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A Survey of the Section 336(e) Regulations

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I. Introduction

Under § 336(e), if one corporation owns an affiliated interest in the stock of a second corporation and sells, exchanges, or distributes all of that stock, Congress has authorized a regulatory election to treat

the transfer of the second corporation's stock as a disposition of its assets, thereby avoiding recognized gain or loss on the sale, exchange, or distribution of that stock.[1] Congress added § 336(e) to the Code in the Tax Reform Act of 1986,[2] intending that it be implemented using "principles similar to those of section 338(h)(10)."[3] Thus, § 336(e) has a purpose similar to § 338(h)(10), which –

> offers taxpayers relief from a potential multiple taxation at the corporate level of the same economic gain, which may result when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in basis of the assets of the corporation.[4]

Final regulations, published in the Federal Register on May 15, 2013, apply § 336(e) by employing a structure and principles like those under the § 338(h)(10) regulations, using those regulations as a template.[5] Despite many similarities, the two regulatory regimes differ in several important respects, including the following: First, although both require the transfer of an affiliated

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[1] An affiliated interest is an interest meeting the requirements of § 1504(a)(2). References in this article to "§" or "section" are to the Internal Revenue Code of 1986, as amended (the "Code"), or to applicable regulations under the Code.

I thank Karen Gilbreath-Sowell and Mark Silverman for the framework for at least of portion of this article. I also thank Michelle Kwon, Gordon Warnke, Ken Cohen, and Krishna Vallabhaneni for their insights in preparing and presenting a panel on the proposed § 336(e) regulations. Finally, I thank Andrew Dubroff for his many helpful suggestions. Any mistakes in this article are my own.

[2] § 631(a) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2270-71 (adding § 336(e)).

[3] H.R. (Conf.) Rep. No. 99-841, II-204 (1986) (also suggesting that special rules may be required to the extent that the regulations permit a § 336(e) election to be made on transfers of controlled corporation stock to related persons to prevent net operating losses from being used to offset liquidation gains or earnings and profits from being manipulated).

[4] *Id.* *See also* 78 Fed. Reg. 28467 (May 15, 2013) (stating in the preamble to the final regulations that "section 336(e) is meant to provide taxpayers relief from a potential multiple taxation of the same economic gain that can result when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in the basis of the assets of the corporation"). *Cf. Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied* 2001 U.S. App. LEXIS 23207 (Fed. Cir. Oct. 3, 2001) (refusing to find a prohibited "double deduction" when one deduction was taken by a consolidated group on its sale of subsidiary stock and another was preserved in the subsidiary attributes, thereby implicitly rejecting the government argument that a consolidated group's loss on its sale of subsidiary stock and a subsidiary inside loss could be the same economic loss).

[5] The regulations apply to any qualified stock disposition for which the disposition date is on or after May 15, 2013. § 1.336-5. They do not apply to transactions where the seller or target is a foreign corporation or to many related-party transactions. *Cf.* James P. Fuller and Amanda Dranginis, Comments on Proposed section 336(e) Regulations, 2008 TNT 195-23 (Sep. 24, 2008) (arguing that § 336(e) should apply to foreign targets even without regulations). Unlike the 2008 proposed regulations and despite any clear statutory authority, the final regulations apply to S corporation targets.

interest in target stock by a corporation, § 338(h)(10) looks to the purchase of that stock interest, while § 336(e) focuses on its disposition. Thus, the § 338(h)(10) regulations (as do the § 338 regulations generally) consider what is purchased, while the § 336(e) regulations measure what is sold, exchanged, or distributed. Second, for § 338(h)(10) to apply to a non-S corporation target, on the date that the affiliated interest in the target is first acquired by purchase (the "acquisition" date), the target must be a member of the consolidated group or affiliated with a selling domestic corporation.[6] In contrast, under the § 336(e) regulations, a § 336(e) election may be made for the target even if it is not affiliated with the selling corporation or a member of the selling consolidated group on the corresponding date (the "disposition" date).[7] Finally, if a § 338(h)(10) election is made, a gain recognition election is required,[8] while a gain recognition election for a purchaser may not be required following a § 336(e) election.[9]

II. The regulations' mechanics

A. Qualification

A § 336(e) election can be made only for a qualified stock disposition,[10] which occurs when an affiliated interest in a domestic corporation is transferred in a disposition or series of dispositions by another domestic corporation over a 12-month disposition period.[11] Any stock sold, exchanged, or

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[6] *See* § 1.338(h)(10)-1(b)(2)-(3); *id*. at (c)(1). A § 338(h)(10) election may also be made for an S corporation target, which is a corporation that is an S corporation immediately before the acquisition date. *Id*. at (b)(4); *Id*. at (c)(1).

[7] *See* § 1.336-2(a); *Id*. at (b)(1)(iii)(A); *id*. at (k), *Ex. 6*. *Cf*. § 332(b)(1) (providing that § 332 applies to a subsidiary liquidation only if the parent corporation owns an affiliated interest in the subsidiary from the date of the adoption of the plan of liquidation until the receipt of property). Note that a § 336(e) election may also be made for an S corporation target, which is a target that is an S corporation immediately before the disposition date. § 1.336-1(b)(3); § 1.336-2(a).

[8] § 1.338(h)(10)-1(d)(1). Under a gain recognition election, the purchasing corporation is treated as selling its nonrecently purchased target stock, recognizing gain but not loss and taking a basis in that stock that reflects the purchase price of recently purchased target stock. § 338(b)(3); § 1.338-5(d)(3).

[9] § 1.336-4(c)(2) (requiring the election only for an "80-percent purchaser" and any related persons and applying the election to nonrecently disposed target stock); § 1.336-1(b)(16) (defining an 80-percent purchaser as any purchaser that after attribution of § 318 (other than § 318(a)(4)) owns at least 80% of the voting power or value of target stock). Note that the regulations do not define when this 80-percent ownership interest is measured, although it makes sense for that interest to be measured on the disposition date immediately after the qualified stock disposition occurs. *Cf*. § 1.338-3(b)(3)(ii) (measuring whether a corporation is a related corporation after the transaction or series of transactions that results in a qualified stock purchase).

[10] § 1.336-2(a).

[11] § 1.336-1(b)(6)(i) (noting that the transfer may be a sale, exchange or distribution of any combination thereof). Unless the target is an S corporation, the transferor is called the "seller." *Id*. at

distributed is transferred in a disposition, unless –

(i) The transferee's basis in the stock is determined in whole or in part by reference to the transferor's basis;

(ii) The transferee's basis in the stock is determined under § 1014;

(iii) Except as noted just following this list, the stock is transferred in a transaction to which § 351, 354, 355, or 356 applies (or another non-recognition transaction described in the regulations); or

(iv) The stock is transferred to a related person.[12]

(b)(1) (stating that *generally* all members of a consolidated group that dispose of target stock are treated as a single seller, cross-referencing § 1.336-2(g)(2)). *See also* § 1.336-2(g)(2) (without reservation, treating all members of the seller's consolidated group as a single seller and providing that treatment regardless of whether a member actually disposes of any stock). For an S corporation target, the transferors are "S corporation shareholders," although that phrase refers to all target shareholders, whether or not they dispose of target stock. *Id*. at (b)(4). Any person who acquires or receives target stock in the qualified stock disposition, whether by purchase or distribution, is called a "purchaser." *Id*. at (b)(2).

The "target" is the corporation, the stock of which is transferred in the qualified stock disposition. *Id*. at (b)(3). An "S corporation target" is a target that is an S corporation immediately before the disposition date; all other targets are "non-S corporation targets." *Id*. Except as the context otherwise requires, a reference to target includes a reference to an S corporation target. *Id*.

The "12-month disposition period is the 12-month period beginning with the first target stock transfer included in the qualified stock disposition. *Id*. at (b)(7). A target's disposition date is the first day on which there is a qualified stock disposition for the target stock. *Id*. at (b)(8).

Finally, a domestic corporation is a corporation that is created or organized under the laws of the United States or any state (*see* § 7701(a)(4) and § 301.7701-5) or otherwise treated as a domestic corporation for purposes of subtitle A of the Code, as long as the corporation is not a DISC, § 1248(e) corporation or § 936 corporation. *Id*. at (b)(10) (referring to the definition in § 1.338-2(c)(9)).

[12] *Id*. at (b)(5)(i). *See also id.* at (b)(5)(iii) (adopting the principles of § 338(h)(3)(C) and § 1.338-3(b)(3) to limit related party transfers); *id*. at (b)(5)(iv) (providing that stock may be considered disposed of if considered sold, exchanged, or distributed under general principles of tax law, even if no amount is paid for (or allocated to) the stock); *id.* at (d)(5)(v) (providing that stock reacquired by the seller or a member of the seller's consolidated group (or reacquired by the transferring S corporation shareholder or a related person) during the 12-month disposition period is not considered disposed of).

Two persons are related if stock owned by one person would be attributed to the other under § 318(a) (other than § 318(a)(4)). *Id*. at (b)(12). Neither § 318(a)(2)(A) nor § 318(a)(3)(A) apply to attribute stock to or from a partner, however, unless the partner owns partnership interests representing at least 5% of the partnership's value. *Id*.

Even if stock is distributed in a § 355 transaction, it is treated as transferred in a disposition if it is transferred to a person who is not a related person in a transaction in which the full amount of stock gain would be recognized under § 355(d)(2) or (e)(2).[13]

If a qualified stock disposition of a target is also a qualified stock purchase for which a § 338 election may be made, a § 336(e) election generally cannot be made for the disposition.[14] As an exception, a section 336(e) election may be made if the target is a subsidiary of another corporation and the target's qualified stock disposition is "a result of the deemed sale of [the other corporation's] assets pursuant to a § 336(e) election."[15] In that exceptional case, a § 338 election cannot be made.[16]

For that purpose, the regulation does not define when a subsidiary's qualified stock disposition is "a result of" the deemed sale of its parent's assets pursuant to a § 336(e) election. Perhaps that result

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The disposition definition has a possible foot fault. The regulation provides that stock is not disposed of if the "purchaser" takes a basis in the stock determined by reference to the transferor's basis or determined under § 1014. However, a "purchaser" is a person who receives stock in a disposition. To avoid circularity, the regulation should refer to a "transferee," not a "purchaser."

Note that a transferee's basis in stock is determined under § 1014 only when the stock is received from a decedent. That exception should apply only for an S corporation target, since otherwise the target stock must be disposed of by a corporate seller. Perhaps the § 1014 exception applies because the decedent is incapable of making the § 336(e) election.

[13] *Id*. at (b)(5)(ii).

