

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

26 CFR 1.338-3: Qualification for the section 338 election.

T.D. 9071

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

#### Effect of Section 338(h)(10) Elections in Certain Multi-step Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document gives effect to section 338(h)(10) elections in certain multi-step transactions. These regulations affect corporations and their shareholders.

The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking (REG-143679-02) on this subject in this issue of the Bulletin.

DATES: Effective Date: These regulations are effective on or after July 9, 2003.

Applicability Date: For dates of applicability, see §1.338(h)(10)-1T(h).

FOR FURTHER INFORMATION CONTACT: Daniel Heins, Mary Goode or Reginald Mombrun at (202) 622-7930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### Background

##### A. Section 338 Generally

In the case of any qualified stock purchase, section 338 allows a purchasing corporation to elect to treat the target corporation as having sold all of its assets at the close of the acquisition date at fair market value and then treats the target corporation as a new corporation that purchased all of its assets as of the beginning of the day after the acquisition date. Section 338 was enacted to replace former section 334(b)(2) and to repeal the *Kimbell-Diamond* doctrine. See H.R. Rep. No. 97-760 at 536 (1982), 1982-2 C.B. 600, 632 (reflecting that section 338 replaces “any non-statutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine”). In *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, aff’d *per curiam*, 342 U.S. 827 (1951), the court held that the purchase of the stock of a target corporation for the purpose of obtaining its assets through a prompt liquidation should be treated by the purchaser as a purchase of the target corporation’s assets with the purchaser receiving a cost basis in the assets.

##### B. Revenue Ruling 2001-46

Rev. Rul. 2001-46, 2001-2 C.B. 321, considers whether the step transaction doctrine should apply to treat certain acquisitions of stock of a target corporation followed by mergers of the target corporation into the acquiring corporation as reorganizations under section 368(a)(1)(A). In Situation 1 of that ruling, Corporation X owns all of the stock of Corporation Y.

Pursuant to an integrated plan, X acquires all of the stock of Corporation T in a statutory merger of Y into T (the “Acquisition Merger”), with T surviving. In the Acquisition Merger, the T shareholders exchange their T stock for consideration, 70 percent of which is X voting stock and 30 percent of which is cash. Following the Acquisition Merger and as part of the plan, T merges into X in a statutory merger (the “Upstream Merger”). If viewed separately from the Upstream Merger, the Acquisition Merger would qualify as a qualified stock purchase. If viewed separately from the Acquisition Merger, the Upstream Merger would qualify as a liquidation described in section 332. However, if the step transaction doctrine were applied to the Acquisition Merger and the Upstream Merger, the integrated transaction would be treated as an integrated acquisition of T’s assets by X in a single statutory merger qualifying as a reorganization under section 368(a).

Considering the appropriate treatment of the Acquisition Merger and the Upstream Merger, Rev. Rul. 2001-46 examines, among other authorities, Rev. Rul. 67-274, 1967-2 C.B. 141, and Rev. Rul. 90-95, 1990-2 C.B. 67. In Rev. Rul. 67-274, a corporation’s acquisition of stock of a target corporation that, viewed independently, qualifies as a reorganization under section 368(a)(1)(B), is followed by a liquidation of the target corporation into the acquiring corporation that, viewed independently, qualifies as a liquidation described in section 332. Rev. Rul. 67-274 holds that the transaction is an acquisition by the acquiring corporation of the target corporation’s assets in a reorganization under section 368(a)(1)(C). In Rev. Rul. 90-95, a subsidiary of the acquiring corporation merges into the target corporation with the target corporation shareholders receiving solely cash in exchange for their stock. Immediately following this merger, the target corporation merges into the acquiring corporation. Rev. Rul. 90-95 rules that the first step is accorded independent significance from the subsequent liquidation of the target corporation and, therefore, is treated as a qualified stock purchase, regardless of whether an election under section 338 is made.

