VII	Goodwill and going concern value	<u>134</u>
			Total	\$ 2,700

*Example 3.* (i) Assume that the facts are the same as §1.338-6(d) *Example 2* except that the recently purchased stock is acquired for \$1,600 plus additional payments that are contingent upon T's future earnings. Assume that, under general principles of tax law, such later payments are properly taken into account when paid. Thus, T's AGUB, determined as of the beginning of the day after the acquisition date (after reduction by T's cash of \$200), is \$2,500 and is allocated among T's acquisition date assets under §1.338-6(c)(3)(iii) as follows:

(ii) At a later point in time, P pays an additional \$200 for its recently purchased T stock. Assume

that the additional consideration paid would not increase T's tax liability for the deemed sale tax consequences.

(iii) T's AGUB increases by \$200, from \$2,700 to \$2,900. This \$200 increase in AGUB is accounted for in accordance with the provisions of §1.338-6(c)(3)(iii).

(iv) The hypothetical purchase price of the T stock is redetermined as follows:

Grossed-up basis of recently purchased stock as determined under §1.338-5(c) ( $\$1,800 \times (1 - .2)/.8$ )	\$ 1,800
Basis of nonrecently purchased stock as if the gain recognition election under §1.338-5(d)(2) had been made ( $\$1,800 \times .2/(1 - .2)$ )	450
Liabilities	<u>1,000</u>
Total	\$ 3,250

(v) Since the redetermined hypothetical purchase price (\$3,250) exceeds the redetermined AGUB (\$2,900) and no gain recognition election was made under section 338(b)(3), the rules of §1.338-6(c)(3)(iii) are reapplied using the redetermined hypothetical purchase price and the redetermined AGUB.

(vi) First, an AGUB amount equal to the redetermined hypothetical purchase price (\$3,250) is allocated among the assets under the general rules of §1.338-6. The allocation is set forth in the column below entitled *Hypothetical Allocation*. Next, the allocation to each asset in Class II through Class VII is multiplied by a fraction with a numerator equal to the actual redetermined AGUB reduced by the amount of Class I assets (\$2,900 - \$200 = \$2,700) and a denominator equal to the redetermined hypothetical purchase price reduced by the amount of Class I assets (\$3,250 - \$200 = \$3,050), or 2,700/3,050. This produces the *Final Allocation*:

Class	Asset	Hypothetical Allocation	Final Allocation
I	Cash	\$ 200	\$ 200
II	Portfolio of actively traded securities	300	266*
III	Accounts receivable	600	531
IV	Inventory	300	266
V	Building	800	708
V	Land	200	177
V	Investment in T1	450	398
VII	Goodwill and going concern value	<u>400</u>	<u>354</u>
	Total	\$ 3,250	\$ 2,900

\* All numbers rounded for convenience.

(vii) As illustrated by this example, reapplying §1.338-6(c)(3) results in a basis increase for some assets and a basis decrease for other assets. The amount of redetermined AGUB allocated to each acquisition date asset is determined as follows:

Asset	Original (c)(3) allocation	Redetermined (c)(3) allocation	Increase (decrease)
Portfolio of actively traded securities	\$ 268	\$ 266	\$ (2)
Accounts receivable	536	531	(5)
Inventory	268	266	(2)
Building	714	708	(6)
Land	178	177	(1)
Investment in T1	402	398	(4)
Goodwill and going concern value	<u>134</u>	<u>354</u>	<u>220</u>
Total	\$ 2,500	\$ 2,700	\$ 200

*Example 4.* (i) On January 1, 2001, P purchases all of the outstanding T stock and makes a section 338 election for T. P pays \$700 of cash and promises also to pay a maximum \$300 of contingent consideration at various times in the future. Assume that, under general principles of tax law, such later payments are properly taken into account by P when paid. Assume also, however, that the current fair market value of the contingent payments is reasonably ascertainable. The fair market value of T's assets (other than goodwill and going concern value) as of the beginning of the following day is as follows:

Class	Asset	Fair market value
V	Equipment	\$ 200
V	Non-actively traded securities	100
V	Building	<u>500</u>
	Total	800

(ii) T has no liabilities. The AGUB is \$700. In calculating ADSP, assume that, under §1.1001-1, the current amount realized attributable to the con-

tingent consideration is \$200. ADSP is therefore \$900 (\$700 cash plus \$200).

(iii) (A) The AGUB of \$700 is ratably allocated among T's Class V acquisition date assets in proportion to their fair market values as follows:

Asset	Basis
Equipment (\$700 x 200/800)	\$175.00
Non-actively traded securities (\$700 x 100/800)	87.50
Building (\$700 x 500/800)	<u>437.50</u>
Total	\$700.00

(B) No amount is allocated to goodwill or going concern value.

(iv) (A) The ADSP of \$900 is ratably allocated among T's Class V acquisition date assets in proportion to their fair market values as follows:

<i>Asset</i>	<i>Basis</i>
Equipment .....	\$200
Non-actively traded securities .....	100
Building .....	<u>500</u>
Total .....	\$800

(B) The remaining ADSP, \$100, is allocated to goodwill and going concern value (Class VII).

(v) P and T file a consolidated return for 2001 and each following year with P as the common parent of the affiliated group.

(vi) In 2004, a contingent amount of \$120 is paid by P. For old T, this payment has no effect on ADSP, because the payment is accounted for as a separate transaction. We have assumed that, under general principles of tax law, the payment is properly taken into account by P at the time made. Therefore, in

2004, there is an increase in new T's AGUB of \$120. The amount of the increase allocated to each acquisition date asset is determined as follows:

<i>Asset</i>	<i>Original AGUB</i>	<i>Redetermined AGUB</i>	<i>Increase</i>
Equipment .....	\$ 175.00	\$ 200.00	\$ 25.00
Land .....	87.50	100.00	12.50
Building .....	437.50	500.00	62.50
Goodwill and going concern value .....	<u>0.00</u>	<u>20.00</u>	<u>20.00</u>
Total .....	\$ 700.00	\$ 820.00	\$ 120.00

**§§1.338-0T through 1.338-7T  
[Removed]**

Par. 4. Sections 1.338-0T through 1.338-7T are removed.

Par. 5. Section 1.338-10 is added to read as follows:

*§1.338-10 Filing of returns.*

(a) *Returns including tax liability from deemed asset sale*—(1) *In general.* Except as provided in paragraphs (a)(2) and (3) of this section, any deemed sale tax consequences are reported on the final return of old target filed for old target's taxable year that ends at the close of the acquisition date. Paragraphs (a)(2), (3) and (4) of this section do not apply to elections under section 338(h)(10). If old target is the common parent of an affiliated group, the final return may be a consolidated return (any such consolidated return must also include any deemed sale tax consequences of any members of the consolidated group that are acquired by the purchasing corporation on the same acquisition date as old target).

(2) *Old target's final taxable year otherwise included in consolidated return of selling group*—(i) *General rule.* If the selling group files a consolidated return for the period that includes the acquisition date, old target is disaffiliated from that group immediately before the deemed asset sale and must file a deemed sale return separate from the group, which includes only the deemed sale tax consequences and the carryover items specified in paragraph (a)(2)(iii) of this section. The deemed asset sale occurs at the close of the acquisition date and is the last

transaction of old target and the only transaction reported on the separate return. Except as provided in §1.338-1(d) (regarding certain transactions on the acquisition date), any transactions of old target occurring on the acquisition date other than the deemed asset sale are included in the selling group's consolidated return. A deemed sale return includes a combined deemed sale return as defined in paragraph (a)(4) of this section.

(ii) *Separate taxable year.* The deemed asset sale included in the deemed sale return under this paragraph (a)(2) occurs in a separate taxable year, except that old target's taxable year of the sale and the consolidated year of the selling group that includes the acquisition date are treated as the same year for purposes of determining the number of years in a carryover or carryback period.

(iii) *Carryover and carryback of tax attributes.* Target's attributes may be carried over to, and carried back from, the deemed sale return under the rules applicable to a corporation that ceases to be a member of a consolidated group.

(iv) *Old target is a component member of purchasing corporation's controlled group.* For purposes of its deemed sale return, target is a component member of the controlled group of corporations including the purchasing corporation unless target is treated as an excluded member under section 1563(b)(2).

(3) *Old target is an S corporation.* If target is an S corporation for the period that ends on the day before the acquisition date and a section 338 election (but not a section 338(h)(10) election) is filed for target, old target files a return as a C cor-

poration reflecting its activities on the acquisition date, including target's deemed sale. See section 1362(d)(2). For purposes of this return, target is a component member of the controlled group of corporations including the purchasing corporation unless target is treated as an excluded member under section 1563(b)(2).

(4) *Combined deemed sale return*—(i) *General rule.* Under section 338(h)(15), a combined deemed sale return (combined return) may be filed for all targets from a single selling consolidated group (as defined in §1.338(h)(10)-1(b)(3)) that are acquired by the purchasing corporation on the same acquisition date and that otherwise would be required to file separate deemed sale returns. The combined return must include all such targets. For example, T and T1 may be included in a combined return if—

(A) T and T1 are directly owned subsidiaries of S;

(B) S is the common parent of a consolidated group; and

(C) P makes qualified stock purchases of T and T1 on the same acquisition date.

(ii) *Gain and loss offsets.* Gains and losses recognized on the deemed asset sales by targets included in a combined return are treated as the gains and losses of a single target. In addition, loss carryovers of a target that were not subject to the separate return limitation year restrictions (SRLY restrictions) of the consolidated return regulations while that target was a member of the selling consolidated group may be applied without limitation to the gains of other targets included in the combined return. If, however, a target has loss carryovers that were subject to the SRLY restric-

tions while that target was a member of the selling consolidated group, the use of those losses in the combined return continues to be subject to those restrictions, applied in the same manner as if the combined return were a consolidated return. A similar rule applies, when appropriate, to other tax attributes.

(iii) *Procedure for filing a combined return.* A combined return is made by filing a single corporation income tax return in lieu of separate deemed sale returns for all targets required to be included in the combined return. The combined return reflects the deemed asset sales of all targets required to be included in the combined return. If the targets included in the combined return constitute a single affiliated group within the meaning of section 1504(a), the income tax return is signed by an officer of the common parent of that group. Otherwise, the return must be signed by an officer of each target included in the combined return. Rules similar to the rules in §1.1502-75(j) apply for purposes of preparing the combined return. The combined return must include an attachment prominently identified as an “ELECTION TO FILE A COMBINED RETURN UNDER SECTION 338(h) (15).” The attachment must—

(A) Contain the name, address, and employer identification number of each target required to be included in the combined return;

(B) Contain the following declaration (or a substantially similar declaration): EACH TARGET IDENTIFIED IN THIS ELECTION TO FILE A COMBINED RETURN CONSENTS TO THE FILING OF A COMBINED RETURN;

(C) For each target, be signed by a person who states under penalties of perjury that he or she is authorized to act on behalf of such target.

(iv) *Consequences of filing a combined return.* Each target included in a combined return is severally liable for any tax associated with the combined return. See §1.338-1(b)(3).

(5) *Deemed sale excluded from purchasing corporation's consolidated return.* Old target may not be considered a member of any affiliated group that includes the purchasing corporation with respect to its deemed asset sale.

(6) *Due date for old target's final return—(i) General rule.* Old target's final

return is generally due on the 15th day of the third calendar month following the month in which the acquisition date occurs. See section 6072 (time for filing income tax returns).

(ii) *Application of §1.1502-76(c)—(A) In general.* Section 1.1502-76(c) applies to old target's final return if old target was a member of a selling group that did not file consolidated returns for the taxable year of the common parent that precedes the year that includes old target's acquisition date. If the selling group has not filed a consolidated return that includes old target's taxable period that ends on the acquisition date, target may, on or before the final return due date (including extensions), either—

(1) File a deemed sale return on the assumption that the selling group will file the consolidated return; or

(2) File a return for so much of old target's taxable period as ends at the close of the acquisition date on the assumption that the consolidated return will not be filed.

(B) *Deemed extension.* For purposes of applying §1.1502-76(c)(2), an extension of time to file old target's final return is considered to be in effect until the last date for making the election under section 338.

(C) *Erroneous filing of deemed sale return.* If, under this paragraph (a)(6)(ii), target files a deemed sale return but the selling group does not file a consolidated return, target must file a substituted return for old target not later than the due date (including extensions) for the return of the common parent with which old target would have been included in the consolidated return. The substituted return is for so much of old target's taxable year as ends at the close of the acquisition date. Under §1.1502-76(c)(2), the deemed sale return is not considered a return for purposes of section 6011 (relating to the general requirement of filing a return) if a substituted return must be filed.

(D) *Erroneous filing of return for regular tax year.* If, under this paragraph (a)(6)(ii), target files a return for so much of old target's regular taxable year as ends at the close of the acquisition date but the selling group files a consolidated return, target must file an amended return for old target not later than the due date (including extensions) for the selling group's

consolidated return. (The amended return is a deemed sale return.)

(E) *Last date for payment of tax.* If either a substituted or amended final return of old target is filed under this paragraph (a)(6)(ii), the last date prescribed for payment of tax is the final return due date (as defined in paragraph (a)(6)(i) of this section).

(7) *Examples.* The following examples illustrate this paragraph (a):

*Example 1.* (i) S is the common parent of a consolidated group that includes T. The S group files calendar year consolidated returns. At the close of June 30 of Year 1, P makes a qualified stock purchase of T from S. P makes a section 338 election for T, and T's deemed asset sale occurs as of the close of T's acquisition date (June 30).

(ii) T is considered disaffiliated for purposes of reporting the deemed sale tax consequences. Accordingly, T is included in the S group's consolidated return through T's acquisition date except that the tax liability for the deemed sale tax consequences is reported in a separate deemed sale return of T. Provided that T is not treated as an excluded member under section 1563(b)(2), T is a component member of P's controlled group for the taxable year of the deemed asset sale, and the taxable income bracket amounts available in calculating tax on the deemed sale return must be limited accordingly.

(iii) If P purchased the stock of T at 10 a.m. on June 30 of Year 1, the results would be the same. See paragraph (a)(2)(i) of this section.

*Example 2.* The facts are the same as in *Example 1*, except that the S group does not file consolidated returns. T must file a separate return for its taxable year ending on June 30 of Year 1, which return includes the deemed asset sale.

(b) *Waiver—(1) Certain additions to tax.* An addition to tax or additional amount (addition) under subchapter A of chapter 68 of the Internal Revenue Code arising on or before the last day for making the election under section 338 because of circumstances that would not exist but for an election under section 338 is waived if—

(i) Under the particular statute the addition is excusable upon a showing of reasonable cause; and

(ii) Corrective action is taken on or before the last day.

(2) *Notification.* The Internal Revenue Service should be notified at the time of correction (e.g., by attaching a statement to a return that constitutes corrective action) that the waiver rule of this paragraph (b) is being asserted.

