Section 338 and Its Foolish Consistency Rules - The Hobgoblin of Little Minds

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SECTION 338 AND ITS FOOLISH CONSISTENCY
RULES—THE HOBOGOBLIN OF LITTLE MINDS*

By Douglas A. Kahn**

Prior to 1986, there was a tax principle, commonly referred to as the "General Utilities doctrine," that provided that a corporation did not recognize gain or loss when it made a distribution to a shareholder of either appreciated or depreciated property. While there were exceptions to that rule of nonrecognition, the General Utilities doctrine was the general rule.

When Congress adopted Section 338 in 1982, it included two sets of "consistency rules" to prevent the continued availability of a means of extending the scope of the General Utilities doctrine by permitting a target corporation (i.e., a corporation that is the object of an acquisition) to select only some of its assets for nonrecognition of income. The principal purpose of those rules was eliminated in 1986 when Congress repudiated

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* Peter L. Faber, The Search for Consistency in Corporate Acquisitions, 13 J. Corp. Tax'n 187 (1986) (quoting RALPH WALDO EMERSON, ESSAYS, FIRST SERIES 57 (1865)). "A foolish consistency is the hobgoblin of little minds, adored by little statesmen." See also William Allen White, A Paste Jewell, EMPORIA GAZETTE, Nov. 17, 1923, at 2 ("Consistency is a paste jewel that only cheap men cherish.").

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1. This doctrine is named after the landmark United States Supreme Court decision in General Utilities Co. v. Helvering, 296 U.S. 200 (1935).

2. An appreciated asset is one with a fair market value that is greater than its adjusted basis; conversely, a depreciated asset is one with an adjusted basis that is greater than its fair market value.

virtually all of the General Utilities doctrine. As a consequence, a number of commentators have urged the repeal of the consistency rules, but Congress has not yet taken action. The rules remain in the statute.

In January, 1992, the Treasury promulgated proposed regulations that would substantially modify the regulatory application of the consistency and related rules so as to eradicate much of their bite and limit the circumstances in which they will apply. On January 12, 1994, with a few modifications, the proposed regulations were finalized effective January 24, 1994 (hereinafter, the final (and current) regulations are sometimes referred to as the “1994 regulations”). The purposes of this Article are to examine whether there is any longer a reason for concern because a target corporation can choose selected assets for nonrecognition and to what extent the 1994 regulations properly deal with potentially abusive circumventions of tax goals.

Before examining the current status of the consistency requirements, the historical background that led to the adoption of Section 338 and the operation of the section is discussed. The historical background includes: the judicially created Kimbell-Diamond rule, the codification and modification of that rule by the old version of Section 334(b)(2), the operation of the old version of Section 337 that provided nonrecognition for certain liquidating sales of corporate assets, and the replacement of the old version of Section 334(b)(2) by Section 338. The general operation of Section 338 is then sketched, and the special election provided by Section 338(h)(10) is examined. Finally, the consistency rules are examined and critiqued.

The circumstance at which the pre-Section 338 rules and Section 338 itself are aimed is the acquisition by a corporation (the “purchasing corporation” or simply “the purchaser”) of sufficient shares of stock of a corporation (the “target corporation”) to provide control of the target. The tax law's treatment of such purchases of stock has evolved over the years.

4. Neil Z. Auerbach, New Proposed Regulations Under Section 338: A Study in Consistency, 55 TAX NOTES 233-36 (1992); Ginsburg, supra note 3, at 317-19. While Peter L. Faber concluded that the repeal of the General Utilities doctrine does not eliminate all of the abuses that the consistency rules were designed to curb, he considers the remaining abuses to be too minor to justify the retention of such a complex rule. Faber, supra note 1, at 232.
I. Taxable Acquisitions of Stock Prior to Section 338

A. The Kimbell-Diamond Rule

Prior to the 1954 Code, judicial doctrine established that when (in a taxable transaction or series of transactions) a party acquired all (or virtually all) of the stock of a corporation for the purpose of liquidating the corporation and thereby obtaining its assets, and, in fact, promptly liquidated the acquired corporation, the transaction was in substance a purchase of the corporation’s assets by the shareholder through the medium of acquiring the stock. Upon liquidation of the corporation, the shareholder recognized no gain or loss, and the shareholder’s basis in the distributed property equalled the purchase price paid for the stock. This judicial principle is commonly referred to as the Kimbell-Diamond rule, in deference to a landmark decision on this issue.5

B. The Section 334(b)(2) Codification of the Kimbell-Diamond Rule

As applied to the purchase of stock by a corporate shareholder, the Kimbell-Diamond rule was codified in the “old version” (i.e., the pre-1982 version) of Section 334(b)(2) with some modifications such as substituting objective criteria for the subjective “intent” test that the judicial rule had established. In particular, the old version of Section 334(b)(2) provided that a parent corporation’s basis in the assets of a subsidiary which were acquired on liquidation of the subsidiary was equal to the adjusted basis of the subsidiary’s stock in the hands of the parent corporation when the following objective conditions were met:

(1) Within a twelve-month period the parent corporation “purchased” stock of the target having at least 80 percent of the voting power of all voting stock and at least 80 percent of the total number of shares of the target’s nonvoting stock (other than nonvoting, nonparticipating preferred stock of the target). The term “purchase” was defined in the statute and was given a restricted meaning. In very general terms, the term referred to a taxable acquisition (i.e., an acquisition in which all

the parties' realized gain or loss is recognized). (2) A plan of liquidation was adopted within two years after the requisite stock was purchased (or if the stock was purchased in several stages, within two years after the date of the last purchase), the target was liquidated under Section 332 (a provision that provides nonrecognition treatment for the liquidation of a controlled subsidiary corporation). The parent need not have liquidated the target within the two-year period provided that it had adopted the plan of liquidation within the stated two-year period. The complete liquidation of target could be delayed for as long as three years after the plan was adopted without disqualifying the liquidation for Section 332 treatment. Consequently, the target could be operated for up to five years after its acquisition, and its tax attributes could be utilized during that period. When the liquidation of the target did not take place promptly after the purchase of its stock, it would have been inappropriate in determining the purchaser's basis in the target's assets to ignore the tax consequences of transactions of the target that occurred after its stock was acquired and prior to its liquidation. In that case, the purchaser's basis in the target's stock was adjusted to reflect gain or loss recognized by the target after its acquisition. In turn, the adjusted basis of the target's stock became the purchaser's basis in the target's assets upon the latter's liquidation.

The stock purchase was not treated as a purchase of assets for all purposes. The seller of the stock usually recognized capital gains on any gain recognized on the sale even though part or all of the gain that would be recognized on a direct sale of the target's assets would have been ordinary income. Also, the seller's gain was measured by his basis in the stock he sold rather than by the corporation's basis in its assets. On the liquidation of the acquired corporation under the old version of Section 334(b)(2), the old version of Section 336 generally prevented the liquidating corporation from recognizing gain or loss, although there were a number of circumstances in which the liquidating corporation had to recognize gain.

II. NONRECOGNITION FOR ASSET SALES PURSUANT TO A LIQUIDATION

Prior to the adoption of the 1954 Code, the order in which the sale of a corporation's assets and the liquidation of the corporation took place had great significance for tax purposes. If a corporation first sold its assets and then distributed the proceeds in liquidation, the transaction was subject to a double tax. If, instead, the shareholders of the target corporation first caused the liquidation of the target and then sold the target's assets, only a single tax incidence would be incurred. The following examples illustrate why that was so.

Ex. (1) In a year prior to 1954, A, an individual, owns all of the outstanding stock of T Corporation. The aggregate fair market value of T's assets is greater than T's basis therein. Similarly, the fair market value of the T stock that A holds is greater than A's basis in the stock. A wishes to sell his interest in T for cash. The tax treatment described in the following alternative transactions comport with pre-1954 law. If T were to sell its assets to a third party for their fair market value, T would recognize a taxable gain and would likely incur a tax liability. If T were then to distribute the net proceeds of the sale to A in liquidation of T, A would also recognize a taxable gain and would likely incur a tax liability. Thus, tax liabilities would be imposed twice on this transaction—once on T and again on A. The purchaser of T's assets would have a basis in those assets equal to their fair market value at the time of purchase.

Ex. (2) If, instead of selling its assets, T were to distribute its assets to A in complete liquidation, subject to a few exceptions, T would not recognize gain or loss on making that distribution. The liquidating distribution would constitute a taxable exchange to A who would therefore incur tax liability. A's basis in the distributed assets would equal their fair market value. If A were then to sell the assets for their value, A would not realize a gain on that sale. The purchaser's basis in the assets would equal their fair market value at the time of purchase. Thus, under pre-1954 law, by reversing the order of sale and distribution, the tax impact on the transaction was substantially altered.

There were two obstacles to the use of the second alternative as a means of minimizing the tax consequences. First, it was not always expedient to distribute a corporation's assets in kind. Second, and more importantly, the sale of a liquidated corporation's assets by a shareholder may be attributed to the corpora-
tion under the *Court Holding* doctrine.⁹

In the *Court Holding* case, the Supreme Court affirmed a Tax Court holding that a shareholder's sale of corporate assets received in liquidation of the corporation was in reality a sale on behalf of the corporation and that the corporation recognized taxable gain therefrom. The transaction was recharacterized as a sale of the assets by the liquidating corporation followed by a distribution to the shareholders of the proceeds of the sale. In the case, the corporation had negotiated the terms of the sale, received a small down payment, and then had distributed its assets to its shareholder who consummated the sale. The fears engendered by *Court Holding* were not abated by the Supreme Court's decision five years later in *United States v. Cumberland Public Service Co.*¹⁰ In *Cumberland*, the shareholders had unsuccessfully sought to sell their corporate shares to a buyer. In turn, the buyer offered to purchase most of the corporate assets from the corporation, but the corporation refused that offer. The corporation's shareholders then offered to acquire the corporate assets and to sell them to the buyer, and upon the buyer's acceptance, the transaction was effected accordingly. The Supreme Court held that the sale in *Cumberland* was not made on behalf of the corporation and therefore was not taxable to it. The reason that the result in *Court Holding* differed from the holding in *Cumberland* was that in *Court Holding* the corporation had come much closer to completing the sale prior to distributing its assets to its shareholder than had the corporation in *Cumberland*.

The result of the *Court Holding* and *Cumberland* cases was to attach unwarranted significance to the order in which the corporation's assets were sold and distributed and to burden shareholders who were contemplating corporate liquidations with substantial doubts as to the tax consequences. Congress sought to remedy this problem when it enacted the 1954 Code.¹¹ To that end, Congress adopted the old version of Section 337, which,

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⁹. This doctrine takes its name from the landmark case of Commissioner v. Court Holding Co., 324 U.S. 331 (1945).
¹¹. S. REP. No. 1622, 83d Cong., 2d Sess. 48-49 (1954). In that report, the Senate Committee on Finance stated: "The result of [the Court Holding and Cumberland] decisions is that undue weight is accorded the formalities of the transactions and they, therefore, represent merely a trap for the unwary." Id. at 49.
when applicable, denied recognition of gains or losses realized by a liquidating corporation on the sale of its assets.

In general, the old version of Section 337 provided nonrecognition for a liquidating corporation’s sale of its assets as long as the sale took place within twelve months after the plan of liquidation was adopted and as long as all of the corporation’s assets and proceeds from the sale of assets were distributed within twelve months after the plan of liquidation was adopted. The preceding statement of the rule is a generalization; the rule was subject to numerous exceptions and special provisions. Certain types of property were excluded from the nonrecognition otherwise provided by the old version of Section 337. For example, the recapture of depreciation rules and the LIFO recapture rules overrode the nonrecognition provision.