[14] § 1.336-1(b)(6)(ii)(A). Technically, this overlap rule states that if "a" transaction satisfies the definitions of both a qualified stock disposition and a qualified stock purchase, it generally is not treated as a qualified stock disposition. *Id*. Because a qualified stock disposition or purchase may result from a series of transactions, this rule should be amended to refer to a transaction *or series* of transactions. For example, suppose that P owns all T stock and sells an affiliated interest in the T stock to X, an unrelated corporation, and within 12 months but in a separate transaction sells the remaining T stock to an individual related to neither P nor X. The first sale is a qualified stock purchase, while the two sales together constitute a qualified stock disposition. However, the overlap rule, unless amended, does not apply, because neither sale, by itself, would be both a qualified stock disposition and qualified stock purchase. Although the series of sales would satisfy both definitions, as the rule now reads, either a § 336(e) or § 338 election could be made.

Note that if a § 338 election is made for P's sale of T stock to X, P's subsequent sale of T stock to the individual would *not* be part of a qualified stock disposition. After the acquisition date (*i.e.*, the date of P's sale to X), T would be treated for federal income tax purposes as a new corporation. § 1.338-1(b)(1). Therefore, when P sold a portion of the T stock to the individual, it would be selling "new" T stock. Because P would not dispose of an affiliated interest in "new" T over a 12-month period, it would not make a qualified stock disposition of "new" T.

[15] *Id*. at (b)(6)(ii)(B) (technically treating the disposition as a qualified stock disposition).

[16] § 1.338-1(a)(1).

occurs when, but for the deemed sale of the parent's assets, there would not be a qualified stock disposition of the subsidiary's stock.[17]

Example 1 – The overlap rule

P owns 80 percent of the only class of T stock and X owns the remaining T stock. X is a corporation and is not related to P.[18] P and T own 80 percent and 20 percent, respectively, of the only class of T1 stock outstanding. P, T, and T1 join in filing consolidated returns.

Assume that P sells a 60-percent block of the T stock to X and a 20-percent block of that stock to Fred, who is also not related to P, and at the same time and as part of the same transaction, P sells its 80-percent block of T1 stock to X. Assume as well that P makes a § 336(e) election for T.[19] Because of the election, "old" T is deemed to sell its 20-percent block of T1 stock and "new" T is deemed to purchase that stock.

Because P and "old" T are members of a consolidated group, they are treated as a single seller.[20] Thus, in a single transaction, a seller is treated as selling all T1 stock, 80 percent actually and 20 percent in T's deemed asset sale. Because X and P and "old" and "new" T are not related, the sales are dispositions and, subject to the overlap rule, could be treated as a qualified stock disposition.[21]

The transaction also should satisfy the definition of a qualified stock purchase, because the X group (including "new" T) acquires all T1 stock by purchase (*i.e.*, a cost-basis acquisition of all T1 stock from unrelated persons).[22] Thus, the transaction presents an overlap.

With or without T's deemed sale of the T1 stock, the transaction would have satisfied the "qualified stock disposition" definition. Thus, that disposition did not "result from" the § 336(e) election, the exception to the overlap rule should not apply, and under the overlap rule, the

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[17] It would be helpful if the regulations made it clear that this "but for" test applied.

[18] In other words, stock owned by X or P is not attributed to the other under § 318(a) (other than § 318(a)(4)). *See* § 1.336-1(b)(12) (for the related person definition). Unless otherwise stated, in each example, assume that any corporation is a domestic corporation.

[19] P disposed of that stock in a qualified stock disposition, because it sells an affiliated interest in that stock to persons not related to P and the purchasers take cost bases in the purchased T stock. *See* § 1.336-1(b)(6)(i).

[20] § 1.336-2(g)(2).

[21] *Id*. at (g)(1) (generally treating the target (*i.e.*, the old and new target) before and after the deemed asset sale as separate corporations for federal income tax purposes).

[22] *See* § 338(h)(3) (defining purchase); *id*. at (d)(3) (defining qualified stock purchase); *id.* at (h)(8) (treating all acquisitions by an affiliated group as made by one corporation); *id*. at (h)(5) (defining an affiliated group by looking to § 1504(a) without regard to the exceptions in § 1504(b)).

transaction is not treated as a qualified stock disposition.

The result should be the same even if P's distribution of the T stock is on a day preceding, or following, its sale of the T1 stock to X, as long as the distribution and sale are part of the same transaction.[23]

Example 2 – Exception to the overlap rule

The facts are the same as in **Example 1**, except that P and T own, respectively, 70 percent and 30 percent of the T1 stock. Thus, P sells a 60-percent block of the T stock to X and a 20-percent block of that stock to Fred and at the same time and as part of the same transaction, P sells its 70-percent block of T1 stock to X. P makes a § 336(e) election for its qualified stock disposition of T, and because of the election, "old" T is deemed to sell its 30-percent block of T1 stock and "new" T is deemed to purchase that stock.

Because P and "old" T are members of a consolidated group, they are treated as a single seller.[24] Thus, in a single transaction, a seller is treated as selling all T1 stock, 70 percent actually and 30 percent in T's deemed asset sale. Because X and P (and "old" and "new" T) are unrelated, the sales are dispositions and, subject to the overlap rule, could be treated as a qualified stock disposition.[25]

The transaction also satisfies the definition of a qualified stock purchase, because the X group acquires all T1 stock by purchase (*i.e.*, a cost basis acquisition of all T1 stock from unrelated persons).[26] Thus, the transaction presents an overlap.

However, without T's deemed sale of the T1 stock, the transaction would not have satisfied the "qualified stock disposition" definition (or, for that matter, the "qualified stock purchase" definition). Thus, but for the deemed sale of T's assets, the P group would not make a qualified stock disposition of the T1 stock, so that the deemed sale results in that disposition. Accordingly, the exception to the overlap rule applies, and the actual and deemed sales of the T1 stock are treated as a qualified stock disposition.[27] A § 336(e) election may be made for the

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[23] If the two steps are separate transactions, the overlap rule literally does not apply. *See supra* note 14 (for a discussion of this point).

[24] § 1.336-2(g)(2).

[25] *Id*. at (g)(1) (generally treating the target before and the target after the deemed asset sale as separate corporations for federal income tax purposes).

[26] *See* § 338(h)(3) (defining purchase); *id*. at (d)(3) (defining qualified stock purchase); *id.* at (h)(8) (treating all acquisitions by an affiliated group as made by one corporation); *Id*. at (h)(5) (defining an affiliated group by looking to § 1504(a) without regard to the exceptions in § 1504(b)).

[27] The result should be the same even if P's sale of the T stock is on a day preceding, or following, its sale of the T1 stock to X, as long as the sales are part of the same transaction.

disposition; a § 338 election may not be made.[28]

Note, however, that when this exception applies, the disposition is still both a qualified stock purchase and a qualified stock disposition. If a § 336(e) election is not made, it is unclear whether the consistency rules under § 336 or § 338 apply. In contrast, when the overlap rule applies, the disposition is not treated as a qualified stock disposition, and if no § 338 election is made, the consistency rules under § 338 should apply.

As a final point, consider the following curious case where the overlap rule, rather than the exception, appears to apply. In that case, the transaction meets the general definition of a qualified stock disposition whether or not a § 336(e) election is made, but the election results in a transaction being treated as a qualified stock purchase. Thus, if the election is made, the overlap rule prevents the transaction from being a qualified stock disposition, likely an unintended result.

Example 3 – A curious case

The facts are the same as in **Example 1**, except that P sells a 60-percent block of T1 stock to X and a 20-percent block of that stock to Fred. Overall, therefore, P sells 60-percent blocks of the T stock and T1 stock to X and 20-percent blocks of the T stock and T1 stock to Fred.

Assume first that P *does not make* a § 336(e) election for its sales of the T stock to X. P's sales of the *T1* stock constitute a qualified stock disposition, because P has sold an affiliated interest in T1 to unrelated persons on one day (and therefore during a 12-month period). Those sales do not constitute a qualified stock purchase of the T1 stock, because no corporation (or affiliated group of corporations) has purchased an affiliated interest in the T1 stock.[29]

Assume, instead, that P makes a § 336(e) election for its sales of the T stock to X and Fred. Because of the election, "old" T is deemed to sell its 20-percent block of T1 stock and "new" T is deemed to purchase that stock. Because P and "old" T are members of a consolidated group, they are treated as a single seller.[30] Thus, in a single transaction, a seller is treated as selling all T1 stock, 80 percent actually (to Fred and X) and 20 percent in "old" T's deemed asset sale. Because X and P, Fred and P, and "old" and "new" T are each not related, the sales are

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[28] § 1.338-1(a)(1) (providing that if as a result of the deemed purchase of a target's assets pursuant to a § 336(e) election, there would be both a qualified stock purchase and qualified stock disposition of a target subsidiary, a § 338 election may not be made for the purchase but a § 336(e) election may be made).

[29] *See* § 338(d)(3) (defining a qualified stock purchase); *id*. at (h)(8) (treating an affiliated group of corporations as one corporation).

[30] § 1.336-2(g)(2).

dispositions and, subject to the overlap rule, could be treated as a qualified stock disposition.[31]

Because of the § 336(e) election, the transaction also satisfies the definition of a qualified stock purchase, because the X group (including "new" T) acquires an affiliated interest in the T1 stock by purchase (*i.e.*, a cost basis acquisition of 80 percent of the T1 stock from unrelated persons).[32] Thus, the transaction presents an overlap.

With or without T's deemed sale of the T1 stock, the transaction would have satisfied the "qualified stock disposition" definition. Thus, the exception to the overlap rule apparently does not apply. Instead, under the overlap rule, it is treated as a qualified stock purchase.

That result seems curious, because the transaction can be treated as a qualified stock purchase only because of a qualified stock disposition and a § 336(e) election. To treat that case as a qualified stock disposition, the exception could be modified to apply if the target is a subsidiary of another corporation and the qualified stock disposition *or qualified stock purchase* of the target is "a result of the deemed sale of [the other corporation's] assets pursuant to a § 336(e) election."

B. Consequences of an election in general

The regulations use two models for the deemed transactions, a model for most qualified stock dispositions and a model that applies for those dispositions to which § 355(d)(2) or (e)(2) apply in whole or in part. This part of the article describes the first of those models.

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[31] *Id*. at (g)(1) (generally treating the target before and the target after the deemed asset sale as separate corporations for federal income tax purposes).

[32] *See* § 338(h)(3) (defining purchase); *id*. at (d)(3) (defining qualified stock purchase); *id.* at (h)(8) (treating all acquisitions by an affiliated group as made by one corporation); *Id*. at (h)(5) (defining an affiliated group by looking to § 1504(a) without regard to the exceptions in § 1504(b)). No one other than X ever appears to own the "new" T stock, so that "new" T should be treated as a member of the X group when it is deemed to purchase its T1 stock.