(3) *Elections or other actions required to be specified on a timely filed return—*

(i) *In general.* If paragraph (b)(1) of this section applies or would apply if there

were an underpayment, any election or other action that must be specified on a timely filed return for the taxable period covered by the late filed return described in paragraph (b)(1) of this section is considered timely if specified on a late-filed return filed on or before the last day for making the election under section 338.

(ii) *New target in purchasing corporation's consolidated return.* If new target is includible for its first taxable year in a consolidated return filed by the affiliated group of which the purchasing corporation is a member on or before the last day for making the election under section 338, any election or other action that must be specified in a timely filed return for new target's first taxable year (but which is not specified in the consolidated return) is considered timely if specified in an amended return filed on or before such last day, at the place where the consolidated return was filed.

(4) *Examples.* The following examples illustrate this paragraph (b):

*Example 1.* T is an unaffiliated corporation with a tax year ending March 31. At the close of September 20 of Year 1, P makes a qualified stock purchase of T. P does not join in filing a consolidated return. P makes a section 338 election for T on or before June 15 of Year 2, which causes T's taxable year to end as of the close of September 20 of Year 1. An income tax return for T's taxable period ending on September 20 of Year 1 was due on December 15 of Year 1. Additions to tax for failure to file a return and to pay tax shown on a return will not be imposed if T's return is filed and the tax paid on or before June 15 of Year 2. (This waiver applies even if the acquisition date coincides with the last day of T's former taxable year, i.e., March 31 of Year 2.) Interest on any underpayment of tax for old T's short taxable year ending September 20 of Year 1 runs from December 15 of Year 1. A statement indicating that the waiver rule of this paragraph is being asserted should be attached to T's return.

*Example 2.* Assume the same facts as in *Example 1*. Assume further that new T adopts the calendar year by filing, on or before June 15 of Year 2, its first return (for the period beginning on September 21 of Year 1 and ending on December 31 of Year 1) indicating that a calendar year is chosen. See §1.338-1(b)(1). Any additions to tax or amounts described in this paragraph (b) that arise because of the late filing of a return for the period ending on December 31 of Year 1 are waived, because they are based on circumstances that would not exist but for the section 338 election. Notwithstanding this waiver, however, the return is still considered due March 15 of Year 2, and interest on any underpayment runs from that date.

*Example 3.* Assume the same facts as in *Example 2*, except that T's former taxable year ends on October 31. Although prior to the election old T had a return due on January 15 of Year 2 for its year ending October 31 of Year 1, that return need not be filed

because a timely election under section 338 was made. Instead, old T must file a final return for the period ending on September 20 of Year 1, which is due on December 15 of Year 1.

### §1.338-10T [Removed]

Par. 6. Section 1.338-10T is removed.

Par. 7. Section 1.338(h)(10)-1 is added to read as follows:

#### §1.338(h)(10)-1 Deemed asset sale and liquidation.

(a) *Scope.* This section prescribes rules for qualification for a section 338(h)(10) election and for making a section 338(h)(10) election. This section also prescribes the consequences of such election. The rules of this section are in addition to the rules of §§1.338-1 through 1.338-10 and, in appropriate cases, apply instead of the rules of §§1.338-1 through 1.338-10.

(b) *Definitions*—(1) *Consolidated target.* A consolidated target is a target that is a member of a consolidated group within the meaning of §1.1502-1(h) on the acquisition date and is not the common parent of the group on that date.

(2) *Selling consolidated group.* A selling consolidated group is the consolidated group of which the consolidated target is a member on the acquisition date.

(3) *Selling affiliate; affiliated target.* A selling affiliate is a domestic corporation that owns on the acquisition date an amount of stock in a domestic target, which amount of stock is described in section 1504(a)(2), and does not join in filing a consolidated return with the target. In such case, the target is an *affiliated target*.

(4) *S corporation target.* An *S corporation target* is a target that is an S corporation immediately before the acquisition date.

(5) *S corporation shareholders.* *S corporation shareholders* are the S corporation target's shareholders. Unless otherwise indicated, a reference to S corporation shareholders refers both to S corporation shareholders who do and those who do not sell their target stock.

(6) *Liquidation.* Any reference in this section to a *liquidation* is treated as a reference to the transfer described in paragraph (d)(4) of this section notwithstanding its ultimate characterization for Federal income tax purposes.

(c) *Section 338(h)(10) election*—(1) *In general.* A section 338(h)(10) election

may be made for T if P acquires stock meeting the requirements of section 1504(a)(2) from a selling consolidated group, a selling affiliate, or the S corporation shareholders in a qualified stock purchase.

(2) *Simultaneous joint election requirement.* A section 338(h)(10) election is made jointly by P and the selling consolidated group (or the selling affiliate or the S corporation shareholders) on Form 8023 in accordance with the instructions to the form. S corporation shareholders who do not sell their stock must also consent to the election. The section 338(h)(10) election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs.

(3) *Irrevocability.* A section 338(h)(10) election is irrevocable. If a section 338(h)(10) election is made for T, a section 338 election is deemed made for T.

(4) *Effect of invalid election.* If a section 338(h)(10) election for T is not valid, the section 338 election for T is also not valid.

(d) *Certain consequences of section 338(h)(10) election.* For purposes of subtitle A of the Internal Revenue Code (except as provided in §1.338-1(b)(2)), the consequences to the parties of making a section 338(h)(10) election for T are as follows:

(1) *P.* P is automatically deemed to have made a gain recognition election for its nonrecently purchased T stock, if any. The effect of a gain recognition election includes a taxable deemed sale by P on the acquisition date of any nonrecently purchased target stock. See §1.338-5(d).

(2) *New T.* The AGUB for new T's assets is determined under §1.338-5 and is allocated among the acquisition date assets under §§1.338-6 and 1.338-7. Notwithstanding paragraph (d)(4) of this section (deemed liquidation of old T), new T remains liable for the tax liabilities of old T (including the tax liability for the deemed sale tax consequences). For example, new T remains liable for the tax liabilities of the members of any consolidated group that are attributable to taxable years in which those corporations and old T joined in the same consolidated return. See §1.1502-6(a).

(3) *Old T—deemed sale*—(i) *In general.* Old T is treated as transferring all of

its assets to an unrelated person in exchange for consideration that includes the discharge of its liabilities in a single transaction at the close of the acquisition date (but before the deemed liquidation). See §1.338-1(a) regarding the tax characterization of the deemed asset sale. Except as provided in §1.338(h)(10)-1(d)(8) (regarding the installment method), old T recognizes all of the gain realized on the deemed transfer of its assets in consideration for the ADSP. ADSP for old T is determined under §1.338-4 and allocated among the acquisition date assets under §§1.338-6 and 1.338-7. Old T realizes the deemed sale tax consequences from the deemed asset sale before the close of the acquisition date while old T is a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders). If T is an affiliated target, or an S corporation target, the principles of §§1.338-2(c)(10) and 1.338-10(a)(1), (5), and (6)(i) apply to the return on which the deemed sale tax consequences are reported. When T is an S corporation target, T's S election continues in effect through the close of the acquisition date (including the time of the deemed asset sale and the deemed liquidation) notwithstanding section 1362(d)(2)(B). Also, when T is an S corporation target (but not a qualified subchapter S subsidiary), any direct and indirect subsidiaries of T which T has elected to treat as qualified subchapter S subsidiaries under section 1361(b)(3) remain qualified subchapter S subsidiaries through the close of the acquisition date.

(ii) *Tiered targets*. In the case of parent-subsidiary chains of corporations making elections under section 338(h)(10), the deemed asset sale of a parent corporation is considered to precede that of its subsidiary. See §1.338-3(b)(4)(i).

(4) *Old T and selling consolidated group, selling affiliate, or S corporation shareholders—deemed liquidation; tax characterization*—(i) *In general*. Old T is treated as if, before the close of the acquisition date, after the deemed asset sale in paragraph (d)(3) of this section, and while old T is a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders), it transferred all of its assets to members of the selling consolidated

group, the selling affiliate, or S corporation shareholders and ceased to exist. The transfer from old T is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur. For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all its stock, one of a series of distributions in complete cancellation or redemption of all its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 336 or 337 applies.

(ii) *Tiered targets*. In the case of parent-subsidiary chains of corporations making elections under section 338(h)(10), the deemed liquidation of a subsidiary corporation is considered to precede the deemed liquidation of its parent.

(5) *Selling consolidated group, selling affiliate, or S corporation shareholders*—(i) *In general*. If T is an S corporation target, S corporation shareholders (whether or not they sell their stock) take their *pro rata* share of the deemed sale tax consequences into account under section 1366 and increase or decrease their basis in T stock under section 1367. Members of the selling consolidated group, the selling affiliate, or S corporation shareholders are treated as if, after the deemed asset sale in paragraph (d)(3) of this section and before the close of the acquisition date, they received the assets transferred by old T in the transaction described in paragraph (d)(4)(i) of this section. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 331 or 332 applies.

(ii) *Basis and holding period of T stock not acquired*. A member of the selling consolidated group (or the selling affiliate or an S corporation shareholder) retaining T stock is treated as acquiring the stock so retained on the day after the acquisition date for its fair market value. The holding period for the retained stock starts on the day after the acquisition date. For purposes of this paragraph, the fair market value of all of the T stock equals the

grossed-up amount realized on the sale to P of P's recently purchased target stock. See §1.338-4(c).

(iii) *T stock sale*. Members of the selling consolidated group (or the selling affiliate or S corporation shareholders) recognize no gain or loss on the sale or exchange of T stock included in the qualified stock purchase (although they may recognize gain or loss on the T stock in the deemed liquidation).

(6) *Nonselling minority shareholders other than nonselling S corporation shareholders*—(i) *In general*. This paragraph (d)(6) describes the treatment of shareholders of old T other than the following: members of the selling consolidated group, the selling affiliate, S corporation shareholders (whether or not they sell their stock), and P. For a description of the treatment of S corporation shareholders, see paragraph (d)(5) of this section. A shareholder to which this paragraph (d)(6) applies is called a minority shareholder.

(ii) *T stock sale*. A minority shareholder recognizes gain or loss on the shareholder's sale or exchange of T stock included in the qualified stock purchase.

(iii) *T stock not acquired*. A minority shareholder does not recognize gain or loss under this section with respect to shares of T stock retained by the shareholder. The shareholder's basis and holding period for that T stock is not affected by the section 338(h)(10) election.

(7) *Consolidated return of selling consolidated group*. If P acquires T in a qualified stock purchase from a selling consolidated group—

(i) The selling consolidated group must file a consolidated return for the taxable period that includes the acquisition date;

(ii) A consolidated return for the selling consolidated group for that period may not be withdrawn on or after the day that a section 338(h)(10) election is made for T; and

(iii) Permission to discontinue filing consolidated returns cannot be granted for, and cannot apply to, that period or any of the immediately preceding taxable periods during which consolidated returns continuously have been filed.

(8) *Availability of the section 453 installment method*. Solely for purposes of applying sections 453, 453A, and 453B, and the regulations thereunder (the in-



installment method) to determine the consequences to old T in the deemed asset sale and to old T (and its shareholders, if relevant) in the deemed liquidation, the rules in paragraphs (d)(1) through (7) of this section are modified as follows:

(i) *In deemed asset sale.* Old T is treated as receiving in the deemed asset sale new T installment obligations, the terms of which are identical (except as to the obligor) to P installment obligations issued in exchange for recently purchased stock of T. Old T is treated as receiving in cash all other consideration in the deemed asset sale other than the assumption of, or taking subject to, old T liabilities. For example, old T is treated as receiving in cash any amounts attributable to the grossing-up of amount realized under §1.338-4(c). The amount realized for recently purchased stock taken into account in determining ADSP is adjusted (and, thus, ADSP is redetermined) to reflect the amounts paid under an installment obligation for the stock when the total payments under the installment obligation are greater or less than the amount realized.

(ii) *In deemed liquidation.* Old T is treated as distributing in the deemed liquidation the new T installment obligations that it is treated as receiving in the deemed asset sale. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as receiving in the deemed liquidation the new T installment obligations that correspond to the P installment obligations they actually received individually in exchange for their recently purchased stock. The new T installment obligations may be recharacterized under other rules. See for example §1.453-11(a)(2) which, in certain circumstances, treats the new T installment obligations deemed distributed by old T as if they were issued by new T in exchange for the stock in old T owned by members of the selling consolidated group, the selling affiliate, or the S corporation shareholders. The members of the selling consolidated group, the selling affiliate, or the S corporation shareholders are treated as receiving all other consideration in the deemed liquidation in cash.

(9) *Treatment consistent with an actual asset sale.* No provision in section 338(h)(10) or this section shall produce a Federal income tax result under subtitle A

of the Internal Revenue Code that would not occur if the parties had actually engaged in the transactions deemed to occur because of this section and taking into account other transactions that actually occurred or are deemed to occur. See, however, §1.338-1(b)(2) for certain exceptions to this rule.

(e) *Examples.* The following examples illustrate the provisions of this section:

*Example 1.* (i) S1 owns all of the T stock and T owns all of the stock of T1 and T2. S1 is the common parent of a consolidated group that includes T, T1, and T2. P makes a qualified stock purchase of all of the T stock from S1. S1 joins with P in making a section 338(h)(10) election for T and for the deemed purchase of T1. A section 338 election is not made for T2.

(ii) S1 does not recognize gain or loss on the sale of the T stock and T does not recognize gain or loss on the sale of the T1 stock because section 338(h)(10) elections are made for T and T1. Thus, for example, gain or loss realized on the sale of the T or T1 stock is not taken into account in earnings and profits. However, because a section 338 election is not made for T2, T must recognize any gain or loss realized on the deemed sale of the T2 stock. See §1.338-4(h).

(iii) The results would be the same if S1, T, T1, and T2 are not members of any consolidated group, because S1 and T are selling affiliates.

*Example 2.* (i) S and T are solvent corporations. S owns all of the outstanding stock of T. S and P agree to undertake the following transaction: T will distribute half its assets to S, and S will assume half of T's liabilities. Then, P will purchase the stock of T from S. S and P will jointly make a section 338(h)(10) election with respect to the sale of T. The corporations then complete the transaction as agreed.

(ii) Under section 338(a), the assets present in T at the close of the acquisition date are deemed sold by old T to new T. Under paragraph (d)(4) of this section, the transactions described in paragraph (d) of this section are treated in the same manner as if they had actually occurred. Because S and P had agreed that, after T's actual distribution to S of part of its assets, S would sell T to P pursuant to an election under section 338(h)(10), and because paragraph (d)(4) of this section deems T subsequently to have transferred all its assets to its shareholder, T is deemed to have adopted a plan of complete liquidation under section 332. T's actual transfer of assets to S is treated as a distribution pursuant to that plan of complete liquidation.