Repeal of nonrecognition for liquidating sales. In the Tax Reform Act of 1986, Congress repudiated the General Utilities doctrine and, subject to a few exceptions, required a liquidating corporation to recognize gain on making a liquidating distribution of appreciated property. Since in most circumstances, gain is recognized on making liquidating distributions, there was no longer any justification for providing nonrecognition for sales of appreciated property by a liquidating corporation. Accordingly, in the Tax Reform Act of 1986, Congress repealed the old version of Section 337. The current version of Section 337 shares the same section number as the old version, but it deals with an entirely different subject matter.

III. The Consequences of Electing Section 338 Treatment for a Qualified Stock Purchase

A. The Replacement of Old Section 334(b)(2) and of the Kimbell-Diamond Rule

In 1982, Congress repealed the old version of Section 334(b)(2) and replaced it with a new Section 338. This change continues the function of old Section 334(b)(2) without the requirement that the subsidiary be liquidated. In a taxable corporate acquisition, the purchasing corporation has the option of purchasing either the corporation’s assets or its outstanding stock. If the assets are purchased, the selling corporation has a taxable event with respect to each asset sold. The purchaser has
a cost basis in each asset. If the outstanding stock was purchased, old Section 334(b)(2) allowed the purchaser to liquidate the target, and the basis of the purchasing corporation in the assets received on liquidation equalled the purchase price for the stock as adjusted for gain or loss recognized by the target during the period between its purchase and its liquidation. The liquidating corporation recognized income only to the extent of several overrides (e.g., recapture provisions) to the then version of Section 336. Thus, taxable acquisitions of a corporation’s assets under the old version of Section 337 or of stock plus a liquidation under old Section 334(b)(2) achieve similar (although not identical) tax consequences. The substitution of new Section 338 for old Section 334(b)(2) was designed to bring even greater consistency between the two methods of taxable corporate acquisitions. Congress wished to eliminate the availability to a purchaser of delaying the complete liquidation of a target for as long as five years. This delay permitted the continued use of the target’s tax attributes for five years even though the purchaser obtained a stepped-up basis in the target’s assets. Congress also expressed its wish to eliminate the complexity in computing the purchaser’s basis in the target’s assets when the target’s liquidation took place several years after the acquisition of its stock. Additionally, Congress sought to simplify the rules applicable to taxable stock acquisitions, allow basis adjustment in assets of the target corporation without the necessity of liquidating it, and eliminate several tax avoidance schemes that had developed under old Section 334(b)(2).

B. The General Operation of Section 338

On January 12, 1994, Treasury published final regulations that describe much of the operation of Section 338. The final regulations are effective for acquisitions made after January 19, 1994; and for certain purposes, they apply earlier than that date. For example, for acquisitions made after January 13, 1992, and before January 20, 1994, an election can be made to have the

13. Id.
14. Id.
final regulations apply. In addition to the final regulations, there are also Temporary Regulations concerning the operation of Section 338 as to some matters not covered by the final regulations. The principal (but not the exclusive) thrust of these revised final regulations is to make substantial changes to the "consistency rules" of Section 338, which are explained in Part IV of this article. The discussion herein incorporates both the 1994 regulations and the current temporary regulations.

The operation of Section 338 is outlined below in broad terms. Since the focus of this article is on the consistency rules, it is not necessary for the reader to know all of the intricate details of the manner in which Section 338 operates.

A purchasing corporation (P) makes a "qualified stock purchase" of the stock of a target corporation (T). A "qualified stock purchase" refers to a corporation's "purchase" of a controlling interest in a target corporation within a "twelve-month acquisition period." In such cases, P is given an election under


16. P must purchase within the twelve-month acquisition period stock of T that possesses both: (1) at least 80% of the voting power of T's outstanding stock, and (2) at least 80% of the value of T's outstanding stock. I.R.C. §§ 338(d)(3), 338(h)(8), 1504(a)(2)(1994).


*Purchase.* The term "purchase" is defined in Section 338(h)(3) and is given a restricted meaning. See also Treas. Reg. § 1.338-2(b)(2)(1994). In general, a purchase is an acquisition of stock in which: (1) the basis of the stock in the hands of the purchaser is not determined in whole or in part by reference to the transferor's basis, (2) the acquisition was not one of certain nonrecognition exchanges listed in the statute and regulations, and (3) with one exception, the stock was not acquired from a related person (as defined in I.R.C. § 338(h)(3)(A)(iii)(1994)). Note that if Section 338 applies to a target that owns stock in another corporation (X corporation), new target's deemed acquisition of those shares of X stock that old target held is treated as a "purchase." I.R.C. § 338(h)(3)(B)(1994). For convenience, a purchasing corporation is often referred to herein as "P." Except when provided otherwise by regulation, when stock of a target corporation (T) is purchased by corporations which are members of the same affiliated group, such stock is treated as having been purchased by one corporation. I.R.C. Section 338(h)(8)(1994). Accordingly, the aggregate purchases of T stock by several corporate members of an affiliated group will be counted in determining whether there has been a qualified stock purchase.

In general, an "affiliated group" is one or more chains of corporations. For a corporation to be included within the group, other members of the group must own stock of that corporation possessing at least 80% of the voting power and at least 80% of the value of that corporation's outstanding stock. For this purpose, a corporation's nonvoting, nonparticipating, nonconvertible preferred stock (whose redemption and liquidation rights do not exceed its issue price plus a reasonable redemption or liquidation premium) is
Section 338 to have the tax consequences of the transaction determined under a special set of rules. An election to have Section 338 apply is sometimes referred to as a "Section 338 election."

The statute also establishes so-called consistency rules; in certain defined circumstances in which a qualified stock purchase takes place, the provisions of Section 338 will be applied as if P had made the election even though P does not make a Section 338 election and regardless of whether P desires to have that section apply.18 The statute authorizes Treasury to establish exceptions so that a deemed election will not be imposed in certain circumstances. Pursuant to that authority, the 1994 regulations narrow the scope of the consistency rules and provide a different consequence when they apply—i.e., Section 338 treatment will apply only if an actual election is made.19 The 1994 regulations' treatment of the consistency rules is explained in Part IV of this article.

If P makes an election under Section 338, T will be deemed to have sold all of its assets at fair market value in a single transaction at the close of the date on which P acquired control of T. The date on which P acquired the requisite control of T is referred to as the "acquisition date."20 Thus, T will recognize gain or loss on any appreciated or depreciated assets that it holds at the time that P acquires control of T. Prior to 1986, much (or all) of the gain or loss realized by T on this constructive sale of its assets was not recognized because of the operation of the old version of Section 337. As a consequence of the repeal of the old version of Section 337 by the Tax Reform Act of 1986, disregarded. In addition, the common parent must own stock in at least one of the member corporations that satisfies the two 80% tests described earlier in this paragraph. I.R.C. § 1504(a)(1994).

Twelve-month acquisition period. In general, this term means the twelve-month period beginning with the date of the first acquisition by purchase of stock included in a qualified stock purchase. I.R.C. § 338(h)(1)(1994). The twelve-month period is extended if the purchase of the requisite shares of the target's stock takes place over a period greater than twelve months because of an arrangement between the parties. Treas. Reg. § 1.338-4(f)(2)(1994).

Acquisition date. This term means the date within the twelve-month acquisition period on which the 80 percent purchase requirement (a qualified stock purchase) is first satisfied.

T will now recognize all of its realized gain or loss from the constructive sale.

The amount realized by T on the constructive sale of all its assets is referred to as the "aggregate deemed sales price" or by the acronym, "ADSP." The ADSP for a deemed sale of a target's assets is equal to the aggregate fair market value of those assets. Rather than permitting appraisals to be made of the values of the target's assets, however, the regulations provide a formula that constructs the value of the target's assets by a computation that utilizes the amount paid by P for T's stock and by taking into account T's liabilities, including the tax liabilities incurred by T as a consequence of the constructive sale. This formula is sometimes referred to as the "ADSP formula."

The ADSP formula applies only for purposes of determining the amount of gain or loss that T recognized on the constructive sale; it does not apply in determining the aggregate basis that T has in its assets after the constructive sale is deemed to have taken place. While the amount realized from a constructive sale will sometimes be the same as the aggregate basis that new T acquires in its assets, those two amounts will often be unequal.

Another consequence of the Section 338 election is that, on the day after the acquisition date, T is deemed to have repurchased all of the assets that T was deemed to have sold on the prior day. The "T" that makes this constructive purchase is treated as a new corporation. The election causes T to be treated as two separate corporations. There is old T, which sells all of its assets at the end of the acquisition date and which ceases to exist at that time; and there is new T, which is treated as a new corporation that purchases the assets of old T on the day after the acquisition date. The taxable year of old T closes on the acquisition date, and the taxable year of new T begins on the next day. Thus, all of the earnings and profits, net operating loss and capital loss carryovers and most other tax attributes of old T cease to exist after the acquisition date. Old T's carryover losses that are otherwise available as deductions can, how-

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24. Id.
ever, be deducted from any gain recognized by old $T$ in its final taxable year (ending on the acquisition date). Therefore, old $T$ may deduct such carryover losses from the net gain that it may have recognized on the constructive sale of all its assets. 26 Since new $T$ is a new corporation, it can adopt a new taxable year and a new method of accounting without regard to the taxable year and method of accounting employed by old $T$. 27 New $T$ can elect to depreciate its depreciable assets under Section 168 as a new purchaser under whatever method and convention it chooses without regard to the elections that had been made by old $T$. 28

But, for purposes other than the income tax and for many rules relating to the relationship of the corporation to its employees, old $T$ and new $T$ usually will be treated as one taxpayer. For example, for purposes of determining the FICA and FUTA taxes on wages of employees, old $T$ and new $T$ are treated as one taxpayer, and new $T$ must use the same employer identification number that old $T$ had. 29

There are some purposes for which old and new $T$ are treated as one taxpayer that do not relate to employees. In applying Sections 1311-1314 (relating to mitigation of the statute of limitations), old and new $T$ are treated as one taxpayer. 30 Also new $T$ is liable for old $T$’s federal income tax liabilities, including old $T$’s liability for income taxes incurred because of the constructive sale of all of its assets on the acquisition date. 31

A “consolidated group” refers to a group of affiliated corporations that file a consolidated federal income tax return. Each member of a consolidated group is jointly and severally liable for the federal income tax incurred by the group. 32 If old $T$ was a member of a consolidated group at the acquisition date, new $T$ is liable for any unpaid tax liabilities incurred by that consolidated group in taxable years in which old $T$ was a member of the group. 33 If an assessment of a deficiency in a consolidated group’s income tax liability occurs after the sale of old $T$’s stock

32. Treas. Reg. § 1.1502-6(a) (as amended in 1994).
(and if the sale was a bona fide sale for fair value), the district
director is authorized to limit the tax collected from new $T$ to
the portion of the deficiency that is attributable to old $T$. But
the district director will not do this if he believes that it will
jeopardize the collection of the balance of the deficiency.\textsuperscript{34} So, in
determining whether to buy the stock of a member of a consoli-
dated group, there is reason for concern as to the target’s liabil-
ity for undisclosed federal tax liabilities of the group for past
years.

New $T$'s aggregate basis in the assets that it is deemed to
have purchased from old $T$ are determined according to the
formula established by Section 338(b) and set forth in greater
detail in Treas. Reg. Section 1.338(b)-1. The aggregate basis of
new $T$'s assets is sometimes referred as the “adjusted gross-up
basis” or by the acronym, “AGUB.”\textsuperscript{35} New $T$'s AGUB is allo-
cated among its assets according to the terms established in
Temp. Reg. Section 1.338(b)-2(T).\textsuperscript{36} In general, this allocation
operates by dividing assets into four broad categories and by
providing a priority of allocation among those categories. The
priority established in the Temporary regulations results in
maximizing the basis allocated to goodwill and similar intangible
properties.