In Rev. Rul. 2001-46, the IRS concluded that treating the Acquisition Merger

and the Upstream Merger as a single statutory merger of T into X would not violate the policy underlying section 338 because that treatment results in a transaction that qualifies as a reorganization under section 368(a)(1)(A) in which X acquires the assets of T with a carryover basis under section 362, not a cost basis under section 1012. Finally, Rev. Rul. 2001-46 states that the IRS and Treasury are considering whether to issue regulations that would reflect the general principles of the revenue ruling, but would allow taxpayers to make an election under section 338(h)(10) with respect to a step in a multi-step transaction that, viewed independently, is a qualified stock purchase and is pursuant to a written agreement that requires, or permits, the purchasing corporation to cause a section 338(h)(10) election in respect of such step to be made. The IRS requested and received comments on this issue.

### Explanation of Provisions

The IRS and Treasury have studied the comments received in response to the request made in Rev. Rul. 2001-46, all of which urge the IRS and Treasury to allow taxpayers to make section 338(h)(10) elections in certain transactions as contemplated by Rev. Rul. 2001-46. These final and temporary regulations adopt this recommendation and provide that the step transaction doctrine will not be applied if a taxpayer makes a valid section 338(h)(10) election with respect to a step in a multi-step transaction, even if the transaction would otherwise qualify as a reorganization, if the step, standing alone, is a qualified stock purchase. The IRS and Treasury are continuing to study the other comments received. In particular, the IRS and Treasury are considering whether any amendments to the portion of the regulations under section 338 related to the corporate purchaser requirement are appropriate.

### Effective Date

These final and temporary regulations are applicable to acquisitions of stock occurring on or after the date of publication of the regulations.

### Special Analyses

These final and temporary regulations are necessary in order to provide taxpayers

with immediate guidance regarding the validity of certain elections made under section 338(h)(10). Accordingly, good cause is found for dispensing with the notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with providing a delayed effective date pursuant to 5 U.S.C. 553(d)(1) and (3). For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking (REG-143679-02) published elsewhere in this issue of the Bulletin. These final and temporary regulations have been submitted to the Chief Counsel of Advocacy of the Small Business Administration for comment on their impact on small businesses.

### Drafting Information

The principal authors of these final and temporary regulations are Daniel Heins and Mary Goode, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

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### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

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

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

Section 1.338(h)(10)-1T also issued under 26 U.S.C. 337(d), 338 and 1502. \*\*\*

Par. 2. Section 1.338-3 is amended by adding a sentence at the end of paragraph (c)(1)(i) to read as follows:

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

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(i) \* \* \* See §1.338(h)(10)-1T(c)(2) for special rules concerning section 338(h)(10) elections in certain multi-step transactions.

Par. 3. Section 1.338(h)(10)-1 is amended as follows:

1. Paragraphs (c)(2), (c)(3) and (c)(4) are redesignated as paragraphs (c)(3), (c)(4) and (c)(5) respectively.

2. A newly designated paragraph (c)(2) is added.

The revisions and addition read as follows:

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

\* \* \* \* \*

(c) \* \* \*

(2) [Reserved] For further guidance, see §1.338(h)(10)-1T(c)(2).

\* \* \* \* \*

Par. 4. Section 1.338(h)(10)-1T is added to read as follows:

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

(a) through (c)(1) [Reserved]. For further guidance, see §1.338(h)(10)-1(a) through (c)(1).

(c)(2) *Availability of section 338(h)(10) election in certain multi-step transactions.* Notwithstanding anything to the contrary in §1.338-3(c)(1)(i), a section 338(h)(10) election may be made for T where P's acquisition of T stock, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P), whether or not, under relevant provisions of law, including the step transaction doctrine, the acquisition of the T stock and the merger or liquidation of T qualify as a reorganization described in section 368(a). If a section 338(h)(10) election is made in a case where the acquisition of T stock followed by a merger or liquidation of T into P qualifies as a reorganization described in section 368(a), for all federal tax purposes, P's acquisition of T stock is treated as a qualified stock purchase and is not treated as part of a reorganization described in section 368(a).