*Example 3.* (i) S1 owns all of the outstanding stock of both T and S2. All three are corporations. S1 and P agree to undertake the following transaction. T will transfer substantially all of its assets and liabilities to S2, with S2 issuing no stock in exchange therefor, and retaining its other assets and liabilities. Then, P will purchase the stock of T from S1. S1 and P will jointly make a section 338(h)(10) election with respect to the sale of T. The corporations then complete the transaction as agreed.

(ii) Under section 338(a), the remaining assets present in T at the close of the acquisition date are deemed sold by old T to new T. Under paragraph

(d)(4) of this section, the transactions described in this section are treated in the same manner as if they had actually occurred. Because old T transferred substantially all of its assets to S2, and is deemed to have distributed all its remaining assets and gone out of existence, the transfer of assets to S2, taking into account the related transfers, deemed and actual, qualifies as a reorganization under section 368(a)(1)(D). Section 361(c)(1) and not section 332 applies to T's deemed liquidation.

*Example 4.* (i) T owns two assets: an actively traded security (Class II) with a fair market value of \$100 and an adjusted basis of \$100, and inventory (Class IV) with a fair market value of \$100 and an adjusted basis of \$100. T has no liabilities. S is negotiating to sell all the stock in T to P for \$100 cash and contingent consideration. Assume that under generally applicable tax accounting rules, P's adjusted basis in the T stock immediately after the purchase would be \$100, because the contingent consideration is not taken into account. Thus, under the rules of §1.338-5, AGUB would be \$100. Under the allocation rules of §1.338-6, the entire \$100 would be allocated to the Class II asset, the actively traded security, and no amount would be allocated to the inventory. P, however, plans immediately to cause T to sell the inventory, but not the actively traded security, so it requests that, prior to the stock sale, S cause T to create a new subsidiary, Newco, and contribute the actively traded security to the capital of Newco. Because the stock in Newco, which would not be actively traded, is a Class V asset, under the rules of §1.338-6 \$100 of AGUB would be allocated to the inventory and no amount of AGUB would be allocated to the Newco stock. Newco's own AGUB, \$0 under the rules of §1.338-5, would be allocated to the actively traded security. When P subsequently causes T to sell the inventory, T would realize no gain or loss instead of realizing gain of \$100.

(ii) Assume that, if the T stock had not itself been sold but T had instead sold both its inventory and the Newco stock to P, T would for tax purposes be deemed instead to have sold both its inventory and actively traded security directly to P, with P deemed then to have created Newco and contributed the actively traded security to the capital of Newco. Section 338, if elected, generally recharacterizes a stock sale as a deemed sale of assets. However, paragraph (d)(9) of this section states, in general, that no provision of section 338(h)(10) or the regulations thereunder shall produce a Federal income tax result under subtitle A of the Internal Revenue Code that would not occur if the parties had actually engaged in the transactions deemed to occur by virtue of the section 338(h)(10) election, taking into account other transactions that actually occurred or are deemed to occur. Hence, the deemed sale of assets under section 338(h)(10) should be treated as one of the inventory and actively traded security themselves, not of the inventory and Newco stock. The anti-abuse rule of §1.338-1(c) does not apply, because the substance of the deemed sale of assets is a sale of the inventory and the actively traded security themselves, not of the inventory and the Newco stock. Otherwise, the anti-abuse rule might apply.

*Example 5.* (i) T, a member of a selling consolidated group, has only one class of stock, all of which is owned by S1. On March 1 of Year 2, S1 sells its T stock to P for \$80,000, and joins with P in making a section 338(h)(10) election for T. There are no selling

costs or acquisition costs. On March 1 of Year 2, T owns land with a \$50,000 basis and \$75,000 fair market value and equipment with a \$30,000 adjusted basis, \$70,000 recomputed basis, and \$60,000 fair market

value. T also has a \$40,000 liability. S1 pays old T's allocable share of the selling group's consolidated tax liability for Year 2 including the tax liability for the deemed sale tax consequences (a total of \$13,600).

(ii) ADSP of \$120,000 (\$80,000 + \$40,000 + 0) is allocated to each asset as follows:

Assets	Basis	FMV	Fraction	Allocable ADSP
Land	\$ 50,000	\$ 75,000	5/9	\$ 66,667
Equipment	30,000	60,000	4/9	53,333
Total	\$ 80,000	\$ 135,000	1	\$ 120,000

(iii) Under paragraph (d)(3) of this section, old T has gain on the deemed sale of \$40,000 (consisting of \$16,667 of capital gain and \$23,333 of ordinary income).

(iv) Under paragraph (d)(5)(iii) of this section, S1 recognizes no gain or loss upon its sale of the old T stock to P. S1 also recognizes no gain or loss upon the deemed liquidation of T. See paragraph (d)(4) of this section and section 332.

(v) P's basis in new T stock is P's cost for the stock, \$80,000. See section 1012.

(vi) Under §1.338-5, the AGUB for new T is \$120,000, i.e., P's cost for the old T stock (\$80,000) plus T's liability (\$40,000). This AGUB is allocated as basis among the new T assets under §§1.338-6 and 1.338-7.

*Example 6.* (i) The facts are the same as in *Example 5*, except that S1 sells 80 percent of the old T stock to P for \$64,000, rather than 100 percent of the old T stock for \$80,000.

(ii) The consequences to P, T, and S1 are the same as in *Example 5*, except that:

(A) P's basis for its 80-percent interest in the new T stock is P's \$64,000 cost for the stock. See section 1012.

(B) Under §1.338-5, the AGUB for new T is \$120,000 (i.e., \$64,000/.8 + \$40,000 + \$0).

(C) Under paragraph (d)(4) of this section, S1 recognizes no gain or loss with respect to the retained stock in T. See section 332.

(D) Under paragraph (d)(5)(ii) of this section, the basis of the T stock retained by S1 is \$16,000 (i.e., \$120,000 - \$40,000 (the ADSP amount for the old T assets over the sum of new T's liabilities immediately after the acquisition date) x .20 (the proportion of T stock retained by S1)).

*Example 7.* (i) The facts are the same as in *Example 6*, except that K, a shareholder unrelated to T or P, owns the 20 percent of the T stock that is not acquired by P in the qualified stock purchase. K's basis in its T stock is \$5,000.

(ii) The consequences to P, T, and S1 are the same as in *Example 6*.

(iii) Under paragraph (d)(6)(iii) of this section, K recognizes no gain or loss, and K's basis in its T stock remains at \$5,000.

*Example 8.* (i) The facts are the same as in *Example 5*, except that the equipment is held by T1, a wholly-owned subsidiary of T, and a section 338(h)(10) election is also made for T1. The T1 stock has a fair market value of \$60,000. T1 has no assets other than the equipment and no liabilities. S1 pays old T's and old T1's allocable shares of the selling group's consolidated tax liability for Year 2 including the tax liability for T and T1's deemed sale tax consequences.

(ii) ADSP for T is \$120,000, allocated \$66,667 to the land and \$53,333 to the stock. Old T's deemed

sale results in \$16,667 of capital gain on its deemed sale of the land. Under paragraph (d)(5)(iii) of this section, old T does not recognize gain or loss on its deemed sale of the T1 stock. See section 332.

(iii) ADSP for T1 is \$53,333 (i.e., \$53,333 + \$0 + \$0). On the deemed sale of the equipment, T1 recognizes ordinary income of \$23,333.

(iv) Under paragraph (d)(5)(iii) of this section, S1 does not recognize gain or loss upon its sale of the old T stock to P.

*Example 9.* (i) The facts are the same as in *Example 8*, except that P already owns 20 percent of the T stock, which is nonrecently purchased stock with a basis of \$6,000, and that P purchases the remaining 80 percent of the T stock from S1 for \$64,000.

(ii) The results are the same as in *Example 8*, except that under paragraph (d)(1) of this section and §1.338-5(d), P is deemed to have made a gain recognition election for its nonrecently purchased T stock. As a result, P recognizes gain of \$10,000 and its basis in the nonrecently purchased T stock is increased from \$6,000 to \$16,000. P's basis in all the T stock is \$80,000 (i.e., \$64,000 + \$16,000). The computations are as follows:

(A) P's grossed-up basis for the recently purchased T stock is \$64,000 (i.e., \$64,000 (the basis of the recently purchased T stock) x (1 - .2)/.8) (the fraction in section 338(b)(4)).

(B) P's basis amount for the nonrecently purchased T stock is \$16,000 (i.e., \$64,000 (the grossed-up basis in the recently purchased T stock) x (.2)/(1.0 - .2) (the fraction in section 338(b)(3)(B))).

(C) The gain recognized on the nonrecently purchased stock is \$10,000 (i.e., \$16,000 - \$6,000).

*Example 10.* (i) T is an S corporation whose sole class of stock is owned 40 percent each by A and B and 20 percent by C. T, A, B, and C all use the cash method of accounting. A and B each has an adjusted basis of \$10,000 in the stock. C has an adjusted basis of \$5,000 in the stock. A, B, and C hold no installment obligations to which section 453A applies. On March 1 of Year 1, A sells its stock to P for \$40,000 in cash and B sells its stock to P for a \$25,000 note issued by P and real estate having a fair market value of \$15,000. The \$25,000 note, due in full in Year 7, is not publicly traded and bears adequate stated interest. A and B have no selling expenses. T's sole asset is real estate, which has a value of \$110,000 and an adjusted basis of \$35,000. Also, T's real estate is encumbered by long-outstanding purchase-money indebtedness of \$10,000. The real estate does not have built-in gain subject to section 1374. A, B, and C join with P in making a section 338(h)(10) election for T.

(ii) Solely for purposes of application of sections 453, 453A, and 453B, old T is considered in its deemed asset sale to receive back from new T the

\$25,000 note (considered issued by new T) and \$75,000 of cash (total consideration of \$80,000 paid for all the stock sold, which is then divided by .80 in the grossing-up, with the resulting figure of \$100,000 then reduced by the amount of the installment note). Absent an election under section 453(d), gain is reported by old T under the installment method.

(iii) In applying the installment method to old T's deemed asset sale, the contract price for old T's assets deemed sold is \$100,000, the \$110,000 selling price reduced by the indebtedness of \$10,000 to which the assets are subject. (The \$110,000 selling price is itself the sum of the \$80,000 grossed-up in paragraph (ii) above to \$100,000 and the \$10,000 liability.) Gross profit is \$75,000 (\$110,000 selling price - old T's basis of \$35,000). Old T's gross profit ratio is 0.75 (gross profit of \$75,000 ÷ \$100,000 contract price). Thus, \$56,250 (0.75 x the \$75,000 cash old T is deemed to receive in Year 1) is Year 1 gain attributable to the sale, and \$18,750 (\$75,000 - \$56,250) is recovery of basis.

(iv) In its liquidation, old T is deemed to distribute the \$25,000 note to B, since B actually sold the stock partly for that consideration. To the extent of the remaining liquidating distribution to B, it is deemed to receive, along with A and C, the balance of old T's liquidating assets in the form of cash. Under section 453(h), B, unless it makes an election under section 453(d), is not required to treat the receipt of the note as a payment for the T stock; P's payment of the \$25,000 note in Year 7 to B is a payment for the T stock. Because section 453(h) applies to B, old T's deemed liquidating distribution of the note is, under section 453B(h), not treated as a taxable disposition by old T.

(v) Under section 1366, A reports 40 percent, or \$22,500, of old T's \$56,250 gain recognized in Year 1. Under section 1367, this increases A's \$10,000 adjusted basis in the T stock to \$32,500. Next, in old T's deemed liquidation, A is considered to receive \$40,000 for its old T shares, causing it to recognize an additional \$7,500 gain in Year 1.

(vi) Under section 1366, B reports 40 percent, or \$22,500, of old T's \$56,250 gain recognized in Year 1. Under section 1367, this increases B's \$10,000 adjusted basis in its T stock to \$32,500. Next, in old T's deemed liquidation, B is considered to receive the \$25,000 note and \$15,000 of other consideration. Applying section 453, including section 453(h), to the deemed liquidation, B's selling price and contract price are both \$40,000. Gross profit is \$7,500 (\$40,000 selling price - B's basis of \$32,500). B's gross profit ratio is 0.1875 (gross profit of \$7,500 ÷ \$40,000 contract price). Thus, \$2,812.50 (0.1875 x \$15,000) is Year 1 gain attributable to the deemed liquidation. In Year 7, when the \$25,000 note is paid, B has \$4,687.50 (0.1875 x \$25,000) of additional gain.

(vii) Under section 1366, C reports 20 percent, or \$11,250, of old T's \$56,250 gain recognized in Year 1. Under section 1367, this increases C's \$5,000 adjusted basis in its T stock to \$16,250. Next, in old T's deemed liquidation, C is considered to receive \$20,000 for its old T shares, causing it to recognize an additional \$3,750 gain in Year 1. Finally, under paragraph (d)(5)(ii) of this section, C is considered to acquire its stock in T on the day after the acquisition date for \$20,000 (fair market value = grossed-up amount realized of \$100,000 x 20%). C's holding period in the stock deemed received in new T begins at that time.

(f) *Inapplicability of provisions.* The provisions of section 6043, §1.331-1(d), and §1.332-6 (relating to information returns and recordkeeping requirements for corporate liquidations) do not apply to the deemed liquidation of old T under paragraph (d)(4) of this section.

(g) *Required information.* The Commissioner may exercise the authority granted in section 338(h)(10)(C)(iii) to require provision of any information deemed necessary to carry out the provisions of section 338(h)(10) by requiring submission of information on any tax reporting form.

#### §1.338(h)(10)-1T [Removed]

Par. 8. Section 1.338(h)(10)-1T is removed.

Par. 9. Section 1.338(i)-1 is added to read as follows:

#### §1.338(i)-1 Effective dates.

(a) *In general.* The provisions of §§1.338-1 through 1.338-7, 1.338-10 and 1.338(h)(10)-1 apply to any qualified stock purchase occurring after March 15, 2001. For rules applicable to qualified stock purchases on or before March 15, 2001, see §§1.338-1T through 1.338-7T, 1.338-10T, 1.338(h)(10)-1T and 1.338(i)-1T in effect prior to March 16, 2001 (see 26 CFR part 1 revised April 1, 2000).

(b) *Section 338(h)(10) elections for S corporation targets.* The requirements of §§1.338(h)(10)-1T(c)(2) and 1.338(h)(10)-1(c)(2) that S corporation shareholders who do not sell their stock must also consent to an election under section 338(h)(10) will not invalidate an otherwise valid election made on the September 1997 revision of Form 8023, "Elections Under Section 338 For Corporations Making Qualified Stock Purchases," not signed by the nonselling shareholders,

provided that the S corporation and all of its shareholders (including nonselling shareholders) report the tax consequences consistently with the results under section 338(h)(10).