Section 338 deals with the recognition of gain or loss by a
target and with the bases that new $T$ will have in its assets when
a qualified stock purchase takes place. Absent an election under
Section 338(h)(10),\textsuperscript{37} the federal income tax on any gain recog-
nized by old $T$ on the constructive sale of its assets on the acqui-
sition date will not be borne by the shareholders of old $T$ even if
old $T$ was a member of a consolidated group. If old $T$ was a
member of a consolidated group, it must file a separate short-
year tax return in which it reports the income or loss from the
constructive sale of its assets on the acquisition date. Since $T$ is
controlled by $P$ (the purchasing corporation) by the time of the
acquisition date, the incidence of a tax on old $T$'s constructive
sale of its assets will fall on $P$ rather than on the shareholders of

\textsuperscript{34.} Treas. Reg. § 1.1502-6(b) (as amended in 1994).
\textsuperscript{35.} Treas. Reg. § 1.338(b)-1(a) (1994).
\textsuperscript{36.} Id.
\textsuperscript{37.} The operation of § 338(h)(10) is explained later in this article. See infra
notes 39-60 and accompanying text.
old $T$ who sold their stock to $P$; this will be true even when old $T$ was a member of a consolidated group.\footnote{See I.R.C. § 338(h)(9)(1994); Treas. Reg. § 1.338-1(e)(2) (1994).} Of course, the selling price of the stock can be negotiated so that all or a part of the tax burden will effectively be borne by the shareholders of old $T$.

Since 1986, an election to have Section 338 apply has required the immediate recognition of the target’s unrealized gain on its assets. Accordingly, there are many fewer circumstances in which it will be desirable to make that election, and Section 338 has much more limited significance than it had prior to 1986.

The repudiation by Congress of the General Utilities doctrine, which includes the repeal of the old version of Section 337, has created a tax bias in favor of purchasing stock of a target corporation (and making no Section 338 election) rather than purchasing the target’s assets. This bias occurs when the target is not a subsidiary that can be liquidated under Section 332 without causing recognition of gain. If the target’s assets are purchased, there will be a tax imposed on the recognition of the unrealized appreciation of the target’s assets; and, in order for the original shareholders of the target promptly to obtain the proceeds of that sale, they will have to recognize a second tax on the appreciation of their stock when they distribute the proceeds in liquidation of the target.\footnote{Recognition of gain by a parent corporation will not occur if the target can be liquidated under § 332, but even in that event minority shareholders would recognize their gain.} On the other hand, if the purchaser acquires the stock of the target, there will only be a single tax, which is imposed on the recognition of the unrealized appreciation of that stock. In the latter case, the target’s basis in its assets will be unchanged, and so the unrealized appreciation in those assets will effectively be recognized either when the target sells its assets or by providing a lower amount of annual depreciation for that asset. But, the tax cost for having a reduced basis in the target’s assets in a stock purchase will be incurred in years subsequent to the year of acquisition; while the tax cost for recognizing a gain when the target is liquidated after an asset sale will be incurred immediately. Because of the time value of money, there is a significant benefit in deferring the imposition of a tax cost to a future date. So, in most circumstances, there can be a cost saving to purchasing and selling stock of a
target rather than its assets. The purchaser and seller may allocate the benefit of this saving between themselves by altering the price to be paid for the stock. There is no policy justification for the tax law to encourage the purchase and sale of a target's stock rather than its assets.

C. Section 338(h)(10) Election

The pre-1986 version of Section 338 granted a corporation (or corporations) that sold the target's stock (the "seller") an election (a Section 338(h)(10) election) to treat the stock sale as a sale of the target's assets in certain circumstances. This election was permitted only if there was a deemed sale of the target's assets under Section 338 and if the stock sale was made by members of an affiliated group of corporations (of which the target also was a member) that file a consolidated return. If the election were made, the sellers would recognize no gain or loss on the sale of the stock, but the gain or loss recognized on the constructive sale of the target's assets would be included in the selling group's consolidated return. An amendment to Section 338(h)(10) that was made by the Tax Reform Act of 1986 retains that provision and authorizes Treasury to extend the same treatment to certain other sellers.

The amendment made by the Tax Reform Act of 1986 authorizes Treasury to promulgate regulations granting a Section 338(h)(10) election to a sale of a target's stock by an affiliated group of which the target is a member regardless of whether the group files a consolidated return. An "affiliated group" of corporations is a group that meets the requirements of Section 1504(a) without regard to the exceptions set forth in Section 1504(b). In general, an affiliated group under Section 1504(a) is a chain of two or more corporations with a common parent. For a corporation to be a member of an affiliated group, the corporation (other than the common parent of the group) must have outstanding stocks owned by other members of the group that represent at least 80 percent of the voting power of such corporation's voting stock and have an aggregate value equal to at least 80 percent of the value of all of the corporation's outstanding stocks. In determining whether the 80 per-

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cent of value requirement is satisfied, nonvoting, nonparticipating, nonconvertible preferred stock is ignored unless it provides redemption or liquidation rights that exceed its issue price plus a reasonable redemption or liquidation premium.  

In the final regulations published in January, 1994, Treasury accepted the Congressional invitation to extend the Section 338(h)(10) election to certain affiliated corporations that do not file a consolidated return. In addition, the 1994 regulations allowed the election to be made for the sale of stock of an S corporation. Accordingly, a Section 338(h)(10) election can be made for a target only if the target is: (1) a member of a selling consolidated group, (2) a member of a selling affiliated group filing separate returns, or (3) an S corporation. A “selling consolidated group” is a selling group that files a consolidated return for the period that includes T’s acquisition date; T will, therefore, be a member of the consolidated group on the acquisition date. A “selling affiliate” is a domestic corporation from whom the purchasing corporation purchased sufficient T stock on the acquisition date to satisfy the stock-holding requirements of Section 1504(a)(2) and which is not a member of a selling consolidated group.  

P (the purchasing corporation) can make a Section 338(h)(10) election only if it makes a qualified stock purchase from either (1) a selling consolidated group, (2) a selling affiliate, or (3) the shareholders of an S corporation. In the case of an affiliated group that does not file a consolidated return, the election is available only as to sales of T stock that are made by the selling affiliate; consequently, it appears that if more than one member of the affiliated group sold T stock to P, no more than one of the selling corporations (the selling affiliate) can benefit from the election.

42. An S corporation is a corporation that satisfies certain requirements and that elects to have the provisions of Subchapter S apply so that it incurs little or no federal income tax and instead passes through to its shareholders its income, deductions, and credits.
45. Stock possessing at least 80% of the voting power of T’s outstanding stock and having a value equal to at least 80% of the aggregate value of T’s outstanding stock are necessary to meet these requirements. I.R.C. § 1504(a)(2) (1994).
A Section 338(h)(10) election applies to \( T \) only if a Section 338 election is applicable to \( T \). However, if a valid Section 338(h)(10) election is made for \( T \), that election is treated as simultaneously also making a Section 338 election for \( T \).\(^{47}\)

A Section 338(h)(10) election must be made jointly by the purchasing corporation \( (P) \) and either the selling consolidated group, the selling affiliate, or the shareholders of the \( S \) corporation, as the case may be. The election must be made no later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs.\(^{48}\)

When a valid Section 338(h)(10) election has been made for a target \( (T) \), old \( T \) is treated as having sold all of its assets in one transaction at the close of the acquisition date at a price determined under a formula provided by the regulations.\(^{49}\) Immediately after the deemed sale of its assets, \( T \) is deemed to have distributed all of the proceeds pursuant to a complete liquidation. The liquidation and distribution are deemed to have taken place while old \( T \) is still owned by the selling consolidated group or by the selling affiliate (or by its shareholders if \( T \) is an \( S \) corporation).\(^{50}\)

If the Section 338(h)(10) election is valid, no gain or loss is recognized by the selling consolidated group, the selling affiliate, or by the shareholders of a target that is an \( S \) corporation, for the sale of the target's stock that is part of a qualified stock purchase.\(^{51}\) Instead, as shown below, those sellers will recognize gain or loss from \( T \)'s deemed sale of its assets. Any sale of \( T \)'s stock by some other seller (i.e., a shareholder who is not a member of the consolidated selling group and who is not a selling affiliate or a shareholder of an \( S \) corporation) will produce gain or loss to that seller. Such other shareholders are sometimes referred to as "minority shareholders."

Where \( T \) makes a constructive liquidating distribution to a selling consolidated group or selling affiliate, the liquidation will qualify for nonrecognition treatment;\(^{52}\) and, pursuant to the pro-

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visions of Section 381 (subject to the limitations imposed by Sections 382-384), the selling consolidated group or the selling affiliate will inherit all or a part of T's tax attributes (such as its earnings and profits, its net operating loss and capital loss carryovers). If T makes a constructive liquidating distribution to shareholders of an S corporation, the shareholders will recognize gain or loss.\textsuperscript{53}

If T's stock was sold by a selling consolidated group, the group must file a consolidated return for the period that includes the acquisition date;\textsuperscript{54} and so, the consolidated group will report in its consolidated return the gain or loss incurred by T on the deemed sale of its assets and will therefore incur the tax liability for that deemed sale. If, instead, T was an S corporation, its gain or loss from the deemed sale of its assets will pass through to its shareholders.\textsuperscript{55} If T makes a deemed liquidating distribution to a selling affiliate, it appears that the tax incurred by T on the deemed sale of its assets will be borne by the selling affiliate as a constructive transferee of T's assets. In any event, Treas. Reg. Section 1.338(h)(10)-1(e)(1), provides that, when old T's stock was purchased from a selling affiliate or from shareholders of an S corporation, the principles of several other regulatory provisions, including Treas. Reg. Section 1.338(h)(10)-1(e)(6), apply to the return for old T's deemed sale. As noted above, Treas. Reg. Section 1.338(h)(10)-1(e)(6) requires a selling consolidated group to file a consolidated return for the period that includes the acquisition date. Applying that principle to a sale by a selling affiliate, the tax liability incurred because of the gain or loss recognized by old T on the deemed sale of its assets becomes a liability of the selling affiliate.

Notwithstanding that, when Section 338(h)(10) applies, the sellers of old T's stock are primarily liable for the tax liability incurred on the deemed sale of old T's assets, new T also is liable for the tax liabilities that old T had (including the tax liability for the deemed sale of old T's assets).\textsuperscript{56} Consequently, the purchasing corporation (P) has a secondary vulnerability to bear

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\textsuperscript{53} I.R.C. § 331 (1994). Note that an S corporation cannot have a shareholder that is a corporation. I.R.C. § 1361(b)(1)(B) (1994).

\textsuperscript{54} Treas. Reg. § 1.338(h)(10)-1(e)(1) (1994).

