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Memorandum

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to: Deborah O. Childers
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from: William D. Alexander
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subject: Elections Under § 338 With Respect to Foreign Corporate Targets

This Chief Counsel Advice responds to your request for legal advice concerning § 338 elections with respect to acquisitions of a foreign target corporations.

ISSUE

Can a domestic or foreign corporation that acquires by purchase the requisite amount of the stock of a foreign target make a § 338 election for the foreign target and thereby obtain a step-up in the basis of the foreign target's assets, even if no U.S. or foreign tax is incurred? Can it do so even if it does not make a § 338 election for the foreign target's U.S. subsidiary, which, if made, would incur a U.S. tax cost?

GENERIC FACT PATTERNS

The "Purchaser" is a corporation for U.S. tax purposes. It may be either domestic or foreign, and, if foreign, either a controlled foreign corporation (CFC) or not.

The "Foreign Target" is a foreign entity that, when relevant, will be classified as a corporation for U.S. tax purposes. It has no previous connection to the U.S. tax system. That is, inter alia, it is not a CFC, is not a passive foreign investment company, is not engaged in a U.S. trade or business, does not hold any U.S. real property interests, and is not required to file a U.S. tax return. Its shareholders are also foreign persons

similarly unconnected to the U.S. taxing jurisdiction. It is unrelated to the Purchaser prior to the transaction described here. The value of Foreign Target's assets exceeds the basis of those assets computed under U.S. income tax principles.

Situation 1.

Purchaser buys all of the outstanding stock of Foreign Target from its shareholders in a single transaction for cash. Purchaser makes an election pursuant to § 338(g) with respect to Foreign Target. The shareholders of Foreign Target may or may not be subject to tax on their sale of its stock in the taxing jurisdictions in which they are subject to tax. The transaction has no tax effect on Foreign Target in any foreign tax jurisdiction.

Situation 2.

The facts are the same as in Situation 1, except that Foreign Target owns all of the stock of a U.S. subsidiary. The U.S. subsidiary is not a U.S. real property interest, and Foreign Target's disposition of the stock of the subsidiary would not give rise to effectively connected income. Purchaser makes an election pursuant to § 338(g) with respect to Foreign Target but makes no such election with respect to Foreign Target's U.S. subsidiary. The value of the U.S. subsidiary's assets exceeds their basis.

LAW AND ANALYSIS

Situation 1.

Section 338 permits an acquiring corporation to elect to treat a qualified stock purchase (QSP) of a target corporation as an asset acquisition. If the election is made, the target ("old target") is treated as having sold all of its assets at fair market value and is further treated as of the next day as a new corporation ("new target") that purchased all of old target's assets. New target is not considered to be related to old target and does not carry over any of old target's attributes. See § 1.338-1(b).

Section 338(d)(3) defines a "qualified stock purchase" as a transaction or series of transactions within a twelve-month acquisition period in which the purchasing corporation purchases stock of the target corporation in the amount specified by § 1504(a)(2) (i.e., stock possessing at least 80 percent of the total voting power and at least 80 percent of the total value of the target's stock, excluding certain nonvoting, nonparticipating, nonconvertible preferred stock). A "purchase," for this purpose, is essentially a cost-basis acquisition from an unrelated party. See § 338(h)(3).

Neither § 338 nor the accompanying regulations require that a purchasing corporation or a target corporation be domestic. Section 338(i)(2) expressly authorizes the promulgation of regulations to coordinate § 338 with provisions relating to foreign corporations and their shareholders. Although § 1.338-2(e) provide special rules for the

filing of a § 338 election by foreign purchasers for foreign targets and § 1.338-9 addresses the international aspects of § 338, there are no rules that generally preclude either a domestic or foreign corporation from making a QSP with respect to a foreign target and making an election under § 338. Either a domestic or foreign purchasing corporation may make a § 338 election with respect to a foreign target that was previously unconnected with the U.S. taxing jurisdiction, even though no U.S. or foreign tax is incurred on old target's deemed sale of assets to new target.

