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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9271

RIN 1545-BB68

Effect of Elections in Certain Multi-Step Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that give effect to section 338(h)(10) elections in certain multi-step transactions. These final regulations are necessary in order to provide taxpayers with guidance regarding the validity of certain elections made under section 338(h)(10). These final regulations affect corporations and their shareholders.

DATES: Effective Date: These regulations are effective July 5, 2006.

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

FOR FURTHER INFORMATION CONTACT: Daniel F. Heins, at (202) 622-7930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

### **Background**

The IRS published temporary regulations (TD 9071) in the **Federal Register** on July 9, 2003 (68 FR 40766) (the temporary regulations), along with a

notice of proposed rulemaking by cross-reference to the temporary regulations (REG-143679-02) (the proposed regulations). These temporary regulations provide, notwithstanding anything to the contrary in §1.338-3(c)(1)(i), a section 338(h)(10) election may be made for T where P's acquisition of T stock, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P), whether or not, under relevant provisions of law, including the step transaction doctrine, the acquisition of the T stock and the merger or liquidation of T qualify as a reorganization described in section 368(a). If a section 338(h)(10) election is made in a case where the acquisition of T stock followed by a merger or liquidation of T into P qualifies as a reorganization described in section 368(a), for all Federal tax purposes, P's acquisition of T stock is treated as a qualified stock purchase and is not treated as part of a reorganization described in section 368(a). For rules about the operation of the step transaction doctrine and the relationship between section 338 and the reorganization provisions when a section 338 election is not made, see §1.338-3(d). See also Rev. Rul. 90-95 (1990-2 CB 67). See §601.601 (d)(2).

No public hearing regarding the proposed regulations was requested or held. The IRS received written and electronic comments regarding the proposed regulations. After consideration of the comments, the proposed regulations are adopted by this Treasury decision. The most significant comments received with respect to the proposed regulations are discussed in this preamble.

## **Explanation of Provisions**

#### A. Section 338(g) Elections

Some commentators recommend that the final regulations allow section 338(g) elections, as well as section 338(h)(10) elections, to turn off the step transaction doctrine in a multi-step transaction that constitutes a reorganization under section 368(a). Although a section 338(g) election is made by the purchasing corporation and the shareholders of the target corporation (target) do not consent to the election, one commentator states that the IRS will not be subject to whipsaw if the IRS provides regulations requiring the shareholders of the acquired corporation to treat the transaction consistently with the acquiring corporation's election, rather than as a reorganization under section 368(a).

The final regulations do not adopt the commentators' recommendation, and continue to turn off the step transaction doctrine only in the case of section 338(h)(10) elections. Extending the final regulations to section 338(g) elections would allow the acquiring corporation to unilaterally elect to treat the transaction, for all parties, as other than a reorganization under section 368(a). In light of potential whipsaw and other concerns, the final regulations continue to apply only to section 338(h)(10) elections, not section 338(g) elections.

#### B. Corporate Purchaser Requirement

One commentator suggests that §1.338-3(b) be amended to clarify under what circumstances a corporation will be considered, for tax purposes, to have purchased the stock of target pursuant to section 338(d)(3).

Under §1.338-3(b), an individual cannot make a qualified stock purchase of target. If an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered, for tax purposes, to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include new P's merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase.

The IRS and Treasury Department are continuing to study whether any amendments to the portion of the regulations under section 338 related to the corporate purchaser requirement are appropriate.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial amount of small entities. The number of corporations affected is limited because section 338(h)(10) elections are made only in extraordinary circumstances, the sale of a business. Furthermore, these regulations only affect transactions in which the stock of the acquiring corporation is a significant part of the consideration. Accordingly, a regulatory flexibility analysis does not apply. Since these final regulations make no changes to the current effective temporary regulations, a delayed effective date pursuant to 5 U.S.C. 553(d)(1) and (3) is not necessary. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these

regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Drafting Information**

The principal author of these regulations is Daniel F. Heins of the Office of the Associate Chief Counsel (Corporate).

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

#### **PART 1--INCOME TAXES**

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

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

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

Par 2. §1.338-3 is amended by revising the last sentence in paragraph (c)(1)(i) to read as follows:

§1.338-3 Qualification for the section 338 election.

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

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

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

1. Paragraph (c)(2) is revised.
2. Paragraph (e) Examples 11 through 14 and paragraph (h) are added.

The revision and additions read as follows:

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

\* \* \* \* \*

(c) \* \* \*

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

\* \* \* \* \*

(e) \* \* \*

Example 11. Stock acquisition followed by upstream merger—without section 338(h)(10) election. (i) P owns all the stock of Y, a newly formed subsidiary. S owns all the stock of T. Each of P, S, T and Y is a domestic corporation. P acquires all of the T stock in a statutory merger of Y into T, with T surviving. In the merger, S receives consideration consisting of 50% P voting stock and 50% cash. Viewed independently of any other step, P's acquisition of T stock constitutes a qualified stock purchase. As part of the plan that includes P's acquisition of the T stock, T subsequently merges into P. Viewed independently of any other step, T's merger into P qualifies as a liquidation described in section 332. Absent the application of paragraph (c)(2) of this section, the step transaction doctrine would apply to treat P's acquisition of the T stock and T's merger into P as an acquisition by P of T's assets in a reorganization described in section 368(a). P and S do not make a section 338(h)(10) election with respect to P's purchase of the T stock.

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

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

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

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

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

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

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

\* \* \* \* \*

(h) Effective date. This section is applicable to stock acquisitions occurring on or after July 5, 2006. For stock acquisitions occurring before July 5, 2006, see §1.338(h)(10)-1T as contained in the edition of 26 CFR part 1, revised as of April 1, 2006.

\* \* \* \* \*



**§1.338(h)(10)-1T [Removed]**

Par. 4. Section 1.338(h)(10)-1T is removed.

/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement.

Approved: June 20, 2006

/s/ Eric Solomon

Acting Deputy Assistant Secretary of the Treasury (Tax Policy).