\textsuperscript{55} I.R.C. § 1366 (1994).

the tax liability for the deemed sale of old T's assets. The basis that a selling consolidated group, selling affiliate, or shareholders of an S corporation have in T stock that they retain (i.e., do not sell to P) equals the stock's fair market value as determined by a formula.57

Minority shareholders (i.e., those who are not members of the selling consolidated group and who are not a selling affiliate or a shareholder of a target that is an S corporation) do not receive any special tax treatment from a Section 338(h)(10) election. If they retain their stock in the target, they will recognize no gain or loss and their basis in their shares will remain the same as it was before the qualified stock purchase took place. If they sell to the purchaser any of their shares of the target's stock, they will recognize gain or loss on that sale.58

On the constructive sale of its assets, old T is treated as having received an amount determined under a formula. As noted earlier, when a Section 338 election is made (but a Section 338(h)(10) election is not made), the selling price of the target's assets is determined by using a formula that is set forth in the regulations. The amount deemed to have been received by old T for its assets is referred to as the "aggregate deemed sales price" or by its acronym, "ADSP." When a Section 338(h)(10) election is made, the purchase price of the constructively sold assets is determined by a formula that is based on the ADSP formula with some modifications. The formula employed is a modified version of the ADSP formula, and is referred to as the "MADSP formula."59 A major difference between the MADSP formula and the ADSP formula is that the latter takes into account the tax liability incurred as a consequence of the constructive sale and the former does not.60 When there is a Section 338(h)(10) election, there is no reason to include the tax liability

60. The temporary regulations that were replaced by the 1994 final regulations were clear in providing that the tax liability incurred from the deemed sale of old T's assets is excluded from MADSP. Temp. Treas. Reg. § 1.338(h)(10)-1T(g), Ex. (2) (1994). An example of the 1994 final regulations, which corresponds to the example used in the prior temporary regulations, also indicates that the tax liability from the deemed sale is excluded both from MADSP and from the determination of new T's basis in its assets. Treas. Reg. § 1.338(h)(10)-1(g)(2) (1994), Ex. (1).
incurred on the constructive sale of T's assets in the purchase price since the Section 338(h)(10) election places the incidence of that tax on the selling group. In a Section 338 election in which an (h)(10) election is not made, the incidence of the tax falls on the purchaser and is properly included in the price paid for the assets.

The MADSP price that is determined as the selling price of all old T's assets is then allocated among those assets. In general, this allocation operates by dividing assets into four broad categories and providing a priority of allocation among those categories.61

IV. THE CONSISTENCY RULES

When Congress first adopted Section 338 in 1982, it expressed concern that if no provision was made to prevent it, taxpayers could manipulate Section 338 elections in combination with other tax provisions in order to treat only some of the target's assets as having been sold. If so, a target could have gain recognition and change of basis apply only to selected assets; the remaining assets would not trigger gain recognition and would have a carryover basis. A step-up in basis is of greater value for some assets than for others. (For example, it may be of little use to step-up the basis of undeveloped land, and a step-up of the basis of goodwill will provide a smaller benefit than would an increase in the basis of assets that can be amortized over a much shorter period). Prior to 1966, the gain realized on the sale (or deemed sale) of many of a corporation's assets could escape recognition when the old version of Section 337 applied; but some assets did not qualify for nonrecognition (e.g., the recapture of depreciation rules overrode nonrecognition provisions). If the corporations could pick and choose, gain would be realized at the corporate level only on those assets that qualified for non-recognition. In addition, the purchaser could retain the benefits of the advantageous tax attributes of the target and still obtain a step-up in basis for selected assets.

The problem of selective treatment of a target's assets existed prior to 1982 in various forms. For example, a corporate purchaser could purchase selected assets directly from the target

and then acquire the target’s stock. The purchaser would thereby obtain some of the target’s tax attributes and yet obtain a cost basis for the assets of the target that it purchased. Another means of accomplishing the same result required the target, prior to its acquisition, to disperse selected assets in tax-free transactions among several corporations. The acquiring corporation then separately purchased these several corporations’ and the target’s stock. The acquiring corporation would then liquidate those subsidiary corporations whose assets it wished to have at a cost basis; it would obtain a cost basis in those assets because of the provisions of the old version of Section 334(b)(2) (the codification of the Kimbell-Diamond rule) that then existed.\footnote{62. See Conference Report to TEFRA, H.R. Rep. No. 760, 97th Cong., 2d Sess., 535-36 (1982).}

In the 1982 Act, Congress expressed the view that selective nonrecognition of gain was an unwarranted extension of the General Utilities doctrine, and so Congress modified the tax law to prevent many of those prior practices from accomplishing that result. Congress did not wish to undermine that modification by opening up a new means for taxpayers to accomplish the same result by using Section 338. To prevent that from occurring, Congress enacted two sets of so-called “consistency rules.” Section 338(e), (f). The primary concern of Congress was to prevent the sale of selected assets (with a resulting recognition of gain and a step-up in basis) and the deferral of recognition of the appreciation of other assets of the target; because, as a consequence of the General Utilities doctrine, the unrealized appreciation of other assets might never be recognized at the corporate level. Regardless of whether there was adequate justification for adopting the consistency rules, when, four years later, Congress terminated the last vestiges of the General Utilities doctrine and substantially strengthened the restrictions of Sections 382 and 383 on the continuing availability of a target’s tax attributes, it eliminated most, and perhaps all, of the reasons for having those rules. In recognition of that fact, Treasury promulgated its proposed regulations in January, 1992, the principal purposes of which were to change the operation of the consistency rules and to restrict their application.\footnote{63. The proposed regulations were finalized on January 12, 1994. See Prop. Treas.
The original statutory scheme was reflected in temporary regulations that were replaced by the 1994 final regulations. However, a knowledge of the original statutory scheme and the defunct temporary regulations is useful to understanding the final regulations. Therefore, a brief discussion of the statutory provisions and the treatment by the temporary regulations follows, but most of the discussion will concentrate on the revised 1994 rules.

The statutory scheme. The consistency rules that Congress adopted in 1982 are divided into two separate sets. One set of consistency rules deals with stock acquisitions, and the other deals with asset acquisitions. Before examining those two sets of rules, certain terms need to be defined.

(1) Affiliated group. Section 338 adopts the definition of this term that is set forth in Section 1504(a), but determined without regard to the exceptions contained in Section 1504(b). Section 1504(a) defines an “affiliated group” as a specific group of parent-subsidiary chains of corporations in which: (1) stock possessing at least 80 percent of the voting power of the outstanding voting stock and at least 80 percent of the total value of the outstanding stock of each corporation (other than the common parent corporation) is owned directly by one or more of the other corporations; and (2) the common parent owns directly stock possessing at least 80 percent of the voting power of the outstanding voting stock and at least 80 percent of the total value of the outstanding stock of at least one of the corporations. The term “stock” does not refer to nonvoting stock that is limited and preferred as to dividends, has limited redemption and liquidation rights and is nonconvertible.

(2) Consistency period. This term means the period consisting of (1) the one-year period before the beginning of the twelve-month acquisition period for T, (2) the portion of the twelve-month acquisition period up to and including the acquisition date, and (3) the one-year period beginning on the day after the


64. I.R.C. §§ 338(a), 338(f) (1994).
acquisition date. Under certain circumstances when a purchasing corporation or a related person had an arrangement to purchase stock or assets of a target (or an affiliate of a target) over a greater period than the normal consistency period, the consistency period will be expanded either backward or forward. 67

(3) Target affiliate. A corporation is treated as a target affiliate of T if each such corporation was, at any time during so much of the consistency period as ends on the acquisition date of T, a member of an affiliated group which had the same common parent. 68 A limited category of corporations (principally foreign corporations) are excepted from the definition. 69

(4) Aggregation of purchases. Section 338(h)(8) provides that, except as provided otherwise in regulations, stock and asset acquisitions made by members of the same affiliated group shall be treated as made by one corporation. Thus, the aggregate purchases of T stock by several members of an affiliated group will be counted in determining whether there has been a qualified stock purchase.

When P acquires T stock by a qualified stock purchase and makes a timely Section 338 election, if T owns stock in a third corporation (T1), the deemed sale and purchase of that T1 stock as a result of P's Section 338 election can itself be a qualified stock purchase. Therefore, if a Section 338 election is made for T1, it will cause a deemed sale and purchase of T1's assets. 70 This should be borne in mind when considering the discussion below.

The thrust of the consistency rules that Congress enacted in 1982 is to impose Section 338 treatment in certain circumstances even though the purchaser did not elect to have that provision operate. There are two broad sets of circumstances in which this occurs—the stock acquisition consistency rule and

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the asset acquisition consistency rule.

Stock acquisition consistency rule. If a corporate purchaser acquired the stock of two or more corporations that were previously members of an affiliated group, and if the acquisitions took place within a fairly short period of time, Congress did not wish to permit the purchaser to elect Section 338 treatment for some but not for others of those acquired corporations. So, if the purchaser made a valid Section 338 election for a target for which there was a qualified stock purchase and if within the consistency period the purchaser subsequently made a qualified purchase of the stock of one or more target affiliates, Congress required that the Section 338 election for the target also apply to each such target affiliate. Conversely, if the purchaser did not elect Section 338 treatment for the target, it was barred from making a Section 338 election for such target affiliates.\(^7\) This provision is known as the stock acquisition consistency rule. The reason that Congress imposed this rule was to prevent the parties from selecting some of the target's assets for deemed sale and purchase treatment while excluding other assets from that treatment. Without this consistency rule, a target could disperse its assets among several corporations in tax-free transactions and then sell the stock of those corporations to the purchaser who would elect Section 338 treatment for some of the corporations but not for others. As noted earlier, acquisitions made by members of an affiliated group are treated as made by one corporation, and so the references above to stock acquisitions by a purchaser include acquisitions by affiliated corporations.\(^2\)

One of the consequences of the stock acquisition consistency rule is that it could cause a deemed Section 338 election to be applied to subsidiaries of a target for which a Section 338 election is made. As noted later, the 1994 regulations prevent that from occurring because they eliminate all deemed Section 338 elections. The following example illustrates how a deemed election for a subsidiary could occur if the 1994 regulations had not eliminated this issue.

\textbf{Ex.} Individual } A \text{ owned 100 percent of the stock of } T, \text{ which in turn owned 100 percent of the stock of } S. \text{ On July 20, } P \text{ pur-

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chased from A all of the stock of T and made a timely Section 338 election. Because of the deemed sale of T's assets, all of the S stock is deemed to have been sold by old T and purchased by new T. The purchase by new T constitutes a qualified stock purchase. Section 338(h)(8) provides that acquisitions by members of the same affiliated group are treated as made by one corporation. After the purchase of T's stock, P and T became members of the same affiliated group, and the deemed purchase of the S stock by new T occurred within T's consistency period. Since the qualified stock purchases of the T stock by P and of the S stock by new T occurred within T's consistency period, and P and new T are treated as one corporation, the consistency requirements of Section 338(f)(1) are satisfied. Therefore, were it not for the changes made by the 1994 regulations, the Section 338 election that P made for T would cause a deemed sale of the assets of S even though no Section 338 election was made for the deemed qualified purchase of the stock of S. However, as a consequence of the 1994 regulations, there will not be a deemed sale of the assets of S unless T makes a Section 338 election for S.

Asset acquisition consistency rule. The other device that Congress sought to prevent was a sale of assets by a target or a target affiliate to the purchaser combined with a purchase of the target's stock without making a Section 338 election. By that means, the purchaser could obtain a cost basis for some of the target's assets and yet avoid gain recognition on other assets and retain the target's tax attributes. To prevent this, Congress imposed Section 338 treatment on a target if at any time during the consistency period the purchaser acquired an asset of the target or of a target affiliate. This provision is known as the asset acquisition consistency rule. The statute established several exceptions to that provision and authorized Treasury to establish additional exceptions in its regulations. As noted, acquisitions made by members of an affiliated group are treated as made by one corporation, and so the references above to asset acquisitions by a purchaser include acquisitions by affiliated corporations. When an asset is acquired in such manner by a pur-

chaser or affiliated corporation, the acquisition is referred to as a "tainted asset acquisition."

The asset acquisition consistency rule is especially troublesome because a minor sale's transaction could cause Section 338 deemed asset sale treatment and thereby cause recognition of a very large amount of gain. This possibility became of even greater concern when the General Utilities doctrine was virtually eliminated by Congress in 1986. Because of the asset acquisition consistency provision, Section 338 could be triggered inadvertently with serious adverse tax consequences. The now defunct temporary regulations provided some relief from that danger.