Note that if P had distributed the T stock to X in the qualified stock disposition, the result would appear to differ, because "new" T apparently would be deemed to purchase its T1 stock before it became a member of the X group. In fact, that deemed purchase would occur before P distributed the T stock to X, because P would be treated as distributing "new" T stock, but only after "new" T was deemed to purchase the T assets, including the T1 stock. § 1.336-2(b)(1)(iv) (providing that if the seller distributes target stock in the qualified stock disposition, the stock deemed distributed is new target stock, which the seller is deemed to purchase after the deemed liquidation of the old target); *id*. at (b)(1)(ii) (providing that the deemed purchase by the "new" target of the target assets occurs before the deemed liquidation of the old target). Thus, new T would apparently make the deemed purchase before it became a member of the X group, the X group would not purchase an affiliated interest in the T1 stock, and the transaction could not be a qualified stock purchase.

1. The deemed events

If a seller or S corporation shareholders dispose of target stock in a qualified stock disposition (other than one to which § 355(d)(2) or (e)(2) applies in whole or in part) and a § 336(e) election is made for the disposition,[33] the following events are deemed to occur at the close of the disposition date in the following order:

(i) The target corporation (referred to in the regulations as the "old target") is treated as selling its assets to an unrelated person in a single transaction at the close of the disposition date;

(ii) The target (referred to in the regulations as the "new target") is treated as acquiring those assets from an unrelated person in a single transaction at the close of the disposition date; and

(iii) The old target is deemed to distribute its assets (*i.e.*, the proceeds from the deemed sale) to the seller or S corporation shareholders.[34]

Except as otherwise provided, the federal income tax consequences of the deemed events are the same as if the parties had actually engaged in the transactions that are deemed to occur.[35]

2. The old target and new target

If a general election is made, "old target" refers to the target on or before the close of the disposition date, while "new target" refers to the target for subsequent periods.[36] Although the old and

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[33] For convenience, this § 336(e) election is called the general election.

[34] *Id*. at 2(b)(1)(i) (providing for the deemed sale by the old target); *id*. at (b)(1)(ii) (providing for the deemed purchase by the new target); *id*. at (b)(1)(iii) (providing for the deemed distribution of all sales proceeds by the old target).

If the target has foreign operations, the principles of § 338(h)(16) apply, and if the target's taxable year for foreign tax purposes does not close at the end of the disposition date, foreign income taxes attributable to foreign taxable income are allocated between the old and new targets under the principles of § 1.1502-76. *Id*. at (g)(3).

[35] *Id*. at (e).

[36] § 1.336-1(b)(3). However, for a § 355(d)(2) or (e)(2) transaction, "old target" refers to the target for all periods, whether before of after the disposition date. *Id*.

Note that if a general election is made, new target is deemed to purchase the target assets immediately before the deemed liquidation of old target and the close of the disposition date. Therefore, old and new target are deemed to simultaneously exist at least for an instant. *Cf*. *id*. (providing that new target refers to target after the close of the disposition date).

new target are actually one corporation under corporate law, they are generally treated as separate corporations for purposes of subtitle A of the Code.[37] However, the new target remains liable for the old target's federal income tax liabilities (including the liabilities of its consolidated group under § 1.1502-6) and the new target must use the old target's employer identification number.[38]

a. The deemed sale by the old target

(i) Recognition of gain or loss

The old target is treated as selling its assets for the aggregate deemed asset disposition price ("ADADP") while the seller or the S corporation shareholders still own the old target stock.[39] If the old target is an S corporation target, the old target's S election continues in effect through the close of the disposition date.[40]

The ADADP is allocated among the target assets using the seven-tier residual method described in § 1.338-6, an allocation that determines the amount realized for each asset in the deemed sale.[41] Under

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[37] *Id*. at (g)(1) (noting that this general rule does not apply as provided in § 1.338-1(b)(2) and also does not apply to a § 355(d)(2) or (e)(2) distribution).

[38] *Id*. at (b)(1)(ii); *id*. at (f) (providing that § 1.338-1(b) applies to new target, treating any reference to § 338 or § 338(h)(10) as a reference to § 336(e)); § 1.338-1(b)(3) (adding that wages earned by employees of old target are considered wages earned by new target employees for purposes of §§ 3103, 3111, and 3301).

[39] *Id*. at (b)(1)(i)(A). *See also* § 1.338-1(c)(1) (for an anti-abuse rule). If elections are made for a parent-subsidiary chain of corporations, the deemed asset disposition of a higher tier subsidiary is considered to precede the deemed asset disposition of a lower-tier subsidiary. *§ 1.336-2*(b)(1)(i)(C). Note that the regulations do not state when the deemed asset disposition of the parent in the chain of tiered targets is deemed to occur. *Cf*. § 1.338(h)(10)-1(d)(3)(ii). Nor do the regulations describe the order of the deemed sales if a § 336(e) election is made for a parent but a § 338(h)(10) election is made for the subsidiary. In the latter case, the parent's deemed sale again should precede the subsidiary's.

[40] *Id*. at (b)(1)(i)(A). Further, if the target is an S corporation, any direct or indirect target subsidiaries that are qualified Subchapter S subsidiaries ("QSubs) remain QSubs through the close of the disposition date. Thus, the assets of any such QSubs are deemed sold as part of the target's deemed asset sale.

[41] § 1.336-3(a). The ADADP is allocated among the disposition date assets, which are the assets of the target held at the beginning of the day after the disposition date. § 1.336-1(b)(9) (defining disposition date assets); § 1.336-2(b)(1)(i). The ADADP is initially determined at the beginning of the day after the target's disposition date. *See* § 1.338-2(b)(2)(i)(A). The ADADP may be redetermined (*e.g.*, to account for contingent liabilities or consideration), and the timing and amount of an increase or decrease to the ADADP is determined under general principles of tax law. *Id*. at (b)(2)(ii). Any increase or decrease is taken into account under the principles of § 1.338-7. *Id*. *See also* § 1.336-1(b)(1)(i)(A)

that residual method, the ADADP is first reduced by the amount of Class I assets.[42] The remainder is then allocated, in order, among Class II assets, then Class III assets, then Class IV assets, then Class V assets, and then Class VI assets, to the extent of, and in proportion to, the fair market value of the assets in each class.[43] Any residual is allocated to Class VII assets. Class I assets are cash, demand deposits, and similar accounts in financial institutions; Class II assets are certificates of deposit, foreign currency, U.S. government securities, publicly traded stock, and any other actively traded personal property (as defined in § 1092(d)(1) without regard to § 1092(d)(3)); Class III assets are accounts receivables and the like; Class IV assets are inventory and the like; Class VI assets are section 197 intangibles other than goodwill or going concern value; and Class VII assets are goodwill and going concern value.[44] Class V assets are any other assets.[45]

On the deemed sale, the old target's realized gain or loss on each asset equals the difference between the asset's allocable share of the ADADP and its adjusted basis.[46] The old target generally recognizes that realized gain and loss.[47] It recognizes any gain, except to the extent that the installment method applies (and typically the seller succeeds to any deferred installment gain).[48]

The old target recognizes its realized loss on the deemed sale, unless the seller distributes old target stock during the 12-month disposition period.[49] In that exceptional case, if the old target's realized loss on its deemed asset sale exceeds its realized gain, a portion of that excess (*i.e.*, its net loss) is disallowed.[50] The disallowed portion equals the net loss multiplied by the following fraction (the "loss

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(referring to the allocation scheme under § 1.338-6 and § 1.338-7).

[42] § 1.338-6(b)(1) (also providing that if the amount of Class I assets exceeds the deemed sales price, the seller recognizes ordinary income equal to that excess).

[43] *Id*. at (b)(2)(i).

[44] *Id*. at (b)(1); *id*. at (b)(2)(ii)-(vii).

[45] *Id*. at (b)(2)(v).

[46] § 1001(a).

[47] § 1.336-2(b)(1)(i).

[48] *Id*. at (b)(1)(i)(B)(*1*) (referring to § 1.338(h)(10)-1(d)(8) for rules that apply § 453, § 453A, and § 453B when the seller receives an installment obligation from a purchaser; under § 1.338(h)(10)-1(d)(8), the old target is treated as receiving a new target installment obligation on its deemed asset sale, it defers gain under the installment method, and if § 337 applies to the old target's deemed liquidation, the seller steps into the old target's shoes, recognizing that gain as the installment obligation is paid).

[49] *Id*. at (b)(1)(i)(B)(*2*)(*i*).

[50] *Id*. at (b)(1)(i)(B)(*2*)(*ii*).

disallowance fraction") --

A/(A + B), where --

A	=	The value of the target stock distributed by the seller during the 12-month disposition period, and
B	=	The value of the target stock disposed of by sale or exchange in the qualified stock disposition during the 12-month disposition period.[51]

The disallowed loss is allocated among the old target's loss assets in proportion to their realized losses.[52]

If stock of a target subsidiary is deemed sold by the target in its deemed asset sale and a § 336(e) election is also made for the subsidiary, any gain or loss realized on the target's deemed sale of the target subsidiary stock is disregarded.[53] However, a portion of that subsidiary stock is deemed distributed in computing the subsidiary's loss disallowance fraction. That portion equals (i) the amount of subsidiary stock deemed sold in the old target's deemed asset sale multiplied by (ii) the old target's loss disallowance fraction.[54] Although the regulation is silent on this point, any remaining portion of the subsidiary stock deemed sold by the target should be treated as disposed of by sale or exchange in the subsidiary's qualified stock disposition.

The loss disallowance rule in the final regulations marks a substantial change from the proposed regulations. Among other things, under the proposed regulations, the disallowed loss was a fraction of

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[51] *Id*. at (b)(1)(i)(B)(*2*)(*iii*) (providing that the value of the target stock for these purposes is determined on the disposition date, adding that loss may also be disallowed under other Code provisions or general tax principles "in the same manner as if those assets were actually sold to an unrelated person"). Note that the value of distributed stock is taken into account in the numerator and denominator of the loss disallowance fraction whether or not the distribution is part of the qualified stock disposition. *Id*.

[52] *Id*. For this purpose, a loss asset is an old target asset for which a loss is realized in the deemed asset sale. *Id*. at (b)(1)(i)(B)(*3*), *Ex. 3* (illustrating that if the old target realizes a loss on its deemed sale of an asset, the asset is a loss asset, even if the asset's value in fact exceeds its basis on the disposition date).