#### §1.338(i)-1T [Removed]

Par. 10. Section 1.338(i)-1T is removed.

Par. 11. Section 1.1060-1 is added to read as follows:

#### §1.1060-1 Special allocation rules for certain asset acquisitions.

(a) *Scope—(1) In general.* This section prescribes rules relating to the requirements of section 1060, which, in the case of an applicable asset acquisition, requires the transferor (the seller) and the transferee (the purchaser) each to allocate the consideration paid or received in the transaction among the assets transferred in the same manner as amounts are allocated under section 338(b)(5) (relating to the allocation of adjusted grossed-up basis among the assets of the target corporation when a section 338 election is made). In the case of an applicable asset acquisition described in paragraph (b)(1) of this section, sellers and purchasers must allocate the consideration under the residual method as described in §§1.338-6 and 1.338-7 in order to determine, respectively, the amount realized from, and the basis in, each of the transferred assets. For rules relating to distributions of partnership property or transfers of partnership interests which are subject to section 1060(d), see §1.755-2T.

(2) *Effective date.* The provisions of this section apply to any asset acquisition occurring after March 15, 2001. For rules applicable to asset acquisitions on or before March 15, 2001, see §1.1060-1T in effect prior to March 16, 2001 (see 26 CFR part 1 revised April 1, 2000).

(3) *Outline of topics.* In order to facilitate the use of this section, this paragraph (a)(3) lists the major paragraphs in this section as follows:

- (a) Scope.
  - (1) In general.
  - (2) Effective date.
  - (3) Outline of topics.
- (b) Applicable asset acquisition.
  - (1) In general.
  - (2) Assets constituting a trade or business.

- (i) In general.
- (ii) Goodwill or going concern value.
- (iii) Factors indicating goodwill or going concern value.
- (3) Examples.
- (4) Asymmetrical transfers of assets.
- (5) Related transactions.
- (6) More than a single trade or business.
  - (7) Covenant entered into by the seller.
  - (8) Partial non-recognition exchanges.
- (c) Allocation of consideration among assets under the residual method.
  - (1) Consideration.
  - (2) Allocation of consideration among assets.
  - (3) Certain costs.
  - (4) Effect of agreement between parties.
  - (d) Examples.
  - (e) Reporting requirements.
    - (1) Applicable asset acquisitions.
      - (i) In general.
      - (ii) Time and manner of reporting.
        - (A) In general.
        - (B) Additional reporting requirement.
    - (2) Transfers of interests in partnerships.

(b) *Applicable asset acquisition—(1) In general.* An applicable asset acquisition is any transfer, whether direct or indirect, of a group of assets if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser and, except as provided in paragraph (b)(8) of this section, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.

(2) *Assets constituting a trade or business—(i) In general.* For purposes of this section, a group of assets constitutes a trade or business if—

(A) The use of such assets would constitute an active trade or business under section 355; or

(B) Its character is such that goodwill or going concern value could under any circumstances attach to such group.

(ii) *Goodwill or going concern value.* Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor. Going concern value is the additional value that attaches to property because of its existence as an integral part

of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership. It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.

(iii) *Factors indicating goodwill or going concern value.* In making the determination in this paragraph (b)(2), all the facts and circumstances surrounding the transaction are taken into account. Whether sufficient consideration is available to allocate to goodwill or going concern value after the residual method is applied is not relevant in determining whether goodwill or going concern value could attach to a group of assets. Factors to be considered include—

(A) The presence of any intangible assets (whether or not those assets are section 197 intangibles), provided, however, that the transfer of such an asset in the absence of other assets will not be a trade or business for purposes of section 1060;

(B) The existence of an excess of the total consideration over the aggregate book value of the tangible and intangible assets purchased (other than goodwill and going concern value) as shown in the financial accounting books and records of the purchaser; and

(C) Related transactions, including lease agreements, licenses, or other similar agreements between the purchaser and seller (or managers, directors, owners, or employees of the seller) in connection with the transfer.

(3) *Examples.* The following examples illustrate paragraphs (b)(1) and (2) of this section:

*Example 1.* S is a high grade machine shop that manufactures microwave connectors in limited quantities. It is a successful company with a reputation within the industry and among its customers for manufacturing unique, high quality products. Its tangible assets consist primarily of ordinary machinery for working metal and plating. It has no secret formulas or patented drawings of value. P is a company that designs, manufactures, and markets electronic components. It wants to establish an immediate presence in the microwave industry, an area in which it previously has not been engaged. P is ac-

quiring assets of a number of smaller companies and hopes that these assets will collectively allow it to offer a broad product mix. P acquires the assets of S in order to augment its product mix and to promote its presence in the microwave industry. P will not use the assets acquired from S to manufacture microwave connectors. The assets transferred are assets that constitute a trade or business in the hands of the seller. Thus, P's purchase of S's assets is an applicable asset acquisition. The fact that P will not use the assets acquired from S to continue the business of S does not affect this conclusion.

*Example 2.* S, a sole proprietor who operates a car wash, both leases the building housing the car wash and sells all of the car wash equipment to P. S's use of the building and the car wash equipment constitute a trade or business. P begins operating a car wash in the building it leases from S. Because the assets transferred together with the asset leased are assets which constitute a trade or business, P's purchase of S's assets is an applicable asset acquisition.

*Example 3.* S, a corporation, owns a retail store business in State X and conducts activities in connection with that business enterprise that meet the active trade or business requirement of section 355. P is a minority shareholder of S. S distributes to P all the assets of S used in S's retail business in State X in complete redemption of P's stock in S held by P. The distribution of S's assets in redemption of P's stock is treated as a sale or exchange under sections 302(a) and 302(b)(3), and P's basis in the assets distributed to it is determined wholly by reference to the consideration paid, the S stock. Thus, S's distribution of assets constituting a trade or business to P is an applicable asset acquisition.

*Example 4.* S is a manufacturing company with an internal financial bookkeeping department. P is in the business of providing a financial bookkeeping service on a contract basis. As part of an agreement for P to begin providing financial bookkeeping services to S, P agrees to buy all of the assets associated with S's internal bookkeeping operations and provide employment to any of S's bookkeeping department employees who choose to accept a position with P. In addition to selling P the assets associated with its bookkeeping operation, S will enter into a long term contract with P for bookkeeping services. Because assets transferred from S to P, along with the related contract for bookkeeping services, are a trade or business in the hands of P, the sale of the bookkeeping assets from S to P is an applicable asset acquisition.

(4) *Asymmetrical transfers of assets.* A purchaser is subject to section 1060 if—

(i) Under general principles of tax law, the seller is not treated as transferring the same assets as the purchaser is treated as acquiring;

(ii) The assets acquired by the purchaser constitute a trade or business; and

(iii) Except as provided in paragraph (b)(8) of this section, the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.

(5) *Related transactions.* Whether the assets transferred constitute a trade or business is determined by aggregating all transfers from the seller to the purchaser in a series of related transactions. Except as provided in paragraph (b)(8) of this section, all assets transferred from the seller to the purchaser in a series of related transactions are included in the group of assets among which the consideration paid or received in such series is allocated under the residual method. The principles of §1.338-1(c) are also applied in determining which assets are included in the group of assets among which the consideration paid or received is allocated under the residual method.

(6) *More than a single trade or business.* If the assets transferred from a seller to a purchaser include more than one trade or business, then, in applying this section, all of the assets transferred (whether or not transferred in one transaction or a series of related transactions and whether or not part of a trade or business) are treated as a single trade or business.

(7) *Covenant entered into by the seller.* If, in connection with an applicable asset acquisition, the seller enters into a covenant (e.g., a covenant not to compete) with the purchaser, that covenant is treated as an asset transferred as part of a trade or business.

(8) *Partial non-recognition exchanges.* A transfer may constitute an applicable asset acquisition notwithstanding the fact that no gain or loss is recognized with respect to a portion of the group of assets transferred. All of the assets transferred, including the non-recognition assets, are taken into account in determining whether the group of assets constitutes a trade or business. The allocation of consideration under paragraph (c) of this section is done without taking into account either the non-recognition assets or the amount of money or other property that is treated as transferred in exchange for the non-recognition assets (together, the non-recognition exchange property). The basis in and gain or loss recognized with respect to the non-recognition exchange property are determined under such rules as would otherwise apply to an exchange of such property. The amount of the money and other property treated as exchanged for non-recognition assets is the amount by which the fair market value of the non-

recognition assets transferred by one party exceeds the fair market value of the non-recognition assets transferred by the other (to the extent of the money and the fair market value of property transferred in the exchange). The money and other property that are treated as transferred in exchange for the non-recognition assets (and which are not included among the assets to which section 1060 applies) are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, then from Class IV assets, then from Class V assets, then from Class VI assets, and then from Class VII assets. For this purpose, liabilities assumed (or to which a non-recognition exchange property is subject) are treated as Class I assets. See *Example 1* in paragraph (d) of this section for an example of the application of section 1060 to a single transaction which is, in part, a non-recognition exchange.

(c) *Allocation of consideration among assets under the residual method* —(1) *Consideration*. The seller's consideration is the amount, in the aggregate, realized from selling the assets in the applicable asset acquisition under section 1001(b). The purchaser's consideration is the amount, in the aggregate, of its cost of purchasing the assets in the applicable asset acquisition that is properly taken into account in basis.

(2) *Allocation of consideration among assets*. For purposes of determining the

seller's amount realized for each of the assets sold in an applicable asset acquisition, the seller allocates consideration to all the assets sold by using the residual method under §§1.338-6 and 1.338-7, substituting consideration for ADSP. For purposes of determining the purchaser's basis in each of the assets purchased in an applicable asset acquisition, the purchaser allocates consideration to all the assets purchased by using the residual method under §§1.338-6 and 1.338-7, substituting consideration for AGUB. In allocating consideration, the rules set forth in paragraphs (c)(3) and (4) of this section apply in addition to the rules in §§1.338-6 and 1.338-7.

(3) *Certain costs*. The seller and purchaser each adjusts the amount allocated to an individual asset to take into account the specific identifiable costs incurred in transferring that asset in connection with the applicable asset acquisition (e.g., real estate transfer costs or security interest perfection costs). Costs so allocated increase, or decrease, as appropriate, the total consideration that is allocated under the residual method. No adjustment is made to the amount allocated to an individual asset for general costs associated with the applicable asset acquisition as a whole or with groups of assets included therein (e.g., non-specific appraisal fees or accounting fees). These latter amounts are taken into account only indirectly through their effect on the total consideration to be allocated.

(4) *Effect of agreement between parties*. If, in connection with an applicable asset acquisition, the seller and purchaser agree in writing as to the allocation of any amount of consideration to, or as to the fair market value of, any of the assets, such agreement is binding on them to the extent provided in this paragraph (c)(4). Nothing in this paragraph (c)(4) restricts the Commissioner's authority to challenge the allocations or values arrived at in an allocation agreement. This paragraph (c)(4) does not apply if the parties are able to refute the allocation or valuation under the standards set forth in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), cert. denied, 389 U.S. 858 (1967) (a party wishing to challenge the tax consequences of an agreement as construed by the Commissioner must offer proof that, in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc.).

(d) *Examples*. The following examples illustrate this section:

*Example 1.* (i) On January 1, 2001, A transfers assets X, Y, and Z to B in exchange for assets D, E, and F plus \$1,000 cash.

(ii) Assume the exchange of assets constitutes an exchange of like-kind property to which section 1031 applies. Assume also that goodwill or going concern value could under any circumstances attach to each of the DEF and XYZ groups of assets and, therefore, each group constitutes a trade or business under section 1060.

(iii) Assume the fair market values of the assets and the amount of money transferred are as follows:

By A		By B	
Asset	Fair Market Value	Asset	Fair Market Value
X .....	\$ 400	D .....	\$ 40
Y .....	400	E .....	30
Z .....	<u>200</u>	F .....	30
Total .....	\$ 1,000	Cash (amount) .....	<u>1,000</u>
		Total .....	\$ 1,100

(iv) Under paragraph (b)(8) of this section, for purposes of allocating consideration under paragraph (c) of this section, the like-kind assets exchanged and any money or other property that are treated as transferred in exchange for the like-kind property are excluded from the application of section 1060.

(v) Since assets X, Y, and Z are like-kind property, they are excluded from the application of the section 1060 allocation rules.

(vi) Since assets D, E, and F are like-kind property, they are excluded from the application of the section 1060 allocation rules. Thus, the allocation rules of section 1060 do not apply in determining B's gain or

loss with respect to the disposition of assets D, E, and F, and the allocation rules of section 1060 and paragraph (c) of this section are not applied to determine A's bases of assets D, E, and F. In addition, \$900 of the \$1,000 cash B gave to A for A's like-kind assets (X, Y, and Z) is treated as transferred in exchange for the like-kind property in order to equalize the fair market values of the like-kind assets. Therefore, \$900 of the cash is excluded from the application of the section 1060 allocation rules.

(vii) \$100 of the cash is allocated under section 1060 and paragraph (c) of this section.

(viii) A received \$100 that must be allocated under section 1060 and paragraph (c) of this section.

Since A transferred no Class I, II, III, IV, V, or VI assets to which section 1060 applies, in determining its amount realized for the part of the exchange to which section 1031 does not apply, the \$100 is allocated to Class VII assets (goodwill and going concern value).

(ix) B gave A \$100 that must be allocated under section 1060 and paragraph (c) of this section. Since B received from A no Class I, II, III, IV, V, or VI assets to which section 1060 applies, the \$100 consideration is allocated by B to Class VII assets (goodwill and going concern value).

*Example 2.* (i) On January 1, 2001, S, a sole proprietor, sells to P, a corporation, a group of assets

that constitutes a trade or business under paragraph (b)(2) of this section. S, who plans to retire immediately, also executes in P's favor a covenant not to compete. P pays S \$3,000 in cash and assumes \$1,000 in liabilities. Thus, the total consideration is \$4,000.

(ii) On the purchase date, P and S also execute a separate agreement that states that the fair market values of the Class II, Class III, Class V, and Class VI assets S sold to P are as follows:

<i>Asset Class</i>	<i>Asset</i>	<i>Fair Market Value</i>
II	Actively traded securities . . . . .	\$ 500
	Total Class II . . . . .	500
III	Accounts receivable . . . . .	200
	Total Class III . . . . .	200
V	Furniture and fixtures . . . . .	800
	Building . . . . .	800
	Land . . . . .	200
	Equipment . . . . .	400
	Total Class V . . . . .	2,200
VI	Covenant not to compete . . . . .	900
	Total Class VI . . . . .	900

(iii) P and S each allocate the consideration in the transaction among the assets transferred under paragraph (c) of this section in accordance with the agreed upon fair market values of the assets, so that \$500 is allocated to Class II assets, \$200 is allocated to the Class III asset, \$2,200 is allocated to Class V assets, \$900 is allocated to Class VI assets, and \$200 (\$4,000 total consideration less \$3,800 allocated to assets in Classes II, III, V, and VI) is allocated to the Class VII assets (goodwill and going concern value).