_Carryover basis elections._ The defunct Temp. Reg. Section 1.338-4T(f)(6) established a "protective carryover election" for a purchaser. If such an election was timely made, "tainted acquisitions" of assets of the target and target affiliates would not cause the imposition of Section 338 treatment. Instead, the defunct temporary regulation imposed a carryover basis on the purchaser of such a tainted asset—that is, if the election was made, a purchaser of such an asset obtained the same basis in the asset that the transferor had. Once made, a protective carryover election was irrevocable and precluded a Section 338 election. Many purchasers of a target's stock made protective carryover elections to guard against inadvertently triggering Section 338 treatment where that treatment was undesirable (as frequently is the case).

The defunct temporary regulations also made provision for a tainted asset acquisition when the purchaser did not make a protective carryover election. In such a case, the defunct regulation provided for a so-called "affirmative action carryover election" that operated in essentially the same manner as a protective carryover election did. The "election" in the case of the affirmative action carryover election was not in the hands of the taxpayer. It was the Service who had the power to make the carryover provision applicable or not. If a protective carryover election was not made, the affirmative action carryover election applied unless the District Director determined not to have it apply because it would be more appropriate to the purposes of the consistency rules to have the deemed sale provisions of Section 338 apply to the transaction. In some circumstances, carry-
over basis treatment for tainted asset acquisitions and the resulting avoidance of a deemed Section 338 election would be advantageous to the parties, but in some circumstances carryover basis treatment would be extremely harsh on them. Since the discretion as to which rules will apply lay in the hands of the District Director, there was concern among tax practitioners that District Directors would exercise that discretion so as to maximize the parties' tax consequences.

Regulatory elimination of the statutory scheme of imposing Section 338 deemed sale treatment when no election was made. The 1994 regulations eliminate the mandated imposition of Section 338 deemed asset sale treatment. Under the 1994 regulations, a deemed sale and purchase of a target's asset arise only if the purchaser makes a valid Section 338 election. The 1994 regulations also eliminate both the protective carryover basis election and the affirmative action carryover basis election (as well as several other mitigating provisions that were included in the defunct temporary regulations); the deletion of provisions that impose Section 338 deemed asset sale treatment eliminates the need for mitigating provisions. As shown below, the 1994 regulations severely limit the application of the consistency rules and make significant changes to the operation of those rules.

Before the General Utilities doctrine was essentially eliminated, the opportunity for a target to recognize gain only on selected assets could result in there never being a corporate tax imposed on the appreciation of the target's other assets. After the 1986 Act's repudiation of virtually all of the General Utilities doctrine, there was no longer a risk that this could occur. In addition, the 1986 Act strengthened the statutory restrictions on the availability of a target's tax attributes. Consequently, after 1986, there was little or no reason to continue to impose consistency requirements.

The only remaining risk (if it can be so characterized) is the potential for a target to sell depreciated assets for a loss and retain its appreciated assets. But, that kind of "cherry picking" of losses is endemic to our entire realization-based income tax

76. The current restrictions on the acquisition of a target's tax attributes are set forth in §§ 382-84 and §269.
system and requires no specific remedy in this isolated circumstance.

There is an issue, therefore, as to whether there is any justification for Congress to retain consistency rules in the statute. But, since Congress has not yet removed the consistency rules from the Code, Treasury may have gone about as far as it could to minimize their scope and impact. In doing so, however, Treasury did state its view that it is desirable to impose the limited consistency rules that are included in the 1994 regulations in order to curb certain potential abuses. The author discusses below whether those perceived abuses really exist and how the 1994 regulations operate.

The 1994 regulatory modification of the consistency rules. In 1992, Treasury determined that as a consequence of the removal of the General Utilities doctrine from the tax law, there was no longer any reason to impose Section 338 deemed asset sale treatment on a corporation when no express election was made. Accordingly, the 1992 proposed regulations eliminated that treatment entirely, and the proposed regulations were adopted as final regulations in 1994. Since Congress did not remove the consistency rules from the Code and since the Code provisions mandating deemed asset sale treatment are still intact, a question might arise as to Treasury's authority to remove those provisions by regulatory action. As to the asset acquisition consistency rule, Section 338(e)(2)(D) authorizes Treasury to create by regulation additional exceptions to that provision under "such conditions as such regulations may provide." It is an interesting question whether that statutory authorization permits Treasury to create a blanket exception that completely eliminates all deemed asset sale treatment. As to the stock acquisition consistency rule (Section 338(f)), there is no explicit statutory authorization for Treasury to create an exception to that provision. Section 338(i) instructs Treasury to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section." It is questionable whether that instruction permits Treasury effectively to expunge explicit statutory language merely because the provisions have become unnec-

necessary. This issue probably will never be tested since it is unlikely that the liberalizing alteration of the consistency rules by Treasury will be challenged by anyone.

Quite possibly, the reason that Treasury included even minor consistency rules in its proposed regulations is attributable to Treasury's concern that it lacks authority to remove all traces of statutory rules that have not been repealed. The probability of that being Treasury's true motive becomes especially high when the frailty of the justifications offered for the retained consistency rules is exposed.

While Treasury eliminated most of the consistency rules in its 1994 regulations, Treasury did retain a significantly reduced version of the rules. Under the 1994 regulations, the consistency rules operate in a very limited set of circumstances, and, when they are invoked, they cause carryover basis treatment for acquired assets rather than causing a deemed sale of assets. Treasury expressed concern that if some remnant of the consistency rules were not retained, there would be opportunities for tax abuse. Treasury set forth two illustrations of how that abuse might take place. The author will examine those illustrations and consider whether they represent tax abuses. Since one of the principal areas of concern centers on the use of certain provisions in the consolidated return regulations, the author will first examine those provisions and then consider Treasury's illustrations.

*Pertinent consolidated return treatment.* The operating rules for determining income for an affiliated group of corporations that file a consolidated return are set forth in regulations.

The provision of the consolidated return regulations that caused Treasury the most concern is the "investment adjustment" provision that is set forth at Treas. Reg. Section 1.1502-32. Under that provision, at the end of each year, a member of the consolidated group that holds stock in another member adjusts its basis in that stock. Depending upon circumstances, the adjustment could be positive (and so increase the basis that a

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80. Id. at 1410-11.
member has in the other member's stock) or negative.\textsuperscript{83} For convenience, we will refer to the member that holds stock in another member as the "higher tier affiliate," and we will refer to the member the basis of whose stock is being adjusted as the "lower tier affiliate." The positive and negative adjustments to the stock held by a higher tier affiliate are combined to form a "net positive adjustment" or a "net negative adjustment" as the case may be. Adjustments made to the basis of common stock of a lower tier affiliate held by a higher tier affiliate include: (1) increasing the basis by an allocable part of the undistributed positive earnings and profits of the lower tier affiliate for that taxable year, (2) decreasing the basis by an allocable part of the deficit earnings and profits that the lower tier affiliate had for that taxable year, and (3) generally decreasing the basis by distributions made by the lower tier affiliate on those shares of stock to the extent made out of earnings and profits that were accumulated in prior years.\textsuperscript{84}

If another member of the consolidated group (hereinafter referred to as a "parent member") owns common stock of a higher tier affiliate, the parent member increases its basis in the common stock of the higher tier affiliate that it holds by an allocable part of the net positive adjustment that was made that year to the basis that the higher tier affiliate had in the common stock of the lower tier affiliate.\textsuperscript{85} Thus, the net positive adjustment that is made to basis of stock held by a member of the consolidated group passes upward in the chain of member corporations to increase the basis of stock held by members at a higher level in that chain. Adjustments are provided also for a member's basis in preferred stock of a lower tier affiliate, but there is no need to examine those rules.\textsuperscript{86}

Treasury has not identified the treatment accorded distri-
butions from one member of a consolidated group to another member as a source of potential tax abuse. But, since some commentators have made reference to those consolidated return rules, the author will briefly describe a few of them.

A Section 301 distribution made to a higher tier affiliate does not cause income recognition to the distributee. As previously noted, a Section 301 distribution from a lower tier affiliate may reduce the basis that the higher tier affiliate had in the distributing corporation's stock. To the extent that the amount distributed exceeds the higher tier affiliate's basis in that stock, the excess does not cause income recognition; instead, the excess is added to an "excess loss account," which causes income recognition when the higher tier affiliate disposes of the stock or when either the higher or the lower tier affiliate ceases to be a member of the consolidated group. Thus, the gain from a receipt of a Section 301 distribution in excess of basis is deferred rather than excluded from income. Similar rules apply to distributions made to a higher tier affiliate that constitute either partial liquidations or Section 302(a) redemptions.

If a lower tier affiliate otherwise recognizes gain because of distributing an appreciated asset to a higher tier affiliate as a distribution on or redemption of its stock, or pursuant to a partial liquidation, the recognition of such gain is deferred. The times when the deferred gain will be recognized are described in the regulations.

_Treasury's reasons for retaining a consistency rule._ With one exception described later in this article, the 1994 regulatory version of the consistency rules will apply only when the target is a lower tier affiliate in a consolidated group (i.e., an affiliated group of corporations that file a consolidated return). Because of the investment adjustment provision of the consolidated return rules, when a lower tier affiliate sells an appreciated asset for a gain, the resulting increase in the lower tier affiliate's earning and profits will cause an increase in the basis that a higher tier affiliate has in stock of the lower tier affiliate that it holds. As a

89. Treas. Reg. § 1.1502-14(b) (as amended in 1994).
90. Treas. Reg. §§ 1.1502-14T(d), 14T(a) (as amended in 1994).
91. Treas. Reg. § 1.1502-14T(a) (as amended in 1994).
consequence, any gain that the higher tier affiliate otherwise would recognize on the subsequent sale of that stock will be reduced and double taxation can be avoided. Treasury's concern was to prevent the purchaser from obtaining a cost basis in selected assets of the target without causing any more gain to be recognized than would have been recognized if the purchaser had simply bought the stock of the target and made no Section 338 election (in which case, the parties would not have obtained a cost basis in the target's assets). The following example is taken from one that is set forth in the preamble to the 1992 proposed regulations.

Ex. (1) S owns all of T's outstanding stock, and S and T file a consolidated return. S has a $100,000 basis in the T stock, which has a fair market value of $200,000. On January 1, Year One, T sells an asset to P (an unrelated corporation) for its value and thereby recognizes a gain of $100,000. As a consequence, the basis that S has in the T stock is increased to $200,000. On March 1, Year One, S sells the T stock to P for its value of $200,000, and S recognizes no gain on that sale. No Section 338 election was made.

As will be shown later in this article, Treasury's 1994 regulations will require P to take a carryover basis in the asset that it purchased on January 1. Treasury's concern is that if consistency rules are not applied, the aggregate gain recognized by S and T would be only $100,000 even though P obtained a cost basis in the purchased asset. Let us consider whether that concern is well founded. To do so, the author will supply several alternative subsets of facts to Ex. (1) as indicated in the following examples.

Ex. (2) The same facts as those stated in Ex. (1) except that T did not sell an asset to P prior to the sale of T's stock, and the following subset of facts exist. Immediately prior to the sale of the T stock, T owned two assets—asset 1 in which T had a basis

92. To the extent that the increase in a higher tier affiliate's basis in stock results in the recognition of a loss (or of a greater amount of loss) on the sale of that stock, the consolidated return regulations deny a deduction for that loss. Treas. Reg. § 1.1502-20 (as amended in 1994).
93. See supra note 78.
of zero and which had a fair market value of $100,000, and asset 2 in which T had a basis of $100,000 and which had a fair market value of $100,000.