This result is not necessarily inappropriate because the appreciation in the Foreign Target's assets accrued while the Foreign Target was outside of the U.S. taxing jurisdiction. In general, our system permits, but does not oblige, the importation of gain into the U.S. taxing jurisdiction, with the consequences depending on how the taxpayers effectuate their transactions. In general, the U.S. tax results are not dependent on whether foreign tax is incurred. It happens to be the case that although many ways of obtaining a cost basis in assets for U.S. tax purposes also result in tax under many foreign tax systems, a § 338 election, because it is relatively unique to our system, typically does not.

Although a § 338 election is permissible in this case, § 338(h)(16) represents Congress' response to the "tax arbitrage" potential from an election unlikely to have parallel target level foreign tax consequences. Section 338(h)(16) limits the foreign tax credit consequences that would otherwise result from a § 338 election by providing, in general, that, except as provided in regulations, § 338 does not apply for purposes of determining the source or character of any item for purposes of §§ 901 through 908 of the Code (relating to the foreign tax credit). However, it does not bar the making of the § 338 election or prevent the "free step-up" in U.S. tax basis.

Accordingly, in Situation 1, Purchaser's cash purchase of the stock of Foreign Target is a QSP, and Purchaser is entitled to make a § 338 election with respect to the acquisition of Foreign Target. The result of this election is to give Foreign Target a cost basis in its assets for U.S. tax purposes as of the day after the QSP, even though there are no U.S. tax consequences to Foreign Target or Purchaser in obtaining this step-up in asset basis. This result obtains regardless of whether the deemed asset sale generates taxable gain for foreign tax purposes.

Situation 2.

The analysis of the acquisition of Foreign Target is as above. One of the assets deemed sold by old Foreign Target to new Foreign Target pursuant to the § 338 election with respect to Foreign Target is the stock of its U.S. subsidiary. New Foreign Target obtains a cost basis in this stock regardless of whether a § 338 election is made with respect to the U.S. subsidiary. Because Foreign Target is a foreign corporation, the gain it realizes on the deemed sale of its assets (other than U.S. real property interests) is foreign source income not subject to tax in the U.S., and thus there is no U.S. tax cost to obtain this basis step-up.

The deemed sale of the stock of the U.S. subsidiary is itself a QSP, enabling the making of a § 338 election with respect to the U.S. subsidiary. See § 338(h)(3)(B).

Section 1.338-8 of the Regulations provides rules governing the circumstances under which § 338 elections must be made for certain related targets if they are made for any of them. Under these regulations, an acquiring corporation that makes a § 338 election with respect to the foreign target may also make a § 338 election with respect to the target's subsidiaries down the corporate chain but is not required to make the election with respect to all such subsidiaries. See § 1.338-8(a)(1). However, if a § 338 election is not made for a particular subsidiary, the acquirer cannot make a § 338 election for any subsidiary at a lower tier in the chain. See § 338(h)(3)(B).

Accordingly, in Situation 2, Purchaser may choose to make a § 338 election with respect to Foreign Target (and any of its foreign subsidiaries) but not make a § 338 election with respect to the U.S. subsidiary.

OTHER TRANSACTIONS

We note that a transaction in which a § 338 election is made with respect to a foreign target may sometimes occur as one step in a series of planned transactions. This memorandum addresses only the tax consequences of a § 338 election under the situations described above and does not express any view regarding other transactional steps that may occur. Any such other steps would have to be analyzed in light of the facts and circumstances of the overall transaction to determine their consequences for U.S. tax purposes. See, e.g., Notice 2004-20, 2004-1 C.B. 608 (describing listed transaction in which a § 338 election with respect to a foreign target is a step in a prearranged plan to generate credits for foreign taxes on gain that is not subject to U.S. tax).

CONCLUSION

A domestic or foreign corporation that acquires by purchase the requisite amount of the stock of a foreign target can make a § 338 election for the foreign target and thereby obtain a step-up in the basis of the foreign target's assets even if no U.S. or foreign tax is incurred. Further, it can do so even if it does not make a § 338 election for the foreign target's U.S. subsidiary, which, if made, would incur a U.S. tax cost.

If you have any further questions, please contact Charles M. Levy at (202) 622-8474.

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