(iv) In connection with the examination of P's return, the Commissioner, in determining the fair market values of the assets transferred, may disregard the parties' agreement. Assume that the Commissioner correctly determines that the fair market value of the covenant not to compete was \$500. Since the allocation of consideration among Class II, III, V, and VI assets results in allocation up to the fair market value limitation, the \$600 of unallocated consideration resulting from the Commissioner's re-determination of the value of the covenant not to compete is allocated to Class VII assets (goodwill and going concern value).

(e) *Reporting requirements*—(1) *Applicable asset acquisitions*—(i) *In general*. Unless otherwise excluded from this requirement by the Commissioner, the seller and the purchaser in an applicable asset acquisition each must report information concerning the amount of consideration in the transaction and its allocation among the assets transferred. They also must report information concerning subsequent adjustments to consideration.

(ii) *Time and manner of reporting*—(A) *In general*. The seller and the purchaser each must file asset acquisition statements on Form 8594, "Asset Allocation Statement," with their income tax returns or returns of income for the taxable year that in-

cludes the first date assets are sold pursuant to an applicable asset acquisition. This reporting requirement applies to all asset acquisitions described in this section. For reporting requirements relating to asset acquisitions occurring before March 16, 2001, as described in paragraph (a)(2) of this section, see the temporary regulations under section 1060 in effect prior to March 16, 2001 (see 26 CFR part 1 revised April 1, 2000).

(B) *Additional reporting requirement*. When an increase or decrease in consideration is taken into account after the close of the first taxable year that includes the first date assets are sold in an applicable asset acquisition, the seller and the purchaser each must file a supplemental asset acquisition statement on Form 8594 with the income tax return or return of income for the taxable year in which the increase (or decrease) is properly taken into account.

(2) *Transfers of interests in partnerships*. For reporting requirements relating to the transfer of a partnership interest, see §1.755-2T(c).

**§1.1060-1T [Removed]**

Par. 12. Section 1.1060-1T is removed.

Par. 13. Section 1.1361-1 is amended as follows:

1. Redesignate paragraph (1)(2)(v) as paragraph (1)(2)(vi).

2. Add a new paragraph (1)(2)(v).

The addition reads as follows:

*§1.1361-1 S corporation defined.*

\* \* \* \* \*

(1) \* \* \*

(2) \* \* \*

(v) *Special rule for section 338(h)(10) elections*. If the shareholders of an S corporation sell their stock in a transaction for which an election is made under section 338(h)(10) and §1.338(h)(10)-1, the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's length negotiations with the purchaser.

\* \* \* \* \*

Par. 14. Section 1.1361-4 is amended by removing the last two sentences of paragraph (b)(4) and adding three sentences to read as follows:

*§1.1361-4 Effect of QSub election.*

\* \* \* \* \*

(b) \* \* \*

(4) *Coordination with section 338 election*. \* \* \* If an S corporation makes an election under section 338 (without a section 338(h)(10) election) with respect to a target, the target must file a final return as a C corporation reflecting the deemed sale. See §1.338-10(a). If the target was an S corporation on the day before the acquisition date, the final return as a C corporation must reflect the activities of the target for the acquisition date, including the deemed sale. See §1.338-10(a)(3).

\* \* \* \* \*

Par. 15. Section 1.1502-76 is amended by adding a parenthetical at the end of paragraph (b)(1)(ii)(B)(3) and before the semicolon to read as follows:

*§1.1502-76 Taxable year of members of group.*

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(ii) \* \* \*

(B) \* \* \*

(3) \* \* \* (but see §1.338-1(d)) \* \* \*

\* \* \* \* \*

**PART 602—OMB CONTROL NUMBERS UNDER PAPERWORK REDUCTION ACT**

Par. 16. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 17. In §602.101, paragraph (b) is amended by removing the entries for §§1.338-2T, 1.338-5T, 1.338-10T, 1.338(h)(10)-1T, and 1.1060-1T from the table and adding new entries to the table in numerical order to read as follows:

§602.101 OMB Control numbers.

\* \* \* \* \*

(b) \* \* \*

Robert E. Wenzel,  
Deputy Commissioner  
of Internal Revenue.

Approved January 4, 2001.

Jonathan Talisman,  
Assistant Secretary  
of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on February 12, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 13, 2001, 66 F.R. 9925)

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.338-2 . . . . .	1545-1658
1.338-5 . . . . .	1545-1658
1.338-10 . . . . .	1545-1658
1.338(h)(10)-1 . . . . .	1545-1658
* * * * *	
1.1060-1 . . . . .	1545-1658
* * * * *	

**Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change**

The adjusted applicable federal long-term rate is set forth for the month of April 2001. See Rev. Rul. 2001-17, on this page.

**Section 467.—Certain Payments for the Use of Property or Services**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, on this page.

**Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, on this page.

**Section 482.—Allocation of Income and Deductions Among Taxpayers**

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, on this page.

**Section 483.—Interest on Certain Deferred Payments**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, on this page.

**Section 642.—Special Rules for Credits and Deductions**

Federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, on this page.

**Section 807.—Rules for Certain Reserves**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, on this page.

**Section 846.—Discounted Unpaid Losses Defined**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, on this page.

**Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property**

*(Also sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)*

**Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate.** For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for April 2001.

**Rev. Rul. 2001-17**

This revenue ruling provides various prescribed rates for federal income tax purposes for April 2001 (the current

month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2001-17 TABLE 1				
Applicable Federal Rates (AFR) for April 2001				
	<i>Period for Compounding</i>			
	<i>Annual</i>	<i>Semiannual</i>	<i>Quarterly</i>	<i>Monthly</i>
<i>Short-Term</i>				
AFR	4.63%	4.58%	4.55%	4.54%
110% AFR	5.10%	5.04%	5.01%	4.99%
120% AFR	5.58%	5.50%	5.46%	5.44%
130% AFR	6.04%	5.95%	5.91%	5.88%
<i>Mid-Term</i>				
AFR	4.94%	4.88%	4.85%	4.83%
110% AFR	5.44%	5.37%	5.33%	5.31%
120% AFR	5.95%	5.86%	5.82%	5.79%
130% AFR	6.44%	6.34%	6.29%	6.26%
150% AFR	7.45%	7.32%	7.25%	7.21%
175% AFR	8.72%	8.54%	8.45%	8.39%
<i>Long-Term</i>				
AFR	5.43%	5.36%	5.32%	5.30%
110% AFR	5.99%	5.90%	5.86%	5.83%
120% AFR	6.53%	6.43%	6.38%	6.35%
130% AFR	7.09%	6.97%	6.91%	6.87%

REV. RUL. 2001-17 TABLE 2				
Adjusted AFR for April 2001				
	<i>Period for Compounding</i>			
	<i>Annual</i>	<i>Semiannual</i>	<i>Quarterly</i>	<i>Monthly</i>
<i>Short-term</i>				
adjusted AFR	3.37%	3.34%	3.33%	3.32%
<i>Mid-term</i>				
adjusted AFR	3.89%	3.85%	3.83%	3.82%
<i>Long-term</i>				
adjusted AFR	4.87%	4.81%	4.78%	4.76%

REV. RUL. 2001-17 TABLE 3	
Rates Under Section 382 for April 2001	
Adjusted federal long-term rate for the current month	4.87%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.92%

REV. RUL. 2001-17 TABLE 4	
Appropriate Percentages Under Section 42(b)(2) for April 2001	
Appropriate percentage for the 70% present value low-income housing credit	8.21%
Appropriate percentage for the 30% present value low-income housing credit	3.52%

REV. RUL. 2001-17 TABLE 5	
Rate Under Section 7520 for April 2001	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	6.0%



## Section 1288.—Treatment of Original Issue Discounts on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, page 1052.

## Section 3221.—Rate of Tax

### Determination of Quarterly Rate of Excise Tax for Railroad Retirement Supplemental Annuity Program

In accordance with directions in section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C., 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning April 1, 2001, shall be at the rate of 26 cents.

In accordance with directions in section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning April 1, 2001, 38.6 percent of the taxes collected under sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 61.4 percent of the taxes collected under such sections 3211(b) and 3221(c) plus 100 percent of the taxes collected under section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

Dated March 12, 2001.

By Authority of the Board.

Beatrice Ezerski,  
*Secretary to the Board.*

(Filed by the Office of the Federal Register on March 21, 2001, 8:45 a.m., and published in the issue of the Federal Register for March 22, 2001, 66 F.R. 16073)

## Section 6103.—Confidentiality and Disclosure of Returns and Return Information

26 CFR 301.6103(j)(1)-1T: Disclosure of return information to officers and employees of the

Department of Commerce for certain statistical purposes and related activities (temporary).

### T.D. 8943

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 301

### Disclosure of Return Information to the Bureau of the Census

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to additions to the list of items of information disclosed to the Bureau of the Census for use in the Longitudinal Employer-Household Dynamics (LEHD) project and the Survey of Income and Program Participation (SIPP) project. These regulations provide guidance to IRS and Social Security Administration (SSA) personnel responsible for disclosing the information. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking (REG-121109-00) on page 1064 of this Bulletin.

DATES: *Effective Date:* These regulations are effective February 13, 2001.

*Applicability Date:* For dates of applicability, see §301.6103(j)(1)-1T(e) of these regulations.

FOR FURTHER INFORMATION CONTACT: Stuart Murray (202) 622-4580 (not a toll-free number).

### Background

Under section 6103(j)(1), upon written request from the Secretary of Commerce, the Secretary is to furnish to the Bureau of the Census (Bureau) tax return information that is prescribed by Treasury regulations for the purpose of, but only to the extent necessary in, structuring censuses and national economic accounts and conducting related statistical activities authorized by law. Section 301.6103(j)(1)-1 of the regulations further defines such purposes by reference to 13 U.S.C. Chapter 5 and provides an itemized description of the return information authorized to be disclosed for such purposes. Section 301.6103(j)(1)-1(b)(5) of the regulations

provides a list of information provided to the Social Security Administration (SSA) pursuant to Internal Revenue Code section 6103(l)(1)(A) or (5) that officers or employees of SSA may disclose to the Bureau. Periodically, the disclosure regulations are amended to reflect the changing needs of the Bureau for data for its statutorily authorized statistical activities.

This document adopts temporary regulations that authorize IRS and SSA personnel to disclose the additional items of return information that have been requested by the Secretary of Commerce for specified purposes related to the LEHD and SIPP projects.

Except for §301.6103(j)(1)-1T(b)(2)(v) and (vi); (b)(3)(xxiii), (xxiv), (xxv), (xxvi), (xxvii) and (xxviii); and (b)(5)(iii), (iv), and (v); the text of the temporary regulations is the same as 26 CFR 301.6103(j)(1)-1. The changes made by §301.6103(j)(1)-1T(b)(2)(v) and (vi); (b)(3)(xxiii), (xxiv), (xxv), (xxvi), (xxvii) and (xxviii); and (b)(5)(iii), (iv), and (v); are discussed below.

### Explanation of Provisions

By letter dated March 27, 2000, the Secretary of Commerce requested that additional items of return information be disclosed to the Bureau for purposes related to the Longitudinal Employer-Household Dynamics (LEHD) project. The request indicates that the Bureau is ready to begin a joint project with SSA to develop data files that contain linked information, matching selected worker and employer records for statistical research, in order to improve programs at the Bureau and SSA. The linked information will come from the Bureau's demographic and economic censuses and surveys, the Bureau's Standard Statistical Establishment List (SSEL), which includes business tax information, and SSA's administrative records. The Bureau's component of this project, the LEHD project, will enable the Bureau to conduct studies that are intended to improve the quality of the Bureau's core demographic and economic censuses and surveys, which are Bureau activities authorized under 13 U.S.C. Chapter 5.

The Bureau has specifically requested information from SSA's Master Earnings File (MEF), which contains information

from IRS Form W-2 and Schedule SE (Form 1040). The IRS information contained in SSA's MEF will permit the Bureau to link employee data with employer data. The Bureau has requested Social Security Numbers (SSNs) and Employer Identification Numbers (EINs) to link the employee and employer data.

The Bureau has also requested the disclosure of wages, tips, and other compensation and deferred wages from the Form W-2. The Bureau indicated that it wants this detailed earnings record information because it is provided separately for each employer of the employee; it covers all persons with wages, including nonfilers and other non-covered employees; and it provides specific information on deferred compensation, such as retirement contributions.

By letter dated August 2, 2000, the Secretary of Commerce requested additional items of information for purposes related to the Bureau's Survey of Income and Program Participation (SIPP) demographic survey. This request indicates that the Bureau and SSA want to ensure that the regulations authorize the continuation of a joint project to develop data files that contain linked information from the SIPP with information from SSA's Master Earnings File. The linkage of Census survey information on family relationships with SSA's earnings histories allows for the study and assessment of welfare and social security/retirement proposals. Specifically, the Bureau intends to improve the quality of the SIPP by adding a series of projected Primary Insurance Amounts (PIAs) to the public-use version of each available SIPP.

In order to adjust for misreported data related to earnings, employment, and pensions from the Bureau's SIPP, the Bureau also requested data from Forms W-2 and 1099R or data derived from these forms. Some of the information requested for LEHD is also requested for SIPP, such as the social security number; employer identification number; wages, tips and other compensation; and deferred wages.

As provided in the Commissioner of Internal Revenue's responses to the LEHD and SIPP requests dated September 25, 2000, and October 27, 2000, respectively, information will be furnished under these temporary regulations only for the purposes of conducting the LEHD project and/or the SIPP/SSA project as

specified in the request letters and with the understanding that the information will be used strictly in accordance with the provisions of the Internal Revenue Code pertaining to confidentiality.

### Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because no notice of proposed rulemaking is required, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

### Drafting Information

The principal author of these regulations is Jamie G. Bernstein, Office of the Associate Chief Counsel, Procedure & Administration (Disclosure & Privacy Law Division) Internal Revenue Service. However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 301 is amended as follows:

#### PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 301.6103(j)(1)–1T also issued under 26 U.S.C. 6103(j)(1); \* \* \*

Par. 2. Section 301.6103(j)(1)–1T is added to read as follows:

*§301.6103(j)(1)–1T Disclosure of return information to officers and employees of the Department of Commerce for certain statistical purposes and related activities (temporary).*

(a) through (b)(2)(iv)[Reserved]. For further guidance, see §301.6103(j)(1)–1(a) through (b)(2)(iv).

(b)(2)(v) Total Social Security Taxable Earnings;

(vi) Quarters of Social Security coverage.