If S then sold the stock to P for its $200,000 value and if no Section 338 election were made, S would recognize a gain of $100,000; T would not recognize any gain; and there would be no change in the basis of T's assets. Thus, S and T would recognize an aggregate gain of $100,000, but there would be no increase in the basis of the assets that T held. This is in contrast to the consequence (if no consistency rule were adopted) shown in Ex. (1) if T first sold asset 1 to P for $100,000, and subsequently, S sold the T stock to P. In that latter event, if the consistency rules had not been retained by Treasury, S and T would still have an aggregate gain of $100,000, but there would also be an increase of $100,000 in the basis of asset 1. However, an examination of several other alternatives and tax policy considerations suggest that there is no tax abuse, and that the adoption of a complex mechanism to prevent a step-up in basis for the assets sold in Ex. (1) is still advised.

Ex. (3) The same facts as those stated in Ex. (2) except that the sales that take place are as follows. On January 1, Year One, T sells all of its assets to P for $200,000 cash, and T thereby recognizes a gain of $100,000. On March 3, Year One, T liquidates and distributes its assets, consisting of $200,000 cash to S. Regardless of whether S and T file a consolidated return, S will not recognize any gain on that liquidation because of Section 338. So, the aggregate gain recognized by S and T is $100,000, and P has a stepped-up basis in asset 1. Since the tax consequence that would be obtained in Ex. (1) if no consistency rules applied is identical in these respects to the consequence incurred in the Ex. (3) facts, what justification is there for applying a consistency rule to Ex. (1)? The only significant difference in results between Ex. (1) and (3) is that in the former example some of the tax attributes of T may survive the transaction, while in Ex. (3), they will be terminated. Perhaps a desire to restrict the circumstances in which a purchaser can retain a target’s tax attributes is a sufficient reason for employing the complex regulatory consistency rules, but the author doubts it. This is especially so since the survival of many of a target’s tax attributes is severely restricted by Sections 382-384 and may be eliminated entirely.
Moreover, there is reason to conclude that Treasury was not motivated to adopt the retained consistency rules because of a concern over the retention of the target’s tax attributes. The sale of selected assets can be successfully combined with a sale of the target’s stock (which thereby preserves target’s tax attributes to the extent otherwise permitted to survive) provided that target is not a member of a consolidated group and does not pay qualified dividends during the consistency period. The apparent focus of the 1994 rules is to prevent a step-up in basis of selected assets of the target if the gain from the sale of those assets will be taxed only once at the corporate level. It is only when that consequence would otherwise occur that the 1994 regulatory consistency rules come into play.

Note that the result reached on the facts set forth in Ex. (3) can also be obtained by having S sell the T stock to P (without selling any assets of T) and then have both a Section 338 election and a Section 338(h)(10) election made. However, just as was true in the facts of Ex. (3), P would not retain any of the tax attributes of T in that case.

Is the concern that motivated Treasury to retain a consistency rule in a situation similar to the one described in Ex. (1) the selectivity that the target can exercise by choosing which assets to sell and which to retain so that all of the aggregate appreciation on a target’s assets need not be either recognized or not recognized in total? It is not obvious why the potential for selectivity is a matter of concern. If, prior to the acquisition of the target’s stock, the target were to sell selected appreciated assets to a person who is unrelated to the purchaser, the consistency rules have no application even though in that case a higher tier affiliate of the consolidated group will enjoy the same increase in basis of the target’s stock that it would obtain if the sale of the target’s assets had been made to the purchaser. Why does the transaction become so much more objectionable when the selected assets are sold to the purchaser? Moreover, the target’s sale of only selected assets to the purchaser is not suffi-

cient to trigger the 1994 regulatory consistency rules. For those rules to apply, the selection of assets for sale must be accompanied by an avoidance of double corporate taxation on the gain recognized on the sale of the selected assets. The latter circumstance (the imposition of only a single tax at the corporate level) must exist for the 1994 consistency rules to apply.

Retaining the consistency rules in the 1994 regulations preserves double taxation of gain at the corporate level. On the sale of an appreciated asset to the purchaser, the target recognizes a gain. Treasury does not wish to allow that gain to be taxed at only one corporate level; and so, if the gain that is recognized by the target is not taxed again to the higher tier affiliate when it sells the target's stock (because of the adjustments made to the higher tier affiliate's basis in the target's stock), the 1994 regulations limit the purchaser's basis in the separately purchased assets to the same basis that the target had in those assets. This treatment assures that the gain will be taxed again at the corporate level either when the corporate purchaser disposes of the asset or (if the asset is depreciable) by virtue of its reduced depreciation deduction for the asset. The double taxation system is designed to impose one tax at the corporate level and one at the individual level; there seems no reason to impose a complex set of rules to protect the imposition of two taxes at the corporate level. Since there will still be a tax at the individual level, the 1994 consistency rules are protecting a triple tax scheme for corporate income.

To the extent that the increase in a higher tier affiliate's basis in stock causes the recognition of a loss (or of a greater loss) on the sale of the stock, there is even less reason to require a carryover basis to the purchase of the target's assets. Treas. Reg. Section 1.1502-20 denies a deduction for a loss recognized on the sale of such stock.97 The imposition of carryover basis on the purchaser of target's assets constitutes a double penalty.

The consistency rules that are retained by the 1994 regulations operate in only one circumstance when the target is not a member of a consolidated group. This can occur only when the target is a subsidiary corporation that, on or prior to the acquisition date, pays a dividend to its parent that qualifies for a 100%
dividend-received deduction under Section 243(a)(3). Such dividends are hereafter sometimes referred to as "qualifying dividends." The conditions under which a consistency rule will be imposed are ones in which a selective sale of assets by the target to the purchaser is combined with a qualifying dividend to prevent the imposition of a second tax at the corporate level on the appreciation of the asset that was sold. The application and conditions of this consistency rule are described later in this article. The following example drawn from the preamble to the 1992 proposed regulations illustrates the circumstance that motivated Treasury to adopt a consistency rule.88

Ex. S owns all of the stock of T, but they do not file a consolidated return. S has a $100,000 basis in the T stock, which has a value of $200,000. On January 1, Year One, T sells an asset to P and recognizes a gain of $100,000. On January 16, Year One, T distributes a $100,000 dividend to S. Since the dividend to S generates a $100,000 dividend-received deduction for S under Section 243(a)(3), that washes out the income that S recognized from its receipt of the dividend. The result is that S has no net income from its receipt of the dividend, and its basis in the T stock is not reduced. On March 1, Year One, S sells its T stock to P for $100,000, and S recognizes no gain on that sale. The effect of the completed transaction is that the aggregate gain recognized by S and T is $100,000, and P obtains a stepped-up basis in the purchased asset. Look familiar?

The underlying purpose for granting a 100% dividend-received deduction is to limit the taxation of corporate income to a single tax at the corporate level. The tax consequences that would occur in the above Example in the absence of consistency rules are perfectly compatible with that purpose. The imposition of a carryover basis on the asset purchased by P would impose a double corporate tax on the appreciation of that asset, and that would contravene tax policy as reflected in Section 243 and elsewhere in the Code.89 The operation and conditions of the consistency rules that were adopted by the 1994 regulations are ex-

88. See supra note 78.
plained below.\textsuperscript{100}

The consistency rules of the 1994 Regulations. For convenience, the portion of the 1994 regulations that relate to the consistency rules are hereinafter sometimes referred to as "the 1994 consistency rules" or simply as the "1994 rules."

As noted above, the 1994 consistency rules do not impose a deemed sale of assets on a transaction. Instead, the 1994 consistency rules impose a mandatory carryover basis for certain assets that are purchased, directly or indirectly, by the purchaser of a qualified stock purchase. You will recall that only a corporation can be a purchaser of a qualified stock purchase.\textsuperscript{101} Any reference herein to a "purchaser" includes not only the purchaser corporation itself, but also all corporations that are members of the same affiliated group as the purchaser corporation.

The 1994 consistency rules contain several provisions dealing with the treatment of controlled foreign corporations.\textsuperscript{102} The author has not discussed those provisions in this article. As important as those provisions are, the author believes that their discussion is better left to works that concentrate on the foreign tax area.

The 1994 consistency rules apply only when, during the consistency period, an asset of a lower tier affiliate (i.e., a subsidiary corporation) either is sold to a "purchaser" (i.e., the corporate purchaser of a qualified stock purchase or an affiliate of that corporation) or is deemed to have been sold to a purchaser. Even then, the 1994 consistency rules often will not apply because there are a number of exceptions to their application or because the requisites to their application did not occur.

As noted above, the 1994 consistency rules operate only when either the consolidated return rules or the dividend-received deduction rules permit a purchaser to obtain a cost basis for selected assets of a target and yet have the appreciated element of the transferred assets taxed at only one corporate level—i.e., the appreciation is taxed as gain to the target but not


\textsuperscript{101} I.R.C. § 338(d)(3) (1994).

\textsuperscript{102} Treas. Reg. § 1.338-5 (1994).
to the target's parent corporation. There are only two tax provisions that aroused Treasury's concern, and the 1994 consistency rules apply only when one of those two provisions is applicable. The principal provision at which the 1994 consistency rules are aimed is the "investment adjustment" provision that is contained in the consolidated return regulations and is explained earlier in this article. So, the most frequent object of the 1994 rules is the sale to the purchaser\textsuperscript{103} of an asset during the portion of the consistency period that ends on the acquisition date by a lower tier affiliate of a consolidated group (i.e., an affiliated group that files a consolidated return). The second provision that creates an opportunity to prevent double corporate taxation even though a purchaser obtains a cost basis in selected assets is the 100\% dividend-received deduction provision of Section 243(a)(3). The 100\% dividend-received deduction effectively excludes from a parent corporation's income a dividend received from a subsidiary.

Consequently, the 1994 consistency rules apply only when an appreciated asset of a target (or of certain target affiliates) is sold (or treated as having been sold) to the purchaser\textsuperscript{104} during the portion of the consistency period that ends on the acquisition date, and the target either is a lower tier affiliate of a group that files a consolidated return or is a subsidiary of a corporation to which the target paid a dividend that qualifies for the 100\% dividend-received deduction of Section 243(a)(3). The author will first examine the conditions and exceptions that apply when the target is a member of a consolidated group, and will then examine the treatment when the target is a member of a group that does not file a consolidated return.

\textit{Consolidated group.} The circumstance involving a target that is a member of a consolidated group that can trigger the 1994 consistency rules is the purchaser's acquisition, during the portion of the consistency period that ends on the acquisition date, of an asset of the target or of a lower tier affiliate of the target. The 1994 rules will not apply unless there is a gain from the disposition of the asset in question which, because of the "investment adjustment" provision of Treas. Reg. Section 1.1502-32, is re-
flected in the basis of shares of outstanding stock of the target.\textsuperscript{105} Since the sale of the asset must take place during a portion of the consistency period and since there can be no consistency period unless there is a qualified stock purchase of the target, the 1994 rules will not operate unless the target’s stock is acquired by the purchaser in a qualified stock purchase. Even then, if the purchaser makes a valid Section 338 election for the purchase of the target’s stock, the 1994 consistency rules usually do not apply.\textsuperscript{106} When a Section 338 election is applicable, all the target’s assets are deemed to have been sold and so there is no selectivity issue.\textsuperscript{107} The sole circumstance in which the 1994 consistency rules can operate when a Section 338 election is made is when Section 338(h)(10) is also elected and causes gain to be recognized on the deemed sale of the target’s assets. Even then, however, the 1994 rules will not apply unless that gain is reflected in the basis of stock of another target (i.e., the target of a different qualified stock purchase) that is a higher tier affiliate than the corporation for which the Section 338(h)(10) election was made.