[53] *Id*. at (b)(1)(i)(B)(*2*)(*iv*). Presumably, if a § 338(g) election is made for the target subsidiary, the old target's gain or loss on its subsidiary stock is not disregarded and loss may be disallowed under the loss disallowance rule. If, instead, a § 338(h)(10) election is made for the subsidiary, however, the old target's gain or loss on subsidiary stock should be disregarded, at least if the subsidiary's deemed liquidation is described in § 332.

[54] *Id*. (adding that in determining the loss disallowance fraction for a subsidiary, if subsidiary stock is deemed sold by the old target, any subsequent sale, exchange, or distribution of that stock is disregarded).

the old target's *gross* loss on its sale of loss assets,[55] an approach greeted with less than favor by commentators.[56] Noting the criticism, the final regulations adopted the net loss disallowance rule, stating in the preamble that the proposed rule was "broader in scope than necessary to serve the purposes of section 336(e)."[57]

Still, it is difficult to support the net loss disallowance rule. Broadly, a loss disallowance rule may be justified, if at all, to further the policy of § 311. Under that policy, the disallowed loss on the target's deemed sale arguably should be limited to the loss that would have been disallowed to the seller under § 311 if it had distributed the target stock but no § 336(e) election had been made.[58] The final regulation, however, looks to the target's net loss on the deemed asset sale, a loss with no necessary connection to the seller's realized loss on its distribution of target stock. The final regulation also provides no exception from loss disallowance for a distribution of target stock in a § 336 liquidation, a distribution where loss is generally allowed.[59]

The net loss disallowance rule is also hard to square with the § 336(e) fictions – that the old target is deemed to sell its assets to an unrelated person and then liquidate into the seller, the model for a § 338(h)(10) transaction. Just as loss is not disallowed under § 311 principles on the deemed sale to an unrelated person under § 338,(h)(10), loss should not be disallowed in a § 336(e) deemed sale.[60] In addition. just like a § 338(h)(10) deemed sale, a § 336(e) deemed sale should not implicate § 311 principles, because all target assets are deemed sold, avoiding selective loss recognition, which arguably is the concern targeted by § 311.[61]

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[55] *See* Prop. § 1.336-2(b)(1)(ii)(B)(*2*) (2009).

[56] *See,* e.g.*,* New York State Bar Association Tax Section Report on Proposed Regulations Implementing Section 336(e), 2009 TNT 1-21 at *17-*18 (Dec. 31, 2008) ("NYSBA report").

[57] *See* 78 Fed. Reg. 28467 (May 15, 2013).

[58] *See* NYSBA report, *supra* note 55 at *18, n. 72 (making this argument).

[59] *See* § 336(a); *cf.* § 336(d). *See also* NYSBA report, supra note 55 at *18 (noting this problem with the proposed regulation).

[60] The proposed loss disallowance rule was consistent with treating the target as if it made a § 311 distribution of an undivided portion of its assets as part of a deemed sale/distribution. For the portion of the deemed transaction treated as a distribution, gross gain would be recognized but gross loss would be disallowed. The final regulation did not adopt a deemed sale/distribution fiction in whole or in part, however, instead using a § 338(h)(10) model, consistent with applicable legislative history. H.R. (Conf.) Rep. No. 99-841, at II-204 (1986) (describing the § 336(e) election, stating that "under regulations, principles similar to those of section 338(h)(10) may be applied to taxable sales or distributions of controlled corporation stock").

[61] *See* George K. Yin, *Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986*, 42 Tax L. Rev. 575, 623 (1987) (suggesting this rationale). *See also* Don

Finally, as the following example illustrates, a § 338(h)(10) transaction may involve a distribution of all target stock. Because that distribution does not result in loss disallowance, nor should a distribution that is part of a § 336(e) transaction.

Example 4 – Distribution resulting in a § 338(h)(10) transaction

P owns all T stock and on one day distributes that stock to X, a corporation, in a taxable complete redemption of X's P stock. Assume that before the redemption, X did not own an affiliated interest in P and after the redemption, X and P are not related. X has made a qualified stock purchase of the T stock, because it has acquired all T stock by purchase during a 12-month acquisition period.[62] Because of the overlap rule, P is not treated as making a qualified stock disposition of the X stock.[63]

Because P owned all T stock on the acquisition date, it owned an affiliated interest in that stock and P and X may join in filing a § 338(h)(10) election.[64] If the election is made, no portion of any loss on T's deemed asset sale will be disallowed (*i.e.*, there is no rule under § 338(h)10) or applicable regulations akin to the loss disallowance rule of § 1.336-1(b)(1)(i)(B)(*2*)).

Note, however, that if P had distributed the T stock to Fred in complete redemption of Fred's stock and Fred and P were unrelated after the redemption, the distribution would be a qualified

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Leatherman, *The Scope of the* General Utilities *Repeal*, 91 TAXES 235, 240 (Mar. 2013) (adding that § 311 may also have targeted the undervaluation of distributed assets).

[62] § 338(d)(3) (defining qualified stock purchase). X's acquisition of the T stock is a purchase, because a purchase includes all acquisitions of stock except for (i) stock the basis of which is not a transferred basis or determined under § 1014, (ii) stock acquired in an exchange to which § 351, 354, 355, or 356 applies (or any other non-recognition transaction identified by regulation), or (iii) stock acquired from a related person (*i.e.*, a person the ownership of whose stock would under § 318(a) (other than (a)(4)) be attributed to the acquiror). § 338(h)(3)(A). Because X takes a cost basis in the T stock and X and P are unrelated after the redemption, X has acquired the T stock by purchase. *See* § 1.338-3(b)(3)(ii) (measuring whether persons are related after the purchase (or purchases) of target stock included in the qualified stock purchase).

[63] § 1.336-1(b)(6)(ii)(A).

[64] P and X may join in filing a § 338(h)(10) election, because either P will be a selling affiliate (if P and T do not join in filing consolidated returns) or T will be a consolidated target and a member of a selling consolidated group (if P and T are members of a consolidated group). *See* § 1.338(h)10)-1(c) (providing that such an election may be made if the target is acquired from a selling affiliate or selling consolidated group); *id*. at (b)(1) (defining a consolidated target as a target that is the member of a consolidated group on the acquisition date but not the common parent); *id.* at (b)(2) (defining a selling consolidated group as the consolidated group of which the consolidated target is a member on the acquisition date); *id*. at (b)(3) (defining a selling affiliate as a domestic corporation that owns an affiliated interest in a domestic target on the acquisition date).

stock disposition, but not a qualified stock purchase.[65] Then, if P made a § 336(e) election for the disposition, all of T's net loss on its deemed asset sale would be disallowed under the loss disallowance rule.

It is hard (if not impossible) to justify applying the loss disallowance rule to the distribution to Fred, but not X, in **Example 4**. Nevertheless, the final regulations retain the rule. Its basic operation is illustrated by the following example:

Example 5 – The loss disallowance rule – a basic case

P owns all of the outstanding shares of T's only class of stock. On one day, P sells 80 percent of the T stock for $800 to an individual not related to P and distributes the remaining T stock, worth $200, to a shareholder. On that date, T has no liabilities and three assets, Asset 1 with a $100 basis and $300 value, Asset 2 with a $600 basis and $200 value, and Asset 3 with a $600 basis and $500 value.

P has made a qualified stock disposition of the T stock, because on one day it has sold an affiliated interest in the T stock to an individual not related to P.[66] Assume that P makes a § 336(e) election for its qualified stock disposition of the T stock.

Assume as well that in the deemed sale, T is deemed to sell each of its assets for its fair market value. Thus, T realizes a $200 gain on Asset 1, a $400 loss on Asset 2, and a $100 loss on Asset 3, or in net a $300 loss. Of that net loss, 20 percent or $60, is disallowed. That percentage (the loss disallowance fraction) equals A /(A + B), where –

A = The value of the target stock distributed by the seller during the 12-month disposition period, and

B = The value of the target stock disposed of by sale or exchange in the qualified stock disposition during the 12-month disposition period.[67]

Thus, A equals $200 (the value of the distributed T stock) and B equals $800 (the value of the T stock sold in the qualified stock disposition, and the loss disallowance fraction equals

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[65] The distribution could not be a qualified stock purchase because a corporation would not acquire by purchase an affiliated interest in the T stock.

[66] § 1.336-1(b)(6)(i) (defining a qualified stock disposition as the sale, exchange or distribution of an affiliated interest in stock of a domestic corporation by another domestic corporation over a 12-month disposition period); *id.* at (b)(5)(i) (defining dispositions).

[67] § 1.336-2(b)(1)(i)(B)(*2*)(*iii*) (providing that the value of the target stock for these purposes is determined on the disposition date, adding that loss may also be disallowed under other Code provisions or general tax principles "in the same manner as if those assets were actually sold to unrelated persons").

$200/($200 + $800) or 20 percent.

The $60 disallowed loss is allocated among the old target's loss assets in proportion to their realized losses.[68] Thus, $48 ($400/$500 times $60) of the $400 loss on Asset 2 is disallowed and $12 ($100/$500 times $60) of the $100 loss on Asset 3 is disallowed.

Note that the result in **Example 5** is the same, whether or not the distributed T stock was disposed of, because all T stock distributed within the 12-month disposition period is taken into account, whether or not it is distributed in a qualified stock disposition.[69] Note as well that if P had owned only 90 percent of the T stock and had distributed a 10-percent block of that stock while selling the remaining 80-percent block to an unrelated person, the loss disallowance fraction would have been 11.11 percent ($100/$900), not 10 percent. In fact, if the seller distributes T stock but owns less than all T stock before the qualified stock disposition, retains some T stock, or sells or exchanges T stock other than in a disposition, the loss disallowance fraction will exceed the percentage of stock (by value) distributed by the seller during the 12-month disposition period.[70]

As one likely unintended result, the loss disallowance fraction appears not to take into account target stock sold or exchanged in a disposition after the disposition date but before the end of the 12-month disposition period.

Example 6 – Disposition by sale or exchange after the disposition date

P owns all of the single class of T stock. On day 1, it distributes 20 percent of that stock to an unrelated shareholder and sells 60 percent of the stock to an unrelated individual. On day 2, it sells the remaining 20 percent of the T stock to an unrelated person. On day 1, P has made a qualified stock disposition of the T stock, because it disposed of an affiliated interest in the T stock that day.[71] Assume that P makes a § 336(e) election for that qualified stock disposition.

The loss disallowance fraction is determined by considering two factors. First, both the numerator and denominator include the value of the T stock distributed by P during the 12-month distribution period, whether or not as part of the qualified stock disposition. Second, the

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[68] *Id.*

[69] *Id.*

[70] It is not altogether clear why the loss disallowance fraction should exceed the percentage of target stock (by value) distributed during the 12-month acquisition period, although it may be a simple, albeit imprecise, way to account for possible later distributions of retained target stock. For example, if in **Example 5** P had retained 10% of the T stock, the loss disallowance fraction would be 11.11% ($100/$900). P could later distribute or sell the retained stock and the 1.11% "penalty" may simply be a way to account for the possible later distribution.