(b)(3)(i) through (xxii) [Reserved]. For further guidance, see §301.6103(j)(1)–1(b)(3)(i) through (xxii).

(xxiii) Wages, tips, and other compensation;

(xxiv) Social Security Wages;

(xxv) Deferred wages;

(xxvi) Social Security Tip Income;

(xxvii) Total Social Security Taxable Earnings;

(xxviii) Gross Distributions from Form 1099R.

(b)(4) through (b)(5)(ii) [Reserved]. For further guidance, see §301.6103(j)(1)–1(b)(4) through (b)(5)(ii).

(b)(5)(iii) From Form W-2, and related forms and schedules—

(A) Social Security Number;

(B) Employer Identification Number;

(C) Wages, tips, and other compensation;

(D) Social Security Wages;

(E) Deferred wages.

(iv) Total Social Security Taxable Earnings.

(v) Quarters of Social Security Coverage.

\* \* \* \* \*

(b)(6) through(d) [Reserved]. For further guidance, see §301.6103(j)(1)–1(b)(6) through (d).

(e) Effective date. This section is applicable to the Bureau of the Census on February 13, 2001, through February 13, 2004.

Robert E. Wenzel,  
Deputy Commissioner  
of Internal Revenue.

Approved January 16, 2001.

Jonathan Talisman,  
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on February 12, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 13, 2001, 66 FR. 9957)

**Section 7520.—Valuation Tables**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, page 1052.

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**Section 7872.—Treatment of Loans With Below-Market Interest Rates**

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 2001. See Rev. Rul. 2001-17, page 1052.

## Part IV. Items of General Interest

### Notice of Proposed Rulemaking

### Return of Property in Certain Cases

#### REG-101520-97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the return of property in certain cases. The proposed regulations reflect changes made to section 6343 of the Internal Revenue Code of 1986 by the Taxpayer Bill of Rights 2. The proposed regulations also reflect certain changes affecting levies enacted by the Internal Revenue Service Restructuring and Reform Act of 1998. The proposed regulations affect taxpayers seeking the return of property from the IRS.

DATES: Written comments and requests for a public hearing must be received by May 15, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-101520-97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered to: CC:M&S:RU (REG-101520-97), room 5226, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Taxpayers may also submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.gov/prod/tax\\_regs/reglist.html](http://www.irs.gov/prod/tax_regs/reglist.html).

FOR FURTHER INFORMATION CONTACT: Kevin B. Connelly at (202) 622-3630 (not a toll-free number).

#### SUPPLEMENTARY INFORMATION:

##### Background

This document contains proposed amendments to the Procedure and Administration Regulations (26 CFR part 301) relating to the return of property under

section 6343 of the Internal Revenue Code (Code). Section 501(b) of the Taxpayer Bill of Rights 2 (TBOR2), Public Law 104-168 (110 Stat. 1452), amended section 6343 to authorize the IRS to return property in certain cases and, to the extent possible, but without payment of interest, return the taxpayer to the same position as if the levy had not been issued. These proposed regulations reflect the amendments made by section 501(b) of TBOR2.

These proposed regulations also reflect modifications made by the Internal Revenue Service Restructuring and Reform Act (RRA 1998), Public Law 105-206 (112 Stat. 685), which added new sections 6331(i) and (j) of the Code, prohibiting the issuance of levies during the pendency of proceedings for refund of divisible taxes or prior to completion of an investigation of the status of property (effective for unpaid tax attributable to tax periods beginning after December 31, 1998). RRA 1998 also added section 6331(k), prohibiting levies during the period an offer-in-compromise is pending or an installment agreement is pending or in effect (effective for offers-in-compromise pending on or made after December 31, 1999, and for installment agreements submitted after July 22, 1998). In addition, the RRA 1998 added section 6330, which provides in certain circumstances for notice and an opportunity for a hearing prior to the imposition of a levy.

##### Explanation of Provisions

Section 6343(b) provides for the return of levied upon property, including levied upon money and money received from the sale of levied upon property, if the property was wrongfully levied upon. Section 501(b) of TBOR2 enacted section 6343(d) of the Code authorizing the IRS to return levied upon property to the taxpayer in certain other prescribed circumstances. Property returned under new section 6343(d) will be returned in accordance with section 6343(b) of the Code as if the property had been wrongfully levied upon, except that no interest will be allowed. The provision is designed to permit the IRS, to the extent possible, to restore the taxpayer to a pre-levy position.

These proposed regulations provide guidance on the circumstances under which levied upon property will be returned by the IRS and the manner in which a request for return of property must be made.

The proposed regulations apply to the return of (1) levied upon money that has been applied toward the taxpayer's liability, (2) money received from the sale of levied upon property under section 6335 of the Code, and (3) levied upon property that the United States has purchased in a sale under section 6335 of the Code. This property may be returned if one of the conditions enumerated in paragraph (c) of the proposed regulations exists.

The regulations also clarify that, other than as provided in §301.6343-1(b) and paragraph (d) of this section, the IRS, in its discretion, may return levied upon property in its possession pending sale. The return of levied upon property in the IRS's possession pending sale is not limited by these proposed regulations. The IRS has the authority to determine what property of the taxpayer to levy. As part of that authority, the IRS may release a levy and return levied upon property in its possession pending sale.

Under paragraph (c) of the proposed regulations, the Commissioner may return levied upon property if one of the following conditions exist: (1) the levy was premature or otherwise not in accordance with the administrative procedures of the IRS; (2) the taxpayer has entered into an agreement under section 6159 of the Code to satisfy the liability for which the levy was imposed by means of installment payments, unless the agreement provides otherwise; (3) the return of property will facilitate collection of the tax liability; or (4) the return of property is in the best interest of the taxpayer, as determined by the National Taxpayer Advocate, and in the best interest of the United States, as determined by the Commissioner.

Section 6343(d)(2)(D) authorizes the return of property if it is in the best interests of both the United States and the taxpayer. Therefore, two distinct determinations must be made before the Commissioner may return property based on these grounds. Under the proposed regulations the Commissioner (or his del-

egate) will determine whether the return of property is in the best interest of the United States. The National Taxpayer Advocate (or his delegate) generally will determine whether the return of property is in the best interest of the taxpayer; however, a finding by the Commissioner (or his delegate) that the return of property is in the best interest of the taxpayer, as well as the United States, will be sufficient to support the return of property. Only the National Taxpayer Advocate (or his delegate) is authorized to determine that the return of property is not in the taxpayer's best interest.

Additionally, the proposed regulations provide that it is in the best interests of the United States and the taxpayer to release levies made in violation of the law. Any property received pursuant to a levy made in violation of the law will be returned unless the taxpayer gives permission to the IRS to keep the property. For example, section 6331(k)(2) of the Internal Revenue Code of 1986 prohibits levies during the period an offer to enter into an installment agreement is pending (and for a 30-day period after rejection of the offer or while a timely appeal from the rejection of an offer to enter into an installment agreement is pending) and during the period an installment agreement is in effect. If property has been received by the IRS as the result of a levy that is prohibited under section 6331(k)(2), the IRS will return the property to the taxpayer pursuant to section 6343(d)(2)(D). It may, however, be advantageous for a taxpayer in some circumstances to allow the IRS to keep the levied upon property and apply the proceeds of that levy to the taxpayer's outstanding tax liabilities. These proposed regulations allow the taxpayer to give permission to the IRS to retain the levied upon property and apply the proceeds of that levy to the taxpayer's outstanding tax liabilities. Absent taxpayer consent, the IRS is required to return the levied upon property (or the proceeds if the property had been sold) to the taxpayer.

Pursuant to the requirement of section 6343(d) that property to be returned under this provision be treated as if it were wrongfully levied upon, the proposed regulations also provide that if the United States purchases property, it will be treated as having received an amount of money equal to the minimum price determined by the Commissioner before the sale.

Property other than money may be returned at any time. Money may be returned any time within 9 months after the date of the levy. In addition, when a timely request for the return of money is filed in accordance with these regulations, or a determination to return an amount of money is made before the expiration of the 9-month period, the money may be returned within a reasonable period of time after the 9-month period if additional time is necessary for investigation or processing. This will ensure that if a timely request has been made, or the IRS timely decides to return money on its own initiative, the IRS will have sufficient time for necessary investigation or processing.

Under the proposed regulations a taxpayer may request the return of property by writing to the address on the levy form or to the Commissioner (marked for the attention of the Chief, Special Procedures Function) of the IRS office in which the levy was made. A written request for the return of property must include: (1) the name, current address, and taxpayer identification number of the taxpayer requesting the return of property; (2) a description of the property levied upon; (3) the date of the levy; and (4) the grounds upon which the return of property is being requested.

The Commissioner must consider each taxpayer's request for the return of property, determine whether any of the conditions authorizing the return of property exist, and decide whether to return the property. The Commissioner also may return the property based on information received from a source other than the taxpayer. A decision to return the property is within the Commissioner's discretion, unless the levy was in violation of law, in which case the Commissioner must return the property.

If the Commissioner returns property, and the taxpayer fails to pay the previously assessed liability for which the levy was made on the returned property, the Commissioner may administratively collect the liability. Collection may include levying again on the returned property provided statutory and administrative requirements are followed.

#### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Exec-

utive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### **Comments and Requests for a Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight (8) copies) to the IRS. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.gov/prod/tax\\_regs/regslst.html](http://www.irs.gov/prod/tax_regs/regslst.html). All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

#### **Drafting Information**

The principal author of these regulations is Kevin B. Connelly, Office of Assistant Chief Counsel (General Litigation) CC:EL:GL, IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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#### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

#### **PART 301—PROCEDURE AND ADMINISTRATION**

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 301.6343-3 is added to read as follows:

*§301.6343-3 Return of property in certain cases.*

(a) *In general.* If money has been levied upon and applied toward the taxpayer's liability, or property has been levied upon and sold, and the receipts have been applied toward the taxpayer's liability, or property has been levied upon and purchased by the United States and the United States still possesses the property, and the Commissioner determines that any of the conditions in paragraph (c) of this section exist, the Commissioner may return—

(1) An amount of money equal to the amount of money levied upon;

(2) An amount of money equal to the amount of money received by the United States from a sale of the property; or

(3) The specific property levied upon and purchased by the United States.

(b) *Return of levied upon property in possession of the Internal Revenue Service (IRS) pending sale under section 6335.* Other than as provided in §301.6343-1(b) or in paragraph (d) of this section, the Commissioner, in his or her discretion, may return levied upon property that is in the possession of the United States pending sale under section 6335.

(c) *Conditions authorizing the return of property.* The Commissioner may return property upon determining that one of the following conditions exist:

(1) *Premature or not in accordance with administrative procedures.* The levy was premature or otherwise not in accordance with the administrative procedures of the Secretary.

(2) *Installment agreement.* Subsequent to the levy, the taxpayer enters into an agreement under section 6159 to satisfy the liability for which the levy was made by means of installment payments. If, however, the agreement specifically provides that already levied upon property will not be returned under section 6343(d), the Commissioner may not grant a request for return of property under this paragraph (c)(2).

(3) *Facilitate collection.* The return of property will facilitate the collection of the tax liability for which the levy was made.

(4) *Best interests of the United States and the taxpayer—(i) In general.* The taxpayer or the National Taxpayer Advocate (or his delegate) has consented to the return of property, and the return of property would be in the best interest of the taxpayer, as determined by the National Taxpayer Advocate (or his delegate), and in the best interest of the United States, as determined by the Commissioner.

(ii) *Best interest of the taxpayer.* The National Taxpayer Advocate (or his delegate) generally will determine whether the return of property is in the best interest of the taxpayer. If, however, a taxpayer requests the Commissioner to return property and has not specifically requested the National Taxpayer Advocate (or his delegate) to determine the taxpayer's best interest, a finding by the Commissioner that the return of property is in the best interest of the taxpayer will be sufficient to support the return of property. Only the National Taxpayer Advocate (or his or her delegate) may determine that a return of property is not in the best interest of the taxpayer.

(5) *Examples.* The following examples illustrate the provisions of this paragraph (c):

*Example 1.* A owes \$1,000 in Federal income taxes. The IRS levies on a broker with respect to a money market account belonging to the taxpayer and receives payment from the broker which it applies to the taxpayer's outstanding liability. However, the IRS failed to follow procedure provided by the Internal Revenue Manual (but not required by statute) with regard to managerial approval prior to the making of the levy. The Commissioner may return an amount of money equal to the amount of money the IRS levied upon and applied toward the taxpayer's tax liability.

*Example 2.* B owes \$1,000 in Federal income taxes. The IRS levies on a bank with respect to a savings account belonging to the taxpayer and receives funds from the bank which it applies to the taxpayer's liability. Subsequent to the levy, B enters into an installment agreement, under which it will pay timely installments to satisfy the entire liability. The installment agreement does not by its terms preclude the return of levied upon property. The revenue officer verifies that B is financially capable of paying the entire liability, including accruals, in the agreed-upon installment payments. The Commissioner may return an amount of money equal to the amount of money levied upon and applied toward the taxpayer's liability.

*Example 3.* C owns a house that is deteriorating and in unsalable condition. C is in the process of renovating the house for sale when the IRS levies upon C's bank account for the payment of a \$20,000 outstanding Federal tax liability and receives funds in the amount of \$3,000, which it applies toward C's liability. A notice of federal tax lien is the only lien

encumbering the house. C requests that an amount of money equal to the amount seized from the bank account be returned so that C can complete the renovations on the house. Without the funds, C will be unable to complete the renovations and sell the house. Upon examination, the Commissioner determines that the IRS will be able to collect the entire tax liability if C's house is restored to salable condition. If the National Taxpayer Advocate, or the Commissioner in lieu of the National Taxpayer Advocate, determines that the return of the seized money is in the taxpayers best interest, the Commissioner may return an amount of money equal to the amount seized from the bank account in the best interest of the taxpayer and the United States.

(d) *Best interests of the United States and the taxpayer to release levy and return of property where levy made in violation of law—(1) In General.* If the Internal Revenue Service (IRS) makes a levy in violation of the law, it is in the best interest of the United States and the taxpayer to release the levy and the IRS will return to the taxpayer any property obtained pursuant to the levy. For example, the IRS will release the levy and return the taxpayer's property if the levy was made—

(i) Without giving the requisite thirty-day notice of intent to levy under section 6330;

(ii) During the pendency of a proceeding for refund of divisible tax in violation of section 6331(i);

(iii) Before investigation of the status of levied upon property in violation of section 6331(j);

(iv) During the pendency of offers-in-compromise in violation of section 6331(k)(1); or

(v) During the period an offer to enter into an installment agreement is pending (or for 30 days following the rejection of an offer, or, if the rejection is timely appealed, during the period that the appeal is pending) or during the period an installment agreement is in effect (or during the 30 days following a termination or, if a timely appeal of termination is filed, during the period the appeal is pending) in violation of section 6331(k)(2).