The requirements for the 1994 consistency rules to operate are: (1) an asset is disposed of for a gain during the portion of the target’s consistency period that ends on the acquisition date, (2) the basis of shares of the target’s stock as of the acquisition date reflects the gain that was recognized on the disposition referred to above, and (3) the asset is owned immediately after its disposition and also on the target’s acquisition date by a corporation that acquired the target’s stock in the qualified stock purchase (or by an affiliate of that corporation).\textsuperscript{108} If the third requirement had no exceptions, the 1994 consistency rules would not apply to a disposition of an asset of the target to a person other than the purchaser. However, the proposed rules apply to more than direct acquisitions of a target’s assets. They also ap-

\textsuperscript{105} Treas. Reg. § 1.338-4(c)(1994).
\textsuperscript{106} Treas. Reg. § 1.338-4(c)(2)(1994).
\textsuperscript{107} Note also that any gain recognized on the deemed sale of the target’s assets (because of a Section 338 election) will not be included in the return of the selling consolidated group (unless a Section 338(h)(10) election is made) and so will not provide an adjustment to the basis of the target’s stock; however, there will be a basis adjustment for gain on assets sold prior to the acquisition date.
ploy to so-called indirect acquisitions of the target’s assets. An indirect acquisition covers a variety of circumstances in which two or more transactions conclude with the target’s asset in the hands of the purchasing corporation or an affiliated corporation. In general, an indirect acquisition takes place if there was an arrangement for: (1) the target to dispose of the asset for a gain during the consistency period, (2) the gain from the sale to be reflected in the basis of shares of the target’s stock at or prior to the acquisition date, and (3) the asset to be owned at any time during the portion of the consistency period that follows the acquisition date by a corporation that at the time it owns the asset is either: (i) affiliated with the target, or (ii) affiliated with a target affiliate that was itself affiliated at any time during the consistency period with the purchaser and the basis of whose stock at or prior to the acquisition date reflects the gain recognized on the sale of such asset. For an arrangement to exist there need not have been an enforceable, written or unconditional agreement, and all the parties to the transaction need not have participated in each step that was taken. The determina-


110. A “target affiliate” is a corporation which at any time during the portion of the consistency period that ends on the acquisition date was a member of an affiliated group of which the target also was a member. I.R.C. § 338(h)(6)(A) (1994).

111. Treas. Reg. § 1.338-4(f) (1994). The 1994 regulations provide two alternative tests for determining whether a corporation that holds the purchased asset during the portion of the consistency period that follows the acquisition date satisfies this third condition for treating the purchase of that asset as an indirect acquisition. Treas. Reg. § 1.338-4(f)(2)(iii) (1994). The first alternative (alternative “A”) is a corporation with a stock basis, at or prior to the acquisition date, that reflects the gain recognized on the sale of the asset, and that is affiliated with the purchaser at any time during the consistency period. Clearly, alternative “A” can refer only to the target itself (the target becomes affiliated with the purchaser as a consequence of the qualified stock purchase of its stock) or to a target affiliate (if the basis of the stock of the target affiliate at or prior to the target’s acquisition date reflects the gain recognized on the sale of the asset and if the target affiliate is affiliated with the purchaser at any time during the portion of the consistency period that follows the acquisition date). It is unlikely that the target or a target affiliate will acquire the purchased asset during the relevant period following the acquisition date. Consequently, alternative “A” will rarely, if ever, apply. However, as explained in the next paragraph, alternative “A” serves as part of the definition of alternative “B,” and that is its principal and perhaps only function.

Alternative “B” is a corporation that, at the time it owns the asset, is affiliated with a corporation described in alternative “A.” Thus, a corporation satisfies alternative “B” if, during the requisite period following the acquisition date, it holds the purchased asset and is affiliated either with the target itself or with a target affiliate that satisfied the conditions of alternative “A.”
tion of whether an arrangement exists turns on the facts and circumstances of the transaction.\textsuperscript{112} The indirect acquisition provision is illustrated in several examples set forth later in this article.

In addition to the indirect acquisition rules, a partnership, estate, or trust can be treated as a "conduit" of a corporation; if so, a portion of the conduit's ownership of assets and acquisition of stock may be attributed to the corporation.\textsuperscript{113} An entity is a conduit of a corporation if the entity is a partnership, estate, or trust whose ownership of stock would be attributed to the corporation under Section 318(a)(2)(A) and (B) [the provisions for attribution of stock from a partnership, estate or trust] and if the corporation together with its affiliates would be treated as owning an aggregate of at least 50 percent of stock owned by such partnership, estate or trust. The conduit rules operate in four circumstances.\textsuperscript{114}

(1) \textit{Asset ownership}. For asset ownership determination purposes, a corporation is deemed to own the portion of an asset that is owned by a conduit to the same extent that such asset would have been attributed to the corporation under Section 318(a) if the asset had been stock. If the asset had been purchased during a target consistency period and if treating a portion of the asset as owned by the corporation would cause the imposition of the 1994 consistency rules, the basis of the asset in the hands of the conduit will be subject to the carryover basis rule. If the carryover basis rule is applicable, it will apply to the basis of the entire asset that is held by the conduit; it will not be limited to the portion of the asset that is attributed to the corporation.\textsuperscript{115}

(2) \textit{Stock acquisition by conduit}. A corporation (the "first corporation") is treated as having purchased stock of another corporation that is attributed to the first corporation from the conduit under Section 318(a). The date of the corporation's deemed purchase of such stock is the date that the stock was purchased by the conduit. This provision does not apply if the stock was purchased by the conduit more than two years before

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\caption{Classification of Sections}
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the date on which it is first attributed to the first corporation.\textsuperscript{116} 

(3) \textit{Purchase of an interest in the conduit by a corporation.} If a corporation purchases an interest in a conduit, the corporation is treated as having purchased on that date any stock held by the conduit on that date that is attributed to the corporation under Section 318(a) with respect to the interest in the conduit that was so purchased by the corporation.\textsuperscript{117}

(4) \textit{Purchase of a conduit by a conduit.} If a conduit (the first conduit) purchases an interest in a second conduit, the first conduit is treated as purchasing on that date any stock that is owned by a conduit on that date and that is attributed to the first conduit under Section 318(a) with respect to the purchased interest in the second conduit.\textsuperscript{118}

If the 1994 consistency rules apply to the sale of an asset, the basis of the asset immediately after its acquisition is equal to the adjusted basis that it had immediately before the disposition.\textsuperscript{119}

The 1994 regulations set forth a number of exceptions to the application of the consistency rules. As noted above, the 1994 rules usually do not operate if a valid Section 338 election is made for the purchase of the target’s stock. In addition, the 1994 consistency rules provide\textsuperscript{120} that the carryover basis rule does not apply to:

(1) an asset disposed of by target or by a target affiliate in the ordinary course of a trade or business,\textsuperscript{121}

(2) an asset whose basis is determined wholly by reference to the adjusted basis of the person who disposed of it,\textsuperscript{122}

(3) a debt or equity instrument issued by target or a target affiliate,\textsuperscript{123}

\textsuperscript{118} \textit{Id.}
\textsuperscript{121} See also I.R.C. § 338(e)(2)(A) (1994).
\textsuperscript{122} Treas. Reg. § 1.338-4(d)(2)(ii) (1994). See also I.R.C. Section 338(e)(2)(B) (1994). This exception seems superfluous because the basis carryover that exists is what the proposed consistency rules would have mandated. Moreover, the apparent reason that a basis carryover exists is that the disposition was a nonrecognition transaction, and because no gain would be recognized by the target, the consistency rules would not operate.
(4) an asset whose basis immediately after the acquisition would otherwise be less than its adjusted basis immediately before its disposition;\textsuperscript{124}

or

(5) an asset excluded by a ruling of the Service.\textsuperscript{128}

The 1994 consistency rules provide a \textit{de minimis} asset exception for carryover basis treatment.\textsuperscript{126} Under this exception, the disposition of an asset will not be subject to the carryover basis rules if: (1) the aggregate amount realized for all assets otherwise subject to the carryover basis rules does not exceed $250,000, and (2) the disposition of the asset is not part of an arrangement to acquire the target's stock.\textsuperscript{127} In his article on the proposed version of the 1994 rules, Neil Auerbach criticizes the requirement that the sale of the asset not be part of the arrangement for the purchase of the target's stock because that requirement introduces a subjective element that makes the applicability of the \textit{de minimis} asset exception difficult to predict and, therefore, less useful as a bright line test that eliminates uncertainty and minimizes controversy.\textsuperscript{128}

The following examples that are drawn from the regulations illustrate the operation of the 1994 consistency rules.\textsuperscript{129} In the following examples, S owns all the stock of T; T owns all the stock of T1; and T1 owns all the stock of T2. All of those corporations file a consolidated return with S as the common parent. B (an individual who is unrelated to the S group) owns all the stock of P, and P owns all the stock of P1. Z is a corporation that is not related to any of the other parties.\textsuperscript{130}

\textsuperscript{124.} Treas. Reg. § 1.338-4(d)(2)(iv) (1994). This provision will rarely apply. If the asset has a lower basis in the hands of the purchaser than it had in the hands of the target, typically there will not have been a gain on the disposition, and so the proposed consistency rules would not operate. But, there are certain circumstances in which it could apply. For example, if the asset were exchanged for another item of like kind plus boot, the transferor could recognize gain (§ 1031(b)) even when the acquiring corporation has a lower basis in the asset than the transferor had. This could occur if the acquiring corporation's basis in the asset it transferred plus the boot it paid is less than the basis that the transferor had in the acquired asset.


\textsuperscript{126.} Treas. Reg. § 1.338-4(d)(3).

\textsuperscript{127.} Id.


\textsuperscript{129.} Treas. Reg. § 1.338-4(e) (1994).

\textsuperscript{130.} Treas. Reg. § 1.338-4(e)(1) (1994).
Ex. (1) On February 1, Year One, T sold an asset to P1 for a gain. The gain increased the basis that S had in its T stock. On January 1, Year Two, P1 made a qualified stock purchase of T from S. No Section 338 election was made for T. The requirements for applying the 1994 consistency rules to the sale of the asset are satisfied: (1) the asset was sold during the portion of T's consistency period that ends on T's acquisition date; (2) the basis of T's stock as of the acquisition date reflects the gain recognized on the sale of the asset; and (3) immediately after P1's acquisition of the asset and on T's acquisition date, the asset is owned by the purchaser corporation [i.e., the corporation (or an affiliated corporation) that made the qualified stock purchase of T's stock]. Therefore, the carryover basis rules apply to the sale of T's asset in Year One, and the basis that P1 has in that asset equals the adjusted basis that T had in it immediately before the sale to P1.

The result would be the same if P (instead of P1) had made the qualified stock purchase of T, and P1 had purchased the asset on February 1, Year One. In that case, P1 would still acquire the same basis in the purchased asset that T had in that asset immediately before the sale.

Ex. (2) On February 1, Year One, P1 made a qualified stock purchase of T2 from T1. A Section 338(h)(10) election was made for T2, and T2 recognized gain on each of its assets, which the S group included in its consolidated return. As a consequence of the purchase of T2's stock, T2 is treated as a new corporation, and new T2 became a member of an affiliated group that includes both P and P1. The sale of old T2's assets is deemed to have been made to new T2. Under the consolidated return regulations, the gain that old T2 recognized on that deemed sale of its assets not only increased the basis that T had in the T1 stock, it also increased the basis that S had in the T stock. On January 1, Year Two, P made a qualified stock purchase of T from S. No Section 338 election was made for that acquisition. The carryover basis rules apply to the deemed sale of T2's assets, and so new T2's basis in those assets is the same as the basis that old T2 had. New T2 was both the acquirer of the purchased assets and the purchaser of the qualified stock purchase of T since new T2 was an affiliated corporation of P at the time that P made the qualified stock purchase of T. P
and \( T2 \) are, therefore, treated as one corporation. The deemed sale of old \( T2 \)’s assets to the purchaser took place during \( T \)’s consistency period. The gain recognized by old \( T2 \) on the deemed sale of its assets was reflected in the basis that \( S \) had in \( T \)’s stock as of \( T \)’s acquisition date. The purchased assets were owned immediately after their acquisition and on \( T \)’s acquisition date by new \( T2 \), who, as an affiliate of \( P \), is the purchaser of the qualified stock purchase of \( T \). The conditions of the 1994 consistency rules are satisfied.