[71] § 1.336-1(b)(6)(i); *id.* at (b)(5)(i).

denominator also includes as a summative factor "the value of [T] stock . . . disposed of by sale or exchange *in the qualified stock disposition* during the 12-month disposition period."[72] That stock includes the T stock sold on day 1 but not on day 2. Although the stock sold on day 2 is disposed of within the 12-month disposition period, it is not part of the qualified stock disposition. Because of the § 336(e) election, T on or before the disposition date ("old" T) is treated as a corporation separate from T after the disposition date ("new" T).[73] In P's qualified stock disposition on day 1, it sells "old" T stock, while on day 2 it sells "new" T stock. Because "new" T is treated as a corporation separate from "old" T, P's sale of the "new" T stock cannot be included in the qualified stock disposition of "old" T, and that sale is not taken into account in computing the loss disallowance factor. Thus, the loss disallowance factor equals 25 percent ($200/$800).[74]

The loss disallowance rule also places a premium on planning, since the seller may be able to avoid the rule through a pre-sale recapitalization of the target corporation or through selective sales of target loss assets Among other things, **Example 7** illustrates a pre-sale recapitalization.

Example 7 – Recapitalization

P owns all of T's only class of stock outstanding. On one day, it distributes 20 percent of that stock to Fred, an unrelated individual, and sells the remaining 80 percent of the stock to X, an unrelated corporation. X has made a qualified stock purchase of the T stock, because it has acquired an affiliated interest in the T stock by purchase over a 12-month period.[75] Because of the overlap rule, P is not treated as making a qualified stock disposition of the T stock.[76] If P and X join in making a § 338(h)(10) election, none of T's loss on its deemed asset sale will be disallowed under a loss disallowance rule like under § 1.336-2(b)(1)(i)(B)(*2*).

That loss disallowance rule will apply, however, if the transaction is modestly changed. Assume,

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[72] § 1.336-2(b)(1)(i)(B)(*2*)(*iii*) (emphasis added).

[73] *Id*. at (g)(1).

[74] This result may be contrary to the regulation's intent, even though it is consistent with its language. In relevant part, the regulation states that the denominator of the loss disallowance fraction takes into account "the value of target stock . . . disposed of by sale or exchange in the qualified stock disposition *during the 12-month disposition period*." *Id*. at (b)(1)(i)(A)(*2*)(*iii*) (emphasis added). The italicized portion may have added to capture target stock, like the T stock sold on day 2, disposed of by sale or exchange after the disposition date. (It appears to have no other purpose.) If that was the regulation's intent, the quoted language should be modified to read as follows: "the value of target stock . . . disposed of by sale or exchange by the seller or S corporation shareholders during the 12-month disposition period."

[75] § 338(d)(3).

[76] 1.336-1(b)(6)(ii)(A).

instead, that P distributes 21 percent of the T stock to Fred and sells only 79 percent to X. The disposition will not be a qualified stock purchase because no corporation has acquired an affiliated interest in the T stock by purchase over a 12-month period. It will, however, be a qualified stock disposition, because a domestic corporation has disposed of all stock of another domestic corporation to unrelated persons over a 12-month period.[77] If P makes a § 336(e) election for the disposition, 21 percent of T's net loss will be disallowed under the loss disallowance rule. Thus, the distribution of an additional one percent of the T stock to Fred occasioned a 21-percent loss disallowance "penalty."

That penalty should be avoided if T appropriately recapitalized its stock before the transaction, so that X still acquired an affiliated interest in the T stock. For example, if as a prelude to the distribution and sale of T stock, P exchanged at least a 1.25-percent block of T common voting stock for T non-voting preferred stock described in § 1504(a)(4), P could sell at least an 80-percent interest in the T voting common stock to X, distributing the remaining T stock to Fred. Because the initial recapitalization should be respected, at least if it is "permanent,"[78] X would acquire an affiliated interest in the T stock, making a qualified stock purchase, P and X could join in making a § 338(h)(10) election, and the loss disallowance rule would not apply.

The loss disallowance rule may also be avoided through a preliminary sale of loss assets, at least if the sale is not unwound. For example, suppose that P distributes all of its T stock to Fred in a qualified stock disposition. If P makes a § 336(e) election for T and T has a net loss, say of $100, that loss is disallowed under the loss disallowance rule. Suppose, instead, that as a prelude to the distribution, T sells a loss asset to Fred, recognizing a $100 loss. If P then distributes the T stock to Fred and makes a § 336(e) election for T, T will have no net loss, so that the loss disallowance rule should not apply.[79] Note, however, that if Fred sold the former loss asset back to T as part of the same plan, the two sales should be disregarded, T should be treated as retaining the loss asset, T would recognize a $100 net loss

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[77] *Id*. at (b)(6)(i). The distribution and sale are dispositions, because each transfer is a taxable, each is to a person not related to P, and Fred and X each take fair market bases in the transferred stock. *See* § 301(d); § 1012.

[78] *See* Rev. Rul. 76-223, 1976-1 C.B. 103 (respecting a "permanent" recapitalizaton of the target's stock, entitling a corporation to acquire control of the target in a § 368(a)(1)(B) reorganization); Rev. Rul. 56-117, 1956-1 C.B. 180 (as part of a plan, a corporation acquired control of a second corporation in a recapitalization and distributed the stock of the second corporation, meeting the control requirements of § 355(a)). *See also* Rev. Rul. 77-227, 1977-2 C.B. 120 (respecting a recapitalizaton of the acquiring corporation as a planned prelude to a § 368 merger, avoiding the application of an older version of § 382 to the net operating loss carryover of the target corporation).

[79] § 1.336-2(b)(1)(i)(A) (providing that in determining the old target's gain or loss, the ADADP is allocated among the disposition date assets); § 1.336-1(b)(9) (defining the disposition date assets as the asset of the target held at the beginning of the day after the disposition date, but referring to the principles of § 1.338-1(d)). *Cf*. § 1.338-1(d) (providing a next-day rule for post-closing transactions on the acquisition date).

on its deemed asset sale, and the loss disallowance rule should disallow that net loss.[80]

(ii) Computing the ADADP

The aggregate amount realized for the target assets in the deemed sale is the aggregate deemed asset disposition price (the "ADADP").[81] To determine the realized gain or loss for each asset, the ADADP is allocated among the disposition date assets using the seven-tier residual method.[82]

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[80] *See* § 1.336-2(e) (providing generally that no provision in § 1.336-2 will "produce a Federal income tax result under subtitle A of the . . . Code that would not occur if the parties had actually engaged in the transactions deemed to occur because of this section, taking into account other transactions that actually occur or are deemed to occur").

Suppose, instead, that P and T file consolidated returns. The loss disallowance rule could be avoided if the following three steps were respected and no anti-avoidance rule applied: First, T distributed the loss asset to P. Second, P distributed the T stock to Fred and made a § 336(e) election for the distribution. Finally, P sold the loss asset to T.

Following form, in the first step (*i.e.*, the asset distribution), T would recognize a loss, which would be deferred. § 1.1502-13(f)(2)(iii) (allowing gain and loss to be recognized and deferred by the distributor on an intercompany distribution). The second step, P's distribution of the T stock, would be a qualified stock disposition. § 1.336-1(b)(6)(i). Under § 336(e), "old" T would recognize no net loss and would be deemed to liquidate under § 332, because P would be deemed to own all "old" T stock. § 332(b); § 1.336-2(b)(1)(iii)(A). Because P would be "old" T's successor, P would succeed to "old" T's deferred items, including its loss on the asset distributed in the first step. § 1.1502-13(j)(2)(i)(A) (treating the transferee in a § 381(a) transaction as the successor of the transferor "as the context may require"). Finally, under the matching rule, when P sold the former loss asset to "new" T, P would take the loss into account. *Id*. at (c)(2). Note that because P would be "old" T's successor, P would be both the selling and buying member.

Even if the steps were respected despite § 1.336-2(e), an anti-avoidance rule should apply, because the loss asset was transferred from T to P to allow the group to take the loss into account, something that would happen solely as a result of the intercompany transaction. *See* § 1.267(f)-1(h) (requiring appropriate adjustments to account for a transaction engaged in with a principal purpose to avoid the purposes of § 1.267(f)-1); *id*. at (a) (providing that the purpose of § 1.267(f)-1 is to prevent a group member from taking a loss into account solely as the result of an intragroup transfer). This anti-avoidance rule should also apply if the loss asset were transferred to another member in an intercompany sale, rather than through an intercompany distribution, and the member sold the asset to T as part of the same plan.

[81] § 1.336-2(b)(1)(i)(A).

[82] *Id. See also supra* notes 41-45 (for a discussion of that allocation).

The ADADP, computed like the adjusted deemed sales price under § 338, equals the following amount:

(i) The grossed-up amount realized on the sale, exchange, or distribution of recently disposed target stock, plus

(ii) Old target liabilities, minus

(iii) The seller's selling costs for its sale or exchange (but not distribution) of recently disposed target stock.[83]

The ADADP is initially determined at the beginning of the day after the disposition date, but it may be redetermined "at such time and in such amount as an increase or decrease would be required, under general principles of tax law, for the elements of the ADADP."[84]

In computing the ADADP, the old target's liabilities are generally measured as of the beginning of the day after the disposition date, and those liabilities must be ones that the old target would have accounted for in amount realized under general principles if it had sold its assets to unrelated persons for consideration that included the discharge of the liabilities.[85] Further, the time at which those liabilities

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[83] § 1.336-3(b)(1) and (c). *See also* § 1.336-1(b)(17) (providing that recently disposed stock must be disposed of by the seller, a member of the seller's consolidated group, or an S corporation shareholder); § 162(k) (providing that no deduction is allowed for any amount paid or incurred by a corporation to reacquire its stock). Note that the regulation actually includes selling costs in the computation of the grossed-up amount realized for recently disposed target stock. § 1.336-3(c) (adding that selling costs must be incurred by the seller in connection with the sale or exchange and must reduce the seller's amount realized (*e.g.*, brokerage commissions)). The formula in the text is arithmetically equivalent.

[84] *Id*. at (b)(2) (also providing that the general tax principles determine the timing and amount of the elements of the ADADP and that increases or decreases in the ADADP result in a reallocation of the ADADP among target's assets in the same manner as under § 1.338-7).

[85] *Id*. at (d)(1) (adding that if the target engages in a transaction outside of the ordinary course on the disposition date but after the event that resulted in the qualified stock disposition, the transaction must be treated as occurring on the following day for all federal income tax purposes by the target and all persons related to the target (before or after the qualified stock disposition) under § 267(b) or § 707(b)).