(2) *Property may not be credited to outstanding liability without the taxpayer's permission.* When the release of a levy and the return of property are required under this paragraph (d), the property or the proceeds from the sale of the property received by the IRS pursuant to the levy must be returned to the taxpayer unless the taxpayer requests otherwise. The

property or proceeds of sale may not be credited to any outstanding tax liability of the taxpayer, including the one with respect to which the IRS made the levy, without the written permission of the taxpayer.

(e) *Time of return.* Levied upon property in possession of the IRS (other than money) may be returned under paragraphs (c) and (d) of this section at any time. An amount of money equal to the amount of money levied upon or received from a sale of property may be returned at any time before the expiration of 9 months from the date of the levy. When a request for the return of money filed in accordance with paragraph (h) of this section is filed before the expiration of the 9-month period, or a determination to return an amount of money is made before the expiration of the 9-month period, the money may be returned within a reasonable period of time after the expiration of the 9-month period if additional time is necessary for investigation or processing.

(f) *Purchase by the United States.* For purposes of paragraph (a)(2) of this section, if property is declared purchased by the United States at a sale pursuant to section 6335(e)(1)(C), the United States will be treated as having received an amount of money equal to the minimum price determined by the Commissioner before the sale.

(g) *Determinations by the Commissioner.* The Commissioner must determine whether any of the conditions authorizing the return of property exists if a taxpayer submits a request for the return of property in accordance with paragraph (h) of this section. The Commissioner also may make this determination independently. If the Commissioner determines that conditions authorizing the return of property are not present, the Commissioner may not authorize the return of property. If the Commissioner determines that conditions authorizing the return of property are present, the Commissioner may (but is not required to, unless the reason for the return of property is that the levy was made in violation of law and is governed by paragraph (d) of this section) authorize the return of property. If the Commissioner decides independently to return property under paragraph (c)(4) of this section based on the best interests of the taxpayer and the United

States, the taxpayer or the National Taxpayer Advocate (or his delegate) must consent to the return of property.

(h) *Procedures for request for the return of property—*(1) *Manner.* A request for the return of property must be made in writing to the address on the levy form.

(2) *Form.* The written request must include the following information—

(i) The name, current address, and taxpayer identification number of the person requesting the return of money (or property purchased by the United States);

(ii) A description of the property levied upon;

(iii) The date of the levy; and

(iv) A statement of the grounds upon which the return of money is being requested (or property purchased by the United States).

(i) *No interest.* No interest will be paid on any money returned under this section.

(j) *Administrative collection upon default.* If the Commissioner returns property under this section, and the taxpayer fails to pay the previously assessed liability for which the levy was made on the returned property, the Commissioner may administratively collect the liability. Collection may include levying again on the returned property as long as statutory and administrative requirements are followed.

(k) *Effective date.* This section is applicable on the date final regulations are published in the **Federal Register**.

Robert E. Wenzel,  
Deputy Commissioner  
of Internal Revenue.

(Filed by the Office of the Federal Register on February 13, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 14, 2001, 66 F.R. 10249)

## Notice of Proposed Rulemaking

### Deposits of Excise Taxes

#### REG-106892-00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the requirements for excise tax returns, pay-

ments, and deposits. These regulations affect persons required to report liability for excise taxes on Form 720, "Quarterly Federal Excise Tax Return."

DATES: Written and electronic comments and requests for a public hearing must be received by May 17, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-106892-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-106892-00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may send submissions electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or directly to the IRS Internet site at [http://www.irs.gov/tax\\_regs/regslst.html](http://www.irs.gov/tax_regs/regslst.html).

FOR FURTHER INFORMATION CONTACT: Concerning submissions, Guy Traynor (202) 622-7180; concerning the regulations, Susan Athy (202) 622-3130 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Background

This document contains proposed amendments to the Excise Tax Procedural Regulations (26 CFR part 40) relating to the requirements for excise tax returns, payments, and deposits. On January 7, 2000, an advance notice of proposed rulemaking was published in the **Federal Register** (65 FR 1076) that invited comments from the public on issues relating to the requirements for excise tax returns and deposits. Several written comments were received that were considered in drafting these proposed regulations.

The advance notice requested comments on: whether there should be a single deposit date for all excise taxes (other than those deposited under the alternative method), such as 14 days after the end of the semimonthly period; whether a taxpayer should be required to deposit only 95 percent of tax liability incurred for the semimonthly period (in lieu of the current requirement of 100 percent with safe harbor rules); and whether the amount required to be deposited for a quarter should

be computed without reduction for the amounts of any claims made on Schedule C of the Form 720 for that quarter.

In general, commentators from the air transportation industry requested that the one-month filing extension provided to those reporting communications, air transportation, and ozone-depleting chemical taxes be retained because airlines need additional time to determine the proper amount of tax liability. The IRS and Treasury believe the need for additional time is adequately addressed by the retention of the alternative method for making deposits of communications and air transportation taxes. Filers choosing to use the alternative method for making deposits of these taxes also are allowed additional time to determine the amount of tax liability. For example, under the alternative method, the activity for December, January, and February is reported as tax liability for January, February, and March on the Form 720 due April 30th. Thus, even without the one-month filing extension, filers reporting under the alternative method have two months after the last activity to determine the amount of tax liability to be reported. In addition, retention of an extended filing date for certain industries would be inconsistent with the simplification and overall fairness sought to be achieved by these changes. Accordingly, the proposed amendments eliminate the one-month filing extension that is now allowed for returns related to taxes imposed by chapter 33 (relating to communications and air transportation) and section 4681 (relating to ozone-depleting chemicals) and require that all Forms 720 be filed by the last day of the month following the quarter for which the return is made.

Commentators generally supported a single deposit date for all taxes other than those deposited under the alternative method (regular method taxes). The proposed amendments provide that deposits for regular method taxes for a semi-monthly period are due by the 14th day of the following semi-monthly period. The proposed amendments change the requirement to deposit by class of tax. The 9-day rule, 14-day rule, and 30-day rule taxes are eliminated. Instead there are two classes: regular method and alternative method.

Commentators generally supported a reduction in the amount of the required deposit for a semi-monthly period from 100 percent of net tax liability to 95 percent of net tax liability. However, they requested that the look-back quarter safe harbor rule be retained. One commentator noted that the look-back quarter safe harbor rule is easy for taxpayers to use and provides a way for taxpayers to meet the deposit requirements when taxpayers have not determined their liability for the current semi-monthly period. Finally, some commentators requested that the provisions allowing deposits to be reduced by Schedule C claims be retained to avoid economic hardship. The proposed amendments adopt the suggestions of these commentators.

The proposed amendments require the deposit of at least 95 percent of net tax liability incurred during the semi-monthly period. This rule replaces both the requirement to deposit 100 percent of net tax liability and the safe harbor rule for taxpayers depositing 95 percent of their current liability. The new requirement is, in fact, more generous than the current safe harbor, which applies only if the 95-percent deposit requirement is met for each semi-monthly period in the quarter. Under the proposed amendments, a taxpayer that deposits 95 percent of net tax liability for a semi-monthly period will satisfy the deposit requirement for that period even if less than 95 percent of net tax liability is deposited for one or more of the other semi-monthly periods in the quarter.

The proposed amendments retain the look-back quarter liability safe harbor rule for taxpayers depositing taxes that were in effect during the look-back quarter. The proposed amendments to the deposit requirements and the safe harbor rule apply to all excise tax deposits, including deposits made under the alternative method. Finally, the proposed amendments continue to allow deposits to be reduced by Schedule C claims.

#### **Proposed Effective Date**

The regulations are proposed to be applicable with respect to returns and deposits that relate to calendar quarters beginning on or after the date of publication of the final regulations in the **Federal Register**.

#### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### **Comments and Requests for a Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

#### **Drafting Information**

The principal author of these regulations is Susan Athy, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

#### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 40 is proposed to be amended as follows:

PART 40—EXCISE TAX  
PROCEDURAL REGULATIONS



Paragraph 1. The authority citation for part 40 is amended by removing the entries for Sections 40.6071(a)-1 and 40.6071(a)-2, and Sections 40.6302(c)-2, 40.6302(c)-3, and 40.6302(c)-4; and adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 40.6071(a)-1 also issued under 26 U.S.C. 6071(a). \* \* \*

Section 40.6302(c)-2 also issued under 26 U.S.C. 6302(a).

Section 40.6302(c)-3 also issued under 26 U.S.C. 6302(a).

#### **§40.0-1 [Amended]**

Par. 2. Section 40.0-1 is amended as follows:

1. Paragraphs (d) and (e) are removed.
2. Paragraph (f) is redesignated as new paragraph (d).

#### **§40.6011(a)-1 [Amended]**

Par. 3. Section 40.6011(a)-1 is amended by removing paragraph (c).

#### **§40.6011(a)-2 [Amended]**

Par. 4. Section 40.6011(a)-2 is amended as follows:

1. In paragraph (b)(2), the language “§40.6302(c)-1(f)(2)” is removed and “§40.6302(c)-1(e)(2)” is added in its place.
2. Paragraph (d) is removed.

Par. 5. Section 40.6071(a)-1 is amended by revising paragraphs (a), (b)(2), and (c) to read as follows:

#### *§40.6071(a)-1 Time for filing returns.*

(a) *Quarterly returns.* Each quarterly return required under §40.6011(a)-1(a)(2) must be filed by the last day of the first calendar month following the quarter for which it is made.

(b) \* \* \*

(2) *Semimonthly returns.* Each semimonthly return required under §40.6011(a)-1(b) must be filed by the last day of the semimonthly period (as defined in §40.0-1(c)) following the semimonthly period for which it is made.

(c) *Effective date.* This section is applicable with respect to returns that relate to calendar quarters beginning on or after the date of publication of the final regulations in the **Federal Register**.

#### **§40.6071(a)-2 [Removed]**

Par. 6. Section 40.6071(a)-2 is removed.

#### **§40.6091-1 [Amended]**

Par. 7. Section 40.6091-1 is amended by removing paragraph (d).

Par. 8. Section 40.6101-1 is revised to read as follows:

#### *§40.6101-1 Period covered by returns.*

See §40.6011(a)-1(a)(2) for the rules relating to the period covered by the return.

Par. 9. Sections 40.6109(a)-1 and 40.6151(a)-1 are revised to read as follows:

#### *§40.6109(a)-1 Identifying numbers.*

Every person required under §40.6011(a)-1 to make a return must provide the identifying number required by the instructions applicable to the form on which the return is made.

#### *§40.6151(a)-1 Time and place for paying tax shown on return.*

Except as provided by statute, the tax must be paid at the time prescribed in §40.6071(a)-1 for filing the return, and at the place prescribed in §40.6091-1 for filing the return.

Par. 10. Section 40.6302(c)-1 is revised to read as follows:

#### *§40.6302(c)-1 Use of Government depositaries.*

(a) *In general*—(1) *Semimonthly deposits required.* Except as provided by statute or by paragraph (e) of this section, each person required under §40.6011(a)-1(a)(2) to file a quarterly return must make a deposit of tax for each semimonthly period (as defined in §40.0-1(c)) in which tax liability is incurred.

(2) *Treatment of taxes imposed by chapter 33.* For purposes of this part 40, tax imposed by chapter 33 (relating to communications and air transportation) is treated as a tax liability incurred during the semimonthly period—

- (i) In which that tax is collected; or
- (ii) In the case of the alternative method, in which that tax is considered as collected.

(3) *Definition of net tax liability.* Net tax liability means the tax liability for the specified period plus or minus any adjust-

ments allowable in accordance with the instructions applicable to the form on which the return is made.

(4) *Computation of net tax liability for a semimonthly period.* The net tax liability for a semimonthly period may be computed by—

(i) Determining the net tax liability incurred during the semimonthly period; or

(ii) Dividing by two the net tax liability incurred during the calendar month that includes that semimonthly period, provided that this method of computation is used for all semimonthly periods in the calendar quarter.

(b) *Amount of deposit*—(1) *In general.* The deposit of tax for each semimonthly period must be not less than 95 percent of the amount of net tax liability incurred during the semimonthly period.

(2) *Safe harbor rules*—(i) *Applicability.* The safe harbor rules of this paragraph (b)(2) are applied separately to taxes deposited under the alternative method provided in §40.6302(c)-3 (alternative method taxes) and to the other taxes for which deposits are required under this section (regular method taxes).

(ii) *Regular method taxes.* Any person that made a return of tax reporting regular method taxes for the second preceding calendar quarter (the look-back quarter) is considered to have complied with the requirement of this part 40 for deposit of regular method taxes for the current calendar quarter if—

(A) The deposit of regular method taxes for each semimonthly period in the current calendar quarter is not less than 1/6 of the net tax liability for regular method taxes reported for the look-back quarter;

(B) Each deposit is made on time;

(C) The amount of any underpayment of regular method taxes is paid by the due date of the return; and

(D) The person's liability does not include any regular method tax that was not imposed at all times during the look-back quarter or a tax on a chemical not subject to tax at all times during the look-back quarter.

(iii) *Alternative method taxes.* Any person that made a return of tax reporting alternative method taxes for the look-back quarter is considered to have complied with the requirement of this part 40 for

deposit of alternative method taxes for the current calendar quarter if—

(A) The deposit of alternative method taxes for each semimonthly period in the current calendar quarter is not less than 1/6 of the net tax liability for alternative method taxes reported for the look-back quarter;

(B) Each deposit is made on time;

(C) The amount of any underpayment of alternative method taxes is paid by the due date of the return; and

(D) The person's liability does not include any alternative method tax that was not imposed at all times during the look-back quarter and the month preceding the look-back quarter.

(iv) *Modification for tax rate increase.* The safe harbor rules of this paragraph (b)(2) do not apply to regular method taxes or alternative method taxes for the first and second calendar quarters beginning on or after the effective date of an increase in the rate of any tax to which this part 40 applies unless the deposit of those taxes for each semimonthly period in the calendar quarter is not less than 1/6 of the tax liability the person would have had with respect to those taxes for the look-back quarter if the increased rate of tax had been in effect for the look-back quarter.

(v) *Failure to comply with deposit requirements.* If a person fails to make deposits as required under this part 40, that failure may be reported to the appropriate IRS office and the IRS may withdraw the person's right to use the safe harbor rules of this paragraph (b)(2).

(c) *Time to deposit—(1) In general.* The deposit of tax for any semimonthly period must be made by the 14th day of the following semimonthly period unless such day is a Saturday, Sunday, or legal holiday in the District of Columbia in which case the immediately preceding day which is not a Saturday, Sunday, or legal holiday in the District of Columbia is treated as the 14th day. Thus, generally, the deposit of tax for the first semimonthly period in a month is due by the 29th day of that month and the deposit of tax for the second semimonthly period in a month is due by the 14th day of the following month.