Ex. (3) On February 1, Year One, \( T \) sold a depreciable asset to \( Z \) for a gain. On February 15, Year One, \( P1 \) made a qualified stock purchase of \( T \) from \( S \). No Section 338 election was made for \( T \). \( P1 \) then bought the asset from \( Z \) on March 1, Year One, before any depreciation deduction had been taken by \( Z \) on the asset.

The depreciable asset was sold by \( T \) during its consistency period and was subsequently acquired by \( P1 \), who was then an affiliated corporation of \( T \), within the portion of the consistency period that follows the acquisition date of \( T \). The basis of \( T \)’s stock in the hands of \( S \) at the acquisition date reflects the gain that \( T \) recognized on that sale. If there was an arrangement that all of these events take place, the carryover basis rules will apply to the sale of the depreciable asset. The transaction will then constitute an indirect acquisition by the purchasing corporation. If so, the basis that \( P1 \) acquires in that asset immediately after purchasing it from \( Z \) would equal the adjusted basis that the asset had in the hands of \( T \) immediately before the sale to \( Z \).

Ex. (4) The same facts as those stated in Ex. (3) except that \( P1 \) purchased the depreciable asset from \( Z \) on January 15, Year Two, after \( Z \) had taken depreciation deductions that reduced its basis in the asset. Note that, even under this change of facts, the depreciable asset was acquired by \( P1 \) within the portion of \( T \)’s consistency period that follows the acquisition date. We will assume that the requisite arrangement existed for all of those transactions to take place so that the carryover basis rules apply to \( P1 \)’s acquisition of the asset. \( P1 \)’s basis in the asset immediately after acquiring it equals the adjusted basis that \( T \) had in the asset immediately before selling it to \( Z \), reduced by the amount of depreciation that had been allowed or allowable to \( Z \).
Ex. (5) On February 1, Year One, T sold an asset to P1 and recognized a gain. On February 15, Year One, Z made a qualified stock purchase of T, but no Section 338 election was made. On November 20, Year One, P1 acquired the T stock from Z in a transaction that is not a qualified stock purchase. P1 thereby became affiliated with T during the portion of the consistency period that follows the acquisition date, and P1 held the purchased asset at that time. The third requirement of an indirect purchase is satisfied since during the portion of T's consistency period that follows the acquisition date, P1 (who had purchased the asset from T) became affiliated with T, which was a corporation that had had the gain from the sale of that asset reflected in the basis of its stock as of the acquisition date and which had been affiliated at one time during the consistency period with the purchaser of the qualified stock purchase of T (i.e., it was affiliated with Z). If there was an arrangement for those transactions to take place, the carryover basis rules will apply to determine the basis that P1 has in the purchased asset.

Sale of asset by member of nonconsolidated affiliated group. The only circumstance in which the 1994 consistency rules apply to a sale of assets by a corporation that is not a lower tier member of a consolidated group is when the selling corporation combines the sale of an asset with the payment of a dividend that qualifies for the 100% dividend-received deduction under Section 243(a)(3). A dividend that qualifies for the 100% dividend-received deduction under Section 243(a)(3) is sometimes referred to herein as a “qualified dividend.” The abuse that Treasury perceived and sought to curb is where the target sold an asset for a gain and then distributed to its parent a dividend equal to the amount of its gain. If the parent could effectively exclude the dividend from its income because it qualified for a 100% dividend-received deduction, the result would be taxation of the gain only once at the corporate level. One problem with applying consistency rules to such a situation is the difficulty in determining whether the target actually made a dividend distribution of the gain it recognized on the sale of its asset. The target may pay dividends for other purposes, and so how is the purpose of a dividend to be determined? The 1994

consistency rules deal with that issue by establishing a mechanical test that rests on whether the qualified dividends that were paid during the portion of the consistency period that ends on the acquisition date were significantly higher than the average qualified dividends paid by it over the past three years. In addition, the 1994 rules establish a *de minimis* dividend rule that precludes carryover basis treatment if the aggregate qualified dividends paid by the target during the portion of the consistency period that ends on the acquisition date do not exceed $250,000.132 The requirements for applying carryover basis treatment to such sales are set forth in Treas. Reg. Section 1.338-4(g)(1) as follows:

(1) target recognizes gain (whether or not deferred) on the disposition of the asset during the portion of the consistency period that ends on the acquisition date,133

(2) the asset is owned immediately after its disposition and on the acquisition date by the purchasing corporation (or by an affiliate of the purchasing corporation),134 and

(3) during the portion of the consistency period that ends on the acquisition date, the aggregate amount of qualified dividends paid by the target exceeds the greater of:

(i) $250,000, or

(ii) 125 percent of the yearly average of qualified dividends paid by the target during the three calendar years immediately preceding the year in which the consistency period begins (or such shorter period that the target was in existence.135

If the 1994 consistency rules apply to a sale by a target in the circumstances above, the carryover basis rule will determine the basis of the purchased asset immediately after its acquisition unless one of the exceptions to that rule applies. The exceptions to carryover basis treatment discussed earlier in this article that apply to sales by a member of a consolidated group also apply to sales by a member of a nonconsolidated affiliated group. So, if a Section 338 election is made for the qualified stock purchase of

132. *Id.*
134. Treas. Reg. § 1.338-4(g)(1)(ii) (1994). This requirement is subject to the same indirect acquisition exception that is applied to acquisitions from a member of a consolidated group. Treas. Reg. § 1.338-4(g)(3) (1994). See *supra* notes 109-112 and accompanying text for a discussion of the operation of the indirect acquisition rules.
the target's stock, the carryover basis rules do not apply.\textsuperscript{136} Also, the other exceptions discussed above and set forth in Treas. Reg. Section 1.338-4(d)(2), (3) are applicable—for example, the \textit{de minimis} asset exception and the exception for assets sold in the ordinary course of the target's business or exchanged in a non-recognition transaction also apply to nonconsolidated affiliated groups.\textsuperscript{137}

A major fault in the regulatory conditions for applying consistency rules to nonconsolidated groups is that there is no linkage of the amount of gain recognized by the target on the sale of its asset with the amount of qualified dividends paid during the requisite portion of the consistency period that exceeds the average past qualified dividends (or exceeds the \textit{de minimis} dividend $250,000 figure). The following example illustrates the arbitrariness of the standard employed by the proposed rules.

Ex. \textit{S} Corporation owned all of the stock of \textit{T}, but the corporations did not file a consolidated return. In January of Years One, Two, and Three, \textit{T} paid a dividend of $400,000 to \textit{S}, and those dividends qualified for the 100\% dividend-received deduction of Section 243(a)(3). On March 1, Year Four, \textit{T} sold to \textit{P} (an unrelated corporation) Land in which \textit{T} had a basis of $200,000. \textit{T} received $2,200,000 from \textit{P} for the Land, and so \textit{T} recognized a gain of $2,000,000. On August 3, Year Four, \textit{T} paid a dividend to \textit{S} of $500,001, all of which qualified for the 100\% dividend-received deduction of Section 243(a)(3). On January 8, Year Five, \textit{P} purchased from \textit{S} all of the outstanding stock of \textit{T}, and no Section 338 election was made. No other dividends were paid during the relevant period. The consistency period begins one year prior to the date on which \textit{P} first purchased stock of \textit{T}, and so it began on January 8, Year Four.

Obviously, the first two requirements for applying the consistency rules to the sale of Land are satisfied. \textit{T} recognized a gain on the sale of Land to \textit{P} which took place during the portion of the consistency period ending on the acquisition date. Land is owned immediately after its acquisition and on the acquisition date by the acquiring corporation. The question then turns on whether the third requirement is satisfied. The average

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{136} Treas. Reg. § 1.338-4(g)(1) (1994).
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\end{footnotesize}
yearly qualified dividends paid by T to S for the three calendar years preceding the year in which the target consistency period begins (i.e., Year Four) is $400,000. The third requirement is that the amount of the qualified dividends paid to S during the portion of the consistency period that ends on the acquisition date ($500,001) exceeds 125% of the average of such dividends paid in the three preceding years; 125% of $400,000 equals $500,000. So, the qualified dividends paid to S during the defined period is only $1 greater than the permitted amount. As a consequence of that $1 overage, P's basis in Land will be $2,000,000 less than its cost. Stating if differently, if on August 3, Year Four, T had paid S a dividend of $1 less, P would have a basis of $2,200,000 in Land instead of the $200,000 basis it has because of the application of the carryover basis rules.

This fault in the proposed rules can be cured by adding to the regulations a provision that imposes a floor on the carryover basis rule so that the purchaser's basis will not be less than the purchaser's cost reduced by the amount of the excess qualified dividends paid by the target during the defined period over the greater of either 125% of the yearly average of qualified dividends for the past three calendar years or the de minimis $250,000 figure. The best solution for Treasury would be to eliminate the consistency rules completely. If it does not do so, it should at least make this modification.

Stock acquisition. There is only one circumstance in which the 1994 consistency rules will apply to a stock acquisition. That occurs when the target is a member of a consolidated group and a Section 338(h)(10) election is made so that the assets of the target are deemed to have been sold. If, in that case, the basis of a higher tier member of the consolidated group which is subsequently acquired by the purchaser of the asset (or its affiliate) in a qualified stock purchase reflects the gain recognized by the target, the proposed carryover basis rules will apply if certain conditions are met.

V. CONCLUSION

While the circumstances that trigger the consistency rules’
imposition of carryover basis are unlikely to arise frequently, the consequences of being trapped within that net can be extremely harsh. A purchaser of a qualified stock purchase should take care that the consistency rules either do not apply or do not impose an unacceptable cost.

The purpose of the retained consistency rules is to insure that there will be double taxation at the corporate level of the gain recognized on the sale of a target’s assets, which sale takes place prior to the date on which the target’s stock is acquired by the purchaser. The corporate tax system seeks to impose double taxation on a corporation’s income so that one tax is imposed at the corporate level and a second tax is imposed on individual shareholders when they dispose of their stock or when the corporation is liquidated. The corporate tax system does not seek to impose more than one tax levy at the corporate level. To the contrary, there are numerous provisions in the Code either to eliminate multiple taxation at the corporate level or to minimize the impact of multiple corporate taxation. While multiple corporate taxation has not been completely eliminated, it is clear that Congress has not favored a multiple imposition of a corporate tax and has not sought to insure that such multiple impositions will occur. The underlying purpose of the consistency rules, therefore, is inconsistent with established tax policy. The circumstances in which the rules operate do not entail an avoidance of taxation by individual shareholders; only the double taxation of corporate entities are involved. The consistency rules should not simply be improved; they should be eliminated entirely.

Even if multiple corporate taxation were deemed worthy of protection, there seems little justification for the manner in which the current regulations single out only certain transactions for carryover basis treatment. When assets of a target are sold for a gain to a party who is neither the purchaser of the target’s stock nor at any time affiliated with the purchaser, the consistency rules do not operate. Yet, the corporate sellers of the target’s stock can avoid double corporate taxation in that setting to the same extent that they would have if the target’s assets had been acquired by the purchaser of its stock. It is not obvious why the avoidance of double corporate taxation becomes objectionable when the target’s assets are acquired by the purchaser.
of its stock. There is some arbitrariness in the operation of the regulations.

Finally, if the consistency rules are to be retained despite their conflict with tax policy, the regulations application of those rules to affiliated corporations that do not file a consolidated return is seriously flawed and should be corrected.