Thus, the old target's liabilities may include the tax liability arising on the deemed sale, and the computation of that tax may require an iterative, or trial and error, computation. *See id*.; *id*. at (e). Note that tax cannot be computed in a way that contravenes other applicable rules (*e.g.*, a capital loss cannot offset ordinary income). *See* § 1.336-3(f). *But cf*. *id*. at (g), *Ex. 3(iv)* (implicitly assuming in the computation of the ADADP that a capital loss (on publicly traded stock) can offset ordinary income (on stock in trade)).

are taken into account and their amount is determined as if the old target had sold its assets in such an unrelated-person sale.[86]

The grossed-up amount realized for recently disposed target stock equals the following amount:

(i) The sum of (A) the amount realized on the sale or exchange of recently disposed target stock, plus (B) the fair market value of recently disposed target stock distributed in the qualified stock disposition, *divided by*

(ii) The percentage of target stock (determined by its value on the disposition date) that is recently disposed stock.[87]

Recently disposed target stock is target stock (i) that is not held by the seller, a member of the seller's consolidated group, or an S corporation shareholder immediately after the disposition date and (ii) that was disposed of by the seller, a member of the seller's consolidated group, or an S corporation shareholder during the 12-month disposition period.[88] Note that recently disposed target stock may therefore include stock acquired and transferred by the seller or an S corporation shareholder after the disposition date but before the end of the 12-month disposition period.[89]

Example 8 – A base case

P owns all 100 shares of the single class of T stock. T has three assets, Asset 1 with a $200 basis and $1,000 value, Asset 2 with a $400 basis and $800 value, and Asset 3, with a $1,400 basis and $1,200 value. On one day, P distributes 10 shares of T stock, worth $265, to Mary and sells 70 shares of T stock to Fred, for $1,855. Neither Fred nor Mary is related to P. Therefore, P has made a qualified stock disposition of the T stock, because it has disposed of an affiliated interest in that stock (through a sale and distribution of the stock to unrelated persons) during a 12-month period.[90] P makes a § 336(e) election for the disposition.

Assume that T's only liability is its tax on the deemed sale, that T is taxed at a 35-percent rate on

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[86] *Id*. at (d)(2).

[87] *Id.* at (c)(1). For this purpose, the amount realized on the sale or exchange of recently disposed target stock is determined as if the seller used the old target's accounting methods and characteristics, as if the installment method were not available, and by disregarding selling costs. *Id*. Further, the fair market value of any distributed stock is determined on its distribution date. *Id*.

[88] § 1.336-1(b)(17). *See also id*. at (g)(2) (treating all members of the seller's consolidated group as one seller).

[89] *Cf*. § 338(b)(6)(A) (defining recently purchased target stock in relevant part as target stock held on the acquisition date by the purchasing corporation).

[90] § 1.336-1(b)(6)(i).

that sale, and that any loss recognized on its deemed sale of assets can offset gain recognized on that sale. Also assume that P incurs no selling costs in its sale of the 70 shares of T stock to Fred.

Because P has no selling costs, the ADADP equals the (i) the grossed-up amount realized on the disposition of recently disposed T stock plus (ii) T's liabilities (*i.e.*, its tax liability on the deemed sale).[91] That grossed-up amount realized equals $2,650, which is $2,120 (the sum of the amount realized on the recently disposed T stock (*i.e.*, $1,855, for the stock sold to Fred) plus the value of the recently disposed T stock distributed in the qualified stock disposition ($265, for the stock distributed to Mary)) divided by 80 percent (the percent, by value, of recently disposed T stock).[92]

Thus, even without accounting for the tax on the deemed sale, the ADADP (at least $2,650) must exceed the aggregate basis of the T assets deemed sold ($2,000, or $200 for Asset 1, plus $400 for Asset 2, plus $1,400 for Asset 3). Thus there will be a net gain on T's deemed sale, and the loss disallowance rule of § 1.336-1(b)(1)(i)(B)(*2*) will not apply.[93]

Assuming that any loss on an asset sold in the deemed sale offsets gain on assets sold in the deemed sale and that the net gain on the deemed sale is taxed at a 35-percent rate, the tax on the deemed sale may be computed as follows:

Tax	=	.35(ADADP - $2,000)
Tax	=	.35[($2,650 + Tax) - $2,000]
.65Tax	=	.35($2,650 - $2,000)
.65Tax	=	$227.50
Tax	=	$350

Therefore, the ADADP equals $3,000 ($2,650, the grossed-up basis of recently disposed T stock, plus $350, the tax on the deemed sale), and the amount realized for each asset equals its fair market value ($1,000 for Asset 1, $800 for Asset 2, and $1,200 for Asset 3).

Note that the ADADP assumes that a qualified stock disposition necessarily includes the sale, exchange, or distribution of recently disposed target stock, which the following example illustrates may

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[91] § 1.336-3(b)(1) and (c).

[92] *Id.* at (c)(1). The stock distributed to Mary and sold to Fred is recently disposed stock, because it is not held by the seller, P, or a member of the seller's consolidated group immediately after the close of the disposition date and it was disposed of by P during the 12-month disposition period. § 1.336-1(b)(17) (defining recently disposed stock). A seller is any domestic corporation that makes a qualified stock disposition of stock of another corporation. *Id*. at (b)(1). Because P made a qualified stock disposition of the T stock, it is a seller of that stock.

[93] *See also* § 1.336-3(g), *Ex. 3(iii)* (illustrating this point).

not be true. As the example also illustrates, it is then unclear what the ADADP for the deemed sale may be.

Example 9 – A qualified stock disposition without recently disposed target stock

Fred owns 10 of the 100 shares of the single class of stock of T, an S corporation. Other individuals own the remaining shares, and no other shareholder is related to Fred. On one day, Fred buys the remaining 90 shares of T stock from the other shareholders for $900. Thus, the remaining S corporation shareholders have made a qualified stock disposition of T, because they have disposed an affiliated interest in T (90 percent) to an unrelated person (Fred) over a 12-month period.[94]

Assume that the S corporation shareholders make a § 336(e) election for the disposition, that T has no liabilities, and that the selling shareholders have no selling costs. Although it seems sensible to treat T as selling its assets in the deemed asset sale for $1,000 ($900 (the amount paid by Fred for 90 percent of the T stock) divided by 90 percent (the percentage of stock disposed of in the qualified stock disposition), the ADADP formula does not produce that result.

Because T has no liabilities and the selling T shareholders have no selling costs, the ADADP simply equals the grossed-up basis of the recently disposed T stock. In other words, it equals (i) the amount realized on the sale of recently disposed T stock *divided by* (ii) the percentage of T stock (determined by its value on the disposition date) that is recently disposed stock.[95] However, the disposition involves no recently disposed T stock, because it is all held by Fred, an S corporation shareholder, immediately after the close of the disposition date.[96] Thus, the ADADP equals an undefined number (0, the amount realized for recently disposed T stock divided by 0, the percentage (by value) of recently disposed T stock). Accordingly, in this case, the amount of the ADADP is uncertain.[97]

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[94] § 1.336-1(b)(6)(i) (defining qualified stock dispositions as including a disposition of an affiliated interest in stock of an S corporation by the S corporation shareholders); *id*. at (b)(4) (stating that unless otherwise provided, a reference to S corporation shareholders is to all shareholders of the S corporation, whether or not they dispose of their S corporation stock). Although the remaining T shareholders sell their stock to Fred, we assume that no selling shareholder is related to Fred. In addition, Fred is not "related" to himself, because only two persons can be related. *See id*. at (b)(12). Thus, all the stock sold is disposed of.

[95] *See* § 1.336-3(c)(1).

[96] § 1.336-1(b)(17) (providing that recently disposed stock cannot be held by the seller, a member of the seller's consolidated group, or an S corporation shareholder immediately after the close of the disposition date).

[97] For similar reasons, the basis of T's assets after the deemed purchase (the adjusted grossed-up basis) is also uncertain.

b. The deemed purchase by the new target

(i) Computing the AGUB

Just as the old target is treated as selling its assets to an unrelated person at the close of the disposition date, the new target is treated as acquiring those assets in a single transaction at that time from an unrelated person.[98] The assets are considered acquired for the adjusted gross-up basis ("AGUB").[99]

Generally and except as the context requires, the principles of § 1.338-5 apply in determining the AGUB.[100] Thus, the basis of each new target asset is determined by allocating the AGUB among those assets using the seven-tier allocation method described in § 1.338-6.[101] In addition, in applying the principles of § 1.338-5, any references to (i) purchasing corporation, (ii) acquisition date, (iii) a § 338 election (including a § 338(h)(10) election), (iv) recently purchased stock, and (v) nonrecently purchased stock are treated, respectively, as references to (i) a purchaser, (ii) disposition date, (iii) a § 336(e) election, (iv) recently disposed stock, and (v) nonrecently disposed stock.[102]

Thus, the AGUB should equal the following amount:

(i) The grossed-up basis in the purchasers' recently disposed target stock, plus

(ii) The purchasers' aggregate basis in nonrecently disposed target stock, plus

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[98] § 1.336-2(b)(1)(ii). The deemed sale and purchase are both deemed to occur before the deemed target liquidation. *Id*.; *id*. at (b)(1)(i)(A). *Cf*. § 1.336-1(b)(3) (providing that "new target" refers to target subsequent to the disposition date). If new target qualifies as a small business corporation and wants to be an S corporation, it must make an S election. § 1.336-2(b)(1)(ii).

[99] *Id*.

[100] § 1.336-5(a). It is not clear when the context would require that those principles do not apply. The regulation provides no general principles to determine that context.

[101] § 1.336-4(a); § 1.336-1(b)(1)(ii). *See supra* notes 41-45 and accompanying text (for a description of the seven-tier residual method). The AGUB is initially determined at the beginning of the day after the target's disposition date. § 1.338-5(b)(2)(i). It may be redetermined (*e.g.*, to account for contingent liabilities or consideration), and the timing and amount of an increase or decrease to the AGUB is determined under general principles of tax law. *Id*. at (b)(2)(ii). Any increase or decrease is taken into account under the principles of § 1.338-7. § 1.336-4(a).

[102] *Id*. at (b). In addition, if a § 336(e) election is made for a disposition described, in whole or in part, in § 355(d)(2) or (e)(2), any reference to new target is treated as a reference to old target in its capacity as a purchaser of assets pursuant to the § 336(e) election. *Id*. at (b)(4).