(2) *Exceptions.* See §40.6302(c)-2 for the special rules for September. See §40.6302(c)-3 for the special rules for deposits under the alternative method.

(d) *Remittance of deposits—(1) Deposits by federal tax deposit coupon.* A completed Form 8109, "Federal Tax Deposit Coupon," must accompany each deposit. The deposit must be remitted, in accordance with the instructions applicable to the form, to a financial institution authorized as a depository for federal taxes (as provided in 31 CFR part 203).

(2) *Deposits by electronic funds transfer.* For the requirement to deposit excise taxes by electronic funds transfer, see §31.6302-1(h) of this chapter. A taxpayer not required to deposit by electronic funds transfer pursuant to §31.6302-1(h) of this chapter remains subject to the rules of this paragraph (d).

(e) *Exceptions—(1) Taxes excluded.* No deposit is required in the case of the taxes imposed by—

(i) Section 4042 (relating to fuel used on inland waterways);

(ii) Section 4161 (relating to sport fishing equipment and bows and arrow components);

(iii) Section 4682(h) (relating to floor stocks tax on ozone-depleting chemicals); and

(iv) Section 48.4081-3(b)(1)(iii) of this chapter (relating to certain removals of gasohol from refineries).

(2) *One-time filings.* No deposit is required in the case of any taxes reportable on a one-time filing (as defined in §40.6011(a)-2(b)).

(3) *De minimis exception.* For any calendar quarter, no deposit is required if the net tax liability for the quarter does not exceed \$2,500.

(f) *Effective date.* This section is applicable with respect to deposits that relate to calendar quarters beginning on or after the date of publication of the final regulations in the **Federal Register**.

Par. 11. Section 40.6302(c)-2 is revised to read as follows:

*§40.6302(c)-2 Special rules for September.*

(a) *In general—(1) Separate deposits required for the second semimonthly period.* In the case of deposits of taxes not deposited under the alternative method (regular method taxes) for the second semimonthly period in September, separate deposits are required for the period September 16th through 26th and for the period September 27th through 30th.

(2) *Amount of deposit—(i) In general.* The deposits of regular method taxes for the period September 16th through 26th and the period September 27th through 30th must be not less than 95 percent of the net tax liability for regular method taxes incurred during the respective periods. The net tax liability for regular method taxes incurred during these periods may be computed by—

(A) Determining the amount of net tax liability for regular method taxes reasonably expected to be incurred during the second semimonthly period in September;

(B) Treating 11/15 of the amount determined under paragraph (a)(2)(i)(A) of this section as the net tax liability for regular method taxes incurred during the period September 16th through 26th; and

(C) Treating the remainder of the amount determined under paragraph (a)(2)(i)(A) of this section (adjusted to reflect the amount of net tax liability for regular method taxes actually incurred through the end of September) as the net tax liability for regular method taxes incurred during the period September 27th through 30th.

(ii) *Safe harbor rules.* The safe harbor rules in §40.6302(c)-1(b)(2) do not apply for the third calendar quarter unless—

(A) The deposit of taxes for the period September 16th through 26th is not less than 11/90 of the net tax liability for regular method taxes reported for the look-back quarter; and

(B) The total deposit of taxes for the second semimonthly period in September is not less than 1/6 of the net tax liability for regular method taxes reported for the look-back quarter.

(3) *Time to deposit.* (i) The deposit required for the period beginning September 16th must be made by September 29th unless—

(A) September 29th is a Saturday, in which case the deposit must be made by September 28th; or

(B) September 29th is a Sunday, in which case the deposit must be made by September 30th.

(ii) The deposit required for the period ending September 30th must be made at the time prescribed in §40.6302(c)-1(c).

(b) *Persons not required to use electronic funds transfer.* The rules of this section are applied with the following modifications in the case of a person not

required to deposit taxes by electronic funds transfer.

(1) *Periods.* The deposit periods for the separate deposits required under paragraph (a) of this section are September 16th through 25th and September 26th through 30th.

(2) *Amount of deposit.* In computing the amount of deposit required under paragraph (a)(2)(i)(B) of this section, the applicable fraction is 10/15. In computing the amount of deposit required under paragraph (a)(2)(ii)(A) of this section, the applicable fraction is 10/90.

(3) *Time to deposit.* In the case of the deposit required under paragraph (a) of this section for the period beginning September 16th, the deposit must be made by September 28th unless—

(i) September 28th is a Saturday, in which case the deposit must be made by September 27th; or

(ii) September 28th is a Sunday, in which case the deposit must be made by September 29th.

(c) *Effective date.* This section is applicable with respect to deposits that relate to calendar quarters beginning on or after the date of publication of the final regulations in the **Federal Register**.

Par. 12. Section 40.6302(c)–3 is amended as follows:

1. In paragraph (b)(1)(ii), the language “9-day rule of §40.6302(c)–1(b)(6)” is removed and “rule of §40.6302(c)–1(c)(1)” is added in its place.

2. In paragraph (b)(3), second sentence, the language “6th” is removed and “16th” is added in its place.

3. In paragraph (d), first sentence, the language “not less than” is removed and “not less than 95 percent of” is added in its place.

4. In paragraph (f)(4), the language “§40.6302(c)–1(c)(2)(i)” is removed and “§40.6302(c)–1(b)(2)” is added in its place.

5. Paragraph (f)(5) is removed.

6. Paragraphs (f)(6) and (f)(7) are redesignated as paragraphs (f)(5) and (f)(6), respectively.

7. Paragraph (g) is revised.

8. Paragraph (h) is removed.

The revision reads as follows:

§40.6302(c)–3 *Special rules for use of Government depositaries under chapter 33.*

\* \* \* \* \*

(g) *Effective date.* This section is applicable with respect to deposits of taxes that are considered as collected in calendar quarters beginning on or after the date of publication of the final regulations in the **Federal Register** and to returns of tax for calendar quarters beginning on or after the date of publication of the final regulations in the **Federal Register**.

#### §40.6302(c)–4 [Removed]

Par. 13. Section 40.6302(c)–4 is removed.

#### §40.9999–1 [Removed]

Par. 14. Section 40.9999–1 is removed.

Robert E. Wenzel,  
*Deputy Commissioner  
of Internal Revenue.*

(Filed by the Office of the Federal Register on February 15, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 16, 2001, 66 F.R. 10650)

## Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations

### Disclosure of Return Information to the Bureau of the Census

#### REG–121109–00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In T.D. 8943, on page 1054 of this Bulletin, the IRS is issuing temporary regulations relating to additions to the list of items of information disclosed to the Bureau of the Census for use in the Longitudinal Employer-Household Dynamics (LEHD) project and the Survey of Income and Program Participation (SIPP) project. These regulations provide guidance to IRS and Social Security Administration (SSA) personnel responsible for disclosing the information. The text of those temporary regulations also serves as the text of these proposed regulations.

DATES: Written and electronic comments and requests for a public hearing must be received by May 14, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–121109–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to CC:M&SP:RU (REG–121109–00), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or sent electronically, via the IRS Internet site at: [http://www.irs.ustreas.gov/tax\\_regs/reglist.html](http://www.irs.ustreas.gov/tax_regs/reglist.html).

FOR FURTHER INFORMATION CONTACT: Stuart Murray (202) 622-4580 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### Background

Under section 6103(j)(1), upon written request from the Secretary of Commerce, the Secretary is to furnish to the Bureau of the Census (Bureau) tax return information that is prescribed by Treasury regulations for the purpose of, but only to the extent necessary in, structuring censuses and national economic accounts and conducting related statistical activities authorized by law. Section 301.6103(j)(1)–1 of the regulations further defines such purposes by reference to 13 U.S.C. Chapter 5 and provides an itemized description of the return information authorized to be disclosed for such purposes. Section 301.6103(j)(1)–1(b)(5) of the regulations provides a list of information provided to the Social Security Administration (SSA) pursuant to Internal Revenue Code section 6103(l)(1)(A) or (5) that officers or employees of SSA may disclose to the Bureau. Periodically, the disclosure regulations are amended to reflect the changing needs of the Bureau for data for its statutorily authorized statistical activities.

This document contains proposed amendments to the regulations authorizing IRS and SSA personnel to disclose additional items of return information that have been requested by the Secretary of Commerce for specified purposes related to the LEHD and SIPP projects.

The text of the temporary regulations also serves as the text of these proposed

regulations. The preamble to the temporary regulations explains the regulations.

### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic and written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulation and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

### Drafting Information

The principal author of these regulations is Jamie G. Bernstein, Office of the Associate Chief Counsel, Procedure & Administration (Disclosure & Privacy Law Division), Internal Revenue Service. However, other personnel from the IRS and Treasury Department participated in their development.

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### Proposed Amendments to the Regulations

Accordingly, 26 CFR Part 301 is proposed to be amended as follows:

## PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 301.6103(j)(1)–1 also issued under 26 U.S.C. 6103(j)(1);\* \* \*

Par. 2. Section 301.6103(j)(1)–1 is amended by:

1. Adding paragraphs (b)(2)(v) and (vi).
2. Adding paragraphs (b)(3)(xxiii), (xxiv), (xxv), (xxvi), (xxvii) and (xxviii).
3. Adding paragraphs (b)(5)(iii), (iv), and (v).
4. Revising paragraph (e).

The additions and revision read as follows:

*§301.6103(j)(1)–1 Disclosure of return information to officers and employees of the Department of Commerce for certain statistical purposes and related activities.*

\* \* \* \* \*

(b)\* \* \*

(2)(v) and (vi)[The text of proposed paragraphs (b)(2)(v) and (vi) is the same as the text of §301.6103(j)(1)–1T(b)(2)(v) and (vi) published in T.D. 8943].

(3)[The text of proposed paragraphs (b)(3)(xxiii), (xxiv), (xxv), (xxvi), (xxvii) and (xxviii) is the same as the text of §301.6103(j)(1)–1T(b)(3)(xxiii), (xxiv), (xxv), (xxvi), (xxvii) and (xxviii) published in T.D. 8943].

\* \* \* \* \*

(5)(iii), (iv), and (v) [The text of proposed paragraphs (b)(5)(iii), (iv), and (v) is the same as the text of §301.6103(j)(1)–1T(b)(5)(iii), (iv), and (v) published in T.D. 8943].

\* \* \* \* \*

(e) [The text of proposed paragraph (e) is the same as the text of §301.6103(j)(1)–1T(e) published elsewhere in T.D. 8943].

Robert E. Wenzel,  
Deputy Commissioner  
of the Internal Revenue.

(Filed by the Office of the Federal Register on February 12, 2001, 8:45 a.m., and published in the issue of the Federal Register for February 13, 2001, 66 F.R. 9991)

## Source of Income From Certain Space and Ocean Activities; Also, Source of Communications Income; Hearing

### Announcement 2001–30

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Change of date of public hearing; extension of time to submit outlines of oral comments.

SUMMARY: This document changes the date of the public hearing on the proposed regulations (REG–106030–98, 2000–11 I.R.B. 820) under sections 863(a), (d), and (e) governing the source of income from certain space and ocean activities and certain communications activities. It also extends the time to submit outlines of oral comments for the hearing.

DATES: The public hearing will be held May 23, 2001, beginning at 10 a.m. Additional outlines of oral comments must be received by May 2, 2001.

ADDRESSES: The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Send submissions to: Regulations Unit CC (REG–106030–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: Regulations Unit CC (REG–106030–98), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington DC. Alternatively, taxpayers may submit outlines of oral comments electronically directly to the IRS Internet site at [http://www.irs.gov/tax\\_regs/reglist.html](http://www.irs.gov/tax_regs/reglist.html).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Anne Shelburne (202) 874-1490; concerning submission, LaNita Van Dyke (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

### Background

A notice of proposed rulemaking and notice of public hearing, appearing in the **Federal Register** on Wednesday, January 17, 2001 (66 FR 3903), announced that a public hearing on the proposed regulations under sections 863(d) and 863(e),

governing the source of income from certain space and ocean activities and certain communications activities would be held on March 28, 2001, in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Subsequently, the date of the public hearing has changed to May 23, 2001, at 10 a.m. in room 2615. Outlines of oral comments must be received by May 2, 2001.

Cynthia Grigsby,  
*Chief, Regulations Unit,*  
*Office of Special Counsel*  
*(Modernization & Strategic Planning).*

(Filed by the Office of the Federal Register on March 9, 2001, 8:45 a.m., and published in the issue of the Federal Register for March 12, 2001, 66 FR. 14351)

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## Definition of Terms

*Revenue rulings and revenue procedures (hereinafter referred to as “rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:*

*Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

*Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

*Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it ap-

plies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

*Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

*Supplemented* is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

*Suspended* is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

## Abbreviations

*The following abbreviations in current use and formerly used will appear in material published in the Bulletin.*

A—Individual.  
Acq.—Acquiescence.  
B—Individual.  
BE—Beneficiary.  
BK—Bank.  
B.T.A.—Board of Tax Appeals.  
C—Individual.  
C.B.—Cumulative Bulletin.  
CFR—Code of Federal Regulations.  
CI—City.  
COOP—Cooperative.  
Ct.D.—Court Decision.  
CY—County.  
D—Decedent.  
DC—Dummy Corporation.  
DE—Donee.  
Del. Order—Delegation Order.  
DISC—Domestic International Sales Corporation.  
DR—Donor.  
E—Estate.  
EE—Employee.

E.O.—Executive Order.  
ER—Employer.  
ERISA—Employee Retirement Income Security Act.  
EX—Executor.  
F—Fiduciary.  
FC—Foreign Country.  
FICA—Federal Insurance Contributions Act.  
FISC—Foreign International Sales Company.  
FPH—Foreign Personal Holding Company.  
FR.—Federal Register.  
FUTA—Federal Unemployment Tax Act.  
FX—Foreign Corporation.  
G.C.M.—Chief Counsel’s Memorandum.  
GE—Grantee.  
GP—General Partner.  
GR—Grantor.  
IC—Insurance Company.  
I.R.B.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.

PHC—Personal Holding Company.  
PO—Possession of the U.S.  
PR—Partner.  
PRS—Partnership.  
PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—Statements of Procedural Rules.  
Stat.—Statutes at Large.  
T—Target Corporation.  
T.C.—Tax Court.  
T.D.—Treasury Decision.  
TFE—Transferee.  
TFR—Transferor.  
T.I.R.—Technical Information Release.  
TP—Taxpayer.  
TR—Trust.  
TT—Trustee.  
U.S.C.—United States Code.  
X—Corporation.  
Y—Corporation.  
Z—Corporation.

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<sup>1</sup> A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2000–27 through 2000–52 is in Internal Revenue Bulletin 2001–1, dated January 2, 2001.





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