(c)(3) through (e) (*Example 10*) [Reserved]. For further guidance, see §1.338(h)(10)-1(c)(3) through (e) (*Example 10*).

(e) *Example 11. Stock acquisition followed by upstream merger — without section 338(h)(10) election.* (i) P owns all the stock of Y, a newly formed subsidiary. S owns all the stock of T. Each of P, S, T and

Y is a domestic corporation. P acquires all of the T stock in a statutory merger of Y into T, with T surviving. In the merger, S receives consideration consisting of 50% P voting stock and 50% cash. Viewed independently of any other step, P's acquisition of T stock constitutes a qualified stock purchase. As part of the plan that includes P's acquisition of the T stock, T subsequently merges into P. Viewed independently of any other step, T's merger into P qualifies as a liquidation described in section 332. Absent the application of paragraph (c)(2) of this section, the step transaction doctrine would apply to treat P's acquisition of the T stock and T's merger into P as an acquisition by P of T's assets in a reorganization described in section 368(a). P and S do not make a section 338(h)(10) election with respect to P's purchase of the T stock.

(ii) Because P and S do not make an election under section 338(h)(10) for T, P's acquisition of the T stock and T's merger into P is treated as part of a reorganization described in section 368(a).

*Example 12. Stock acquisition followed by upstream merger — with section 338(h)(10) election.* (i) The facts are the same as in *Example 11* except that P and S make a joint election under section 338(h)(10) for T.

(ii) Pursuant to paragraph (c)(2) of this section, as a result of the election under section 338(h)(10), for all federal tax purposes, P's acquisition of the T stock is treated as a qualified stock purchase and P's acquisition of the T stock is not treated as part of a reorganization described in section 368(a).

*Example 13. Stock acquisition followed by brother-sister merger — with section 338(h)(10) election.* (i) The facts are the same as in *Example 12*, except that, following P's acquisition of the T stock, T merges into X, a domestic corporation that is a wholly owned subsidiary of P. Viewed independently of any other step, T's merger into X qualifies as a reorganization described in section 368(a). Absent the application of paragraph (c)(2) of this section, the step transaction doctrine would apply to treat P's acquisition of the T stock and T's merger into X as an acquisition by X of T's assets in a reorganization described in section 368(a).

(ii) Pursuant to paragraph (c)(2) of this section, as a result of the election under section 338(h)(10), for all federal tax purposes, P's acquisition of T stock is treated as a qualified stock purchase and P's acquisition of T stock is not treated as part of a reorganization described in section 368(a).

*Example 14. Stock acquisition that does not qualify as a qualified stock purchase followed by upstream merger.* (i) The facts are the same as in *Example 11*, except that, in the statutory merger of Y into T, S receives only P voting stock.

(ii) Pursuant to section 1.338-3(c)(1)(i) and paragraph (c)(2) of this section, no election under section 338(h)(10) can be made with respect to P's acquisition of the T stock because, pursuant to relevant provisions of law, including the step transaction doctrine, that acquisition followed by T's merger into P is treated as a reorganization under section 368(a)(1)(A), and that acquisition, viewed independently of T's merger into P, does not constitute a qualified stock purchase under section 338(d)(3). Accordingly, P's acquisition of the T stock and T's merger into P is treated as a reorganization under section 368(a).

(f) through (g) [Reserved]. For further guidance, see §1.338(h)(10)-1(f) through (g).

(h) *Effective date.* This section is applicable to stock acquisitions occurring on or after July 9, 2003.

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Robert E. Wenzel,  
*Deputy Commissioner for  
Services and Enforcement.*

Approved June 27, 2003.

Pamela F. Olson,  
*Assistant Secretary of the Treasury.*

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