(iii) The liabilities of the new target.[103]

For this purpose, the new target's liabilities are its liabilities as of the beginning of the day after the disposition date, and those liabilities must be ones that the new target would take into account in basis under general tax principles if it had acquired its assets from an unrelated person for consideration that included the discharge of the liabilities.[104] Further, the time at which those liabilities are taken into account and their amount is determined as if the new target had acquired its assets in such an unrelated-person purchase.[105]

The grossed-up basis of recently disposed target stock equals (A * B/C) + D, where --

A	=	The purchasers' aggregate basis in recently disposed target stock at the beginning of the day after the disposition date (determined without taking the acquisition costs described in D into account);[106]
B	=	100 minus the percentage of the target stock (by value, determined on the disposition date) attributable to the purchasers' nonrecently disposed target stock;
C	=	The percentage of the target stock (by value, determined on the disposition date) attributable to the purchasers' recently disposed target

[103] *See* § 1.338-5(b). A quick reading of the regulation may suggest that a grossed-up basis amount must be calculated for each purchaser, since the regulation treats any reference in § 1.338-5 to "purchasing corporation" as a reference to "a" purchaser. § 1.336-4(b)(1). However, the context requires a single computation for all purchasers collectively. The general formula for the AGUB assumes a single computation, because it takes into account all target liabilities, and the regulations provide no mechanism to allocate those liabilities among multiple purchasers. Further, the computation for grossed-up basis also assumes a single computation, since it determines a value for 100% of the target stock, and the regulation provides no mechanism to modify that formula so that it applies to purchasers separately rather than collectively. *See also id*. at (d), *Ex. 1* (making a collective computation but in a case in which the target has no liabilities).

[104] § 1.338-5(e)(1). *See* § 1.336-3(d)(1) (describing a special rule to account for a transaction outside the ordinary course that occurs on the disposition date after the event that resulted in the qualified stock disposition). Thus, the new target's liabilities may include the tax liability arising on the deemed sale. *See* § 1.338-5(e)(1).

[105] § 1.338-5(e)(2); *See also id.* at (e)(3) (noting that if the amount realized on the deemed sale is later increased and the tax on the deemed sale is a new target liability, any increase in that liability because of an increase in the amount realized is taken into account in redetermining the AGUB); *id*. at (f) (noting that the AGUB may be increased or decreased on audit).

[106] Note that if recently disposed target stock is distributed in the qualified stock disposition, the purchaser's basis in that stock is deemed to be its fair market value when acquired. § 1.336-4(b)(5).

stock; and

D = The acquisition costs that the purchasers incurred in connection with their acquisitions of recently disposed target stock that are capitalized in the basis of such stock.[107]

Recently disposed target stock is target stock (i) that is not held by the seller, a member of the seller's consolidated group, or an S corporation shareholder immediately after the disposition date and (ii) that was disposed of by the seller, a member of the seller's consolidated group, or an S corporation shareholder during the 12-month disposition period.[108] Nonrecently disposed target stock is target stock that is not recently disposed target stock and that is held on the disposition date by a purchaser or person related to the purchaser who on that date actually and constructively owns at least 10 percent of total voting power or value of target stock.[109]

Even if the purchaser makes a fair market value purchase of all target stock, if it acquires a portion of that stock from the seller after the disposition date, an anomaly in the AGUB formula may create an artificial built-in gain in the target assets.

Example 10 – Artificial built-in gain created

P and T are members of a consolidated group, and P owns all T common stock, while Y, a partnership in which P is a partner, owns all T preferred stock, which is § 1504(a)(4) stock. T owns assets with a $1,400 basis and $1,500 value and has no liabilities.

On July 1, Year 1, P sells its T common stock to Fred, who is not related to P, for $1,000. Because P sells an affiliated interest in the T stock on one day to an individual, its disposition is a qualified stock disposition.[110] P makes a § 336(e) election for the disposition. On June 1, Year 2, the partnership liquidates and P receives the T preferred stock, which its sells to Fred on June 30, Year 2, for $500.[111] Assume that P has no selling costs for its sales of T stock and T has no

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[107] § 1.338-5(c). If the target stock is disposed of in a public offering, it may be impracticable for the target to determine these acquisition costs, unless it is allowed to estimate them using surveys and statistical sampling. *Cf*. Rev. Proc. 2011-35, 2011-25 I.R.B. 890 (permitting the use of these techniques to determine the basis of transferred stock for certain § 351 transfers and § 368(a)(1)(B) reorganizations).

[108] § 1.336-1(b)(17). *See also* § 1.336-2(g)(2) (treating all members of the seller's consolidated group as one seller).

[109] § 1.336-1(b)(18) (noting that ownership is determined by applying § 318(a) (other than § 318(a)(4)).

[110] *See id*. at (b)(6)(i).

[111] Note that the preferred stock is not "retained" stock, because P did not own the stock on the disposition date or immediately thereafter. *Cf*. § 1.336-1(b)(1)(v) (discussing the treatment of retained

liabilities.

All of the T stock transferred by P is recently disposed target stock. None of that T stock was held by P (or a member of the P group) immediately after the close of July 1, Year 1, the disposition date, and the stock was sold by P during the 12-month disposition period (*i.e.*, on July 1, Year 1, and June 30, Year 2) to an unrelated person.[112] Thus, all of the T stock is recently disposed T stock for purposes of computing the ADADP and AGUB.

The ADADP equals the grossed-up amount realized on the sale, exchange, and disposition of recently disposed T stock.[113] Because all T stock is recently disposed T stock and the stock was sold for $1,500, the ADADP is that amount. Thus, on its deemed sale, T recognizes an aggregate $100 gain ($1,500 aggregate amount realized (*i.e.*, the ADADP) minus $1,400 basis).

The AGUB, or the aggregate basis of T assets deemed purchased by T, however, apparently equals only $1,000. Because T has no liabilities, that amount equals the grossed-up basis in recently disposed T stock, which equals the following fraction (assuming that Fred has no capitalized, third-party acquisition costs):

A * B/C, where –

A	=	The purchasers' basis in recently disposed at the beginning of the day after the disposition date
B	=	100 minus the percentage of the target stock (by value, determined on the disposition date) attributable to the purchasers' nonrecently disposed target stock
C	=	The percentage of the target stock (by value, determined on the disposition date) attributable to the purchasers' recently disposed target stock

At the beginning of the day after the disposition date (*i.e.*, July 2, Year 1), Fred had a $1,000 basis in his recently disposed T stock (the T common stock). Because he did not acquire the T preferred stock until June 30, Year 2, he had no basis on that stock on July 2, Year 1. Thus, "A" in the formula above equals just $1,000. Because all of the T stock is recently disposed stock, however, B and C each equal 100, and the fraction B/C equals 1. Thus, the AGUB equals only $1,000 and T takes an aggregate basis in its assets after the deemed sale of only $1,000, creating a $500 built-in gain.

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stock).

[112] Note that recently disposed target stock can be old target or new target stock.

[113] 1.336-3(b)(1).

The anomaly illustrated by **Example 10** arises because the AGUB formula inconsistently takes into account recently disposed target stock, considering only the stock held by the purchasers at the beginning of the day after the disposition date for factor "A" but considering all of the purchasers' recently disposed stock for factor "C."[114] The regulation should be amended to remove that inconsistency, for example, by changing factor C to consider only the purchasers' recently disposed target stock held at the beginning of the day after the disposition date.[115]

(ii) Gain recognition election

If a § 336(e) election is made for a target, an irrevocable gain recognition election may be made for nonrecently disposed target stock.[116] Broadly speaking, if the election is made (or deemed made) for an owner's nonrecently disposed target stock, the owner takes a fair market value basis in that stock but must recognize any built-in gain in the stock.[117] Each owner of nonrecently disposed stock determines basis and gain recognized under the election separately.[118] This election is deemed made by any 80-percent purchaser or any person related to the 80-percent purchaser for its nonrecently disposed target stock.[119] A gain recognition election must actually be made by any other purchaser.[120]

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[114] This concern does not arise under § 338, because recently purchased target stock must be held by the purchasing corporation on the acquisition date. § 338(b)(6) (defining recently purchased target stock).

[115] With that change, the § 336(e) AGUB definition will more closely parallel the § 338 AGUB definition.

[116] § 1.336-4(c); § 1.338-5(d)(1). The regulation states that any "holder" of nonrecently disposed target stock may make a gain recognition election. § 1.336-4(c)(1). However, it generally seems unwise for a holder other than a purchaser to make the election, because that election will either eliminate built-in loss or result in recognized gain while providing no basis benefit to the target. Perhaps for that reason, the regulation describes elections only for 80-percent and non-80-percent purchasers. *See id*. at (c)(2) and (c)(3). Note that it still may make sense for a non-purchaser to make the election if, for example, the non-purchaser would recognize gain offset by an expiring loss and step-up its basis in target stock.

[117] More precisely, the basis and recognized gain is determined by reference to the owner's basis in recently disposed target stock.

[118] § 1.336-4(c)(1) (providing that each owner of nonrecently disposed stock determines its basis amount and gain by applying § 1.338-5(c) and (d)(3)(ii) by reference to its recently disposed and nonrecently disposed stock, not by reference to all recently disposed and nonrecently disposed stock).

[119] § 1.336-4(c)(2).

[120] *Id*. at (c)(3). Without defining the term, the regulation labels such a purchaser a "non-80-percent purchaser." For that purchaser's election to have effect, each person related to that purchaser must also make a gain recognition election. *Id*. Although the regulation does not limit the pool of related

If a gain recognition election is not made for an owner's nonrecently disposed target stock, the owner retains its basis in that stock.[121] If the election is made, the owner's basis in that stock equals the basis amount, the computation of which is described below.[122] Those bases are taken into account in computing the AGUB (for purchasers) and for all other relevant federal income tax purposes (for all owners).

If an owner makes (or is deemed to make) a gain recognition election for its nonrecently disposed target stock, it is deemed to sell that stock on the disposition date for its "basis amount,"[123] recognizing all of its realized gain but none of its realized loss.[124] The "basis amount" for that stock equals the following:

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persons who must also make the election, presumably only those who own nonrecently disposed target stock must make the election, not everyone in the pool.

A non-80-percent purchaser and all related persons must provide a gain recognition statement to the appropriate party before the due date for filing the § 336(e) election statement. *Id.* Generally, the target is the appropriate party, and the target must retain each statement. *Id*. However, if the seller and target were members of the same consolidated group, the seller is the appropriate party, and the common parent of the group must retain each statement. *Id*. *See also* § 1.336-2(g)(2) (treating all members of a consolidated group as a single seller); *id*. at (h)(6)(xii) (providing that the name, address, and taxpayer identification number of each purchaser making a gain recognition election must be included in the § 336(e) election statement and that a copy of the gain recognition election statement must be retained by the appropriate party). *Cf*. § 1.338-5(d)(2) (for a § 338 election, providing that the gain recognition statement must be attached to the Form 8023).

If a gain recognition statement is actually made, the statement must include the maker's name, address, taxpayer identification number, a statement that the maker has elected to recognize gain under § 1.336-4(c) with respect to its nonrecently disposed stock, and a statement that the maker agrees to report that gain, if any, on its federal income tax return (or amended return, if appropriate) for its year that includes the disposition date. § 1.336-4(c)(4).

The regulation does not have a procedure for a non-purchaser holder of nonrecently disposed target stock to make a gain recognition election. Possibly, that election could be made by following the procedure for a non-80-percent purchaser.

[121] § 1.338-5(d)(1). Note that § 1.336-5(c) refers to an "owner" or "holder" of nonrecently disposed stock rather than a "purchaser" who also owns nonrecently disposed stock, because a gain recognition election may be made (or deemed made) by a person who is not a purchaser (*i.e.*, a person who may not have acquired recently disposed target stock and therefore is not a purchaser).

[122] § 1.338-5(d)(3)(i)(B).

[123] *Id*. at (d)(3)(i)(A).

[124] *Id*. at (d)(3)(iii)

A * B/C, where –

A	=	The owner's basis in recently disposed target stock at the beginning of the day after the disposition date (determined without taking the capitalized, third-party acquisition costs into account);[125]
B	=	The percentage of the owner's target stock (by value, determined on the disposition date) that is nonrecently disposed target stock; and
C	=	The percentage of the owner's target stock (by value, determined on the disposition date) that is recently disposed target stock.[126]

The regulatory formula does not work in one obvious case – where the owner actually owns no recently disposed target stock – because the denominator in the gain recognition formula would then be zero, so that the fraction in the formula would be undefined.

Example 11 – Dividing by zero

For many years, P has owned 80 of 100 shares of T's only class of stock and Mary has owned the remaining 20 T shares with a $100 basis. P sells its 80 shares of T stock to Fred for $800. Fred is not related to P but is Mary's son. Because P sells an affiliated interest in the T stock to Fred, an unrelated individual, on one day, the sale is a qualified stock disposition. Assume that a § 336(e) election is made for T.

Fred is an 80-percent purchaser, because he acquires T stock as part of a qualified stock disposition and owns at least 80 percent of the vote or value of the T stock, actually and constructively owning all of both.[127] Although Mary is not a purchaser because she does not acquire target stock in the qualified stock disposition, she is related to Fred, an 80-percent purchaser, because she is his mother.[128]

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[125] Those capitalized costs are described in § 1.338-5(c)(3). *See supra* note 107 and accompanying text (where "D" more completely describes those capitalized, third-party acquisition costs).

[126] § 1.338-5(d)(3)(ii); § 1.338-5(c). The text simplifies the regulatory formula, which is A * (B/(100 -C)) * ((100-C)/C). *Id.* at (d)(3)(ii).

[127] § 1.336-1(b)(16) (defining an 80-percent purchaser as any purchaser who owns at least 80 percent of the vote or value of target stock, determined after applying § 318(a) (other than (a)(4)); *id*. at (b)(2) (defining a purchaser as a person who acquires target stock in a qualified stock disposition). Fred owns 80% of the T stock actually and 20% by attribution from his mother, Mary. *See* § 318(a)(1)(A)(ii) (attributing stock from a parent to her child).

[128] § 1.336-1(b)(12) (providing generally that two persons are related if, among other things, stock owned by one would be attributed to another under § 318(a)(1)(A)); § 318(a)(1)(A)(ii) (providing

Because Mary and Fred are related, Fred is an 80-percent purchaser, and a § 336(e) election is made for T, Mary is deemed to make a gain recognition election for her nonrecently disposed T stock.[129] All of her T stock is nonrecently disposed T stock, because her stock was not disposed of during T's 12-month disposition period, she held the stock on the disposition date, and she owned 100 percent of the T stock, actually and constructively.[130]

Each owner of nonrecently disposed target stock who makes a gain recognition election applies the gain recognition formula by taking into account only the owner's recently disposed and nonrecently disposed target stock.[131] That formula, which derives the "basis amount," is A * B/C, where –

A	=	The owner's basis in recently disposed target stock at the beginning of the day after the disposition date (determined without taking the capitalized, third-party acquisition costs into account);
B	=	The percentage of the owner's target stock (by value, determined on the disposition date) that is nonrecently disposed target stock; and
C	=	The percentage of the owner's target stock (by value, determined on the disposition date) that is recently disposed target stock.[132]

The owner is deemed to sell her nonrecently disposed T stock for the "basis amount" and takes a basis in that stock equal to that amount.

Because Mary owns no recently disposed T stock, in the gain recognition formula, A and C equal 0 while B equals 100, and the fraction B/C (*i.e.*, 100/0) is undefined. Thus, it is unclear how Mary implements the gain recognition election, what her basis amount should be, and how much gain she should recognize because of the gain recognition election.

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that stock is attributed from a parent to child).

[129] § 1.336-4(c)(2).

[130] Target stock is nonrecently disposed target stock if, for example, (i) it was not disposed of during the 12-month disposition period. (and therefore cannot be recently disposed target stock), (ii) it was held on the disposition date by a purchaser or person related to the purchaser, and (iii) on that date, the holder actually and constructively owned at least 10 percent of total voting power or value of target stock. § 1.336-1(b)(18) (noting that ownership is determined by applying § 318(a) (other than § 318(a)(4)).

[131] § 1.336-4(c)(1).

[132] § 1.338-5(d)(3)(ii); § 1.338-5(c)

The regulation could be amended to account for a person in Mary's situation (*i.e.*, a person who actually owns no recently disposed target stock but is deemed to make a gain recognition election because a related person makes (or is deemed to make) a gain recognition election). Such an owner could take into account relevant attributes of the related person who owns recently disposed target stock and whose gain recognition election led to the election by the owner.[133]

This change, however, will not address all circumstances where an owner may actually hold no recently disposed target stock. In fact, in some circumstances, that owner may actually be a purchaser and be unrelated to any purchaser of recently disposed target stock.

Example 12 – Intercompany qualified stock disposition

P owns all stock of S1 and all common stock of S2. An unrelated person owns preferred stock of S2, described in § 1504(a)(2), that comprises more than 50 percent by value of the S2 stock. S2 also owns all 80 shares of the only class of T stock and S2 owns the remaining 20 shares of T stock. P, S1, S2, and T join in filing consolidated returns.

As part of one transaction, S1 sells 20 shares of T stock to Fred, a person unrelated to any member of the P group, and sells 60 shares of T stock to S2. Although S1 and S2 are both members of the P group, they are not related, because stock owned by either S1 or S2 would not be attributed to the other under § 318(a) (other than (a)(4)).[134] Thus, S1's sales of the T stock to Fred and S2 are dispositions, because each takes a cost basis in the T stock and neither is related to S1.[135] Because S1 sells an affiliated interest in the T stock on one day, those sales constitute a qualified stock disposition. Assume that a § 336(e) election is made for the disposition.

S2 is an 80-percent purchaser, because it purchases T stock in the qualified stock disposition and owns at least 80 percent of that stock after the disposition.[136] Thus, S2 is deemed to make a gain recognition election for its nonrecently disposed T stock. Curiously, none of S2's T stock is recently disposed T stock, because S2 is a member of the same consolidated group as S1, the

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[133] If there is more than one such related person, the relevant related person may be the person from whom the highest value of recently disposed target stock is attributed or perhaps the related person irrevocably chosen by the owner of the nonrecently disposed stock.

[134] § 1.336-1(b)(12) (defining related persons). *See also* § 318(a)(2)(C) (providing that stock is attributed from a corporation to a shareholder if the shareholder owns at least 50% (by value) of the corporation's stock); *id*. at (a)(3)(C) (providing that stock is attributed from a shareholder to a corporation if the shareholder owns at least 50% (by value) of the corporation's stock). Because P owns less than 50% (by value) of the S2 stock, no stock owned by P or S2 is attributed to the other (and therefore no stock owned by S1 or S2 is attributed through P to the other).

[135] *Id*. at (b)(5)(i) (defining dispositions). *See also* § 1.1502-80(b) (providing that § 304 does not apply to any acquisition of stock in an intercompany transaction).

[136] § 1.336-1(b)(2) (defining purchaser); *id*. at (b)(16) (defining 80-percent purchaser).

seller, and S2 owns that stock immediately after the close of the disposition date.[137] Instead, all of its T stock is nonrecently disposed stock, because S2 is a purchaser and holds more than 10 percent of the T stock.[138]

For the same reasons as were noted in **Example 11**, in the gain recognition formula, A and C equal 0 while B equals 100, and the fraction B/C (*i.e.*, 100/0) is undefined. Thus, it is unclear how S2 implements the gain recognition election, what its basis amount should be, and how much gain it should recognize because of the gain recognition election.

Perhaps a person in S2's position could apply the gain recognition formula by taking into account any recently disposed stock in the qualified stock disposition, but even that technique would be of no avail in the following case:

Example 13 – A qualified stock disposition with no recently disposed target stock

T, an S corporation, has 100 shares of stock outstanding, all of which is voting stock. Fred owns 10 of those shares and persons unrelated to Fred own the remaining T shares. Those persons sell their T shares to Fred on one day for $900. T is an S corporation target, and its shareholders are S corporation shareholders.[139] The sale of the T stock to Fred is a qualified stock disposition, because S corporation shareholders sold 90 percent of the T stock (and therefore an affiliated interest in that stock) on one day to an unrelated person, thereby disposing that T stock. Assume that a § 336(e) election is made for the disposition.

Fred is an 80-percent purchaser, because he purchases T stock in the qualified stock disposition and owns at least 80 percent of that stock after the disposition.[140] Thus, he is deemed to make a gain recognition election for his nonrecently disposed T stock. However, none of Fred's T stock is recently disposed T stock, because Fred, an S corporation shareholder, owns that stock immediately after the close of the disposition date.[141] Instead, all of his T stock is nonrecently disposed stock, because Fred is a purchaser and holds more than 10 percent of the T stock.[142]

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[137] *Id*. at (b)(17) (providing, among other things, that recently disposed target stock cannot be held by the seller or a member of the seller's consolidated group immediately after the close of the disposition date).

[138] *Id*. at (b)(18).

[139] *Id*. at (b)(3) (defining an S corporation target as a target that was an S corporation immediately before the disposition date); *id*. at (b)(4) (defining S corporation shareholders).

[140] *Id*. at (b)(2) (defining purchaser); *id*. at (b)(16) (defining 80-percent purchaser).

[141] *Id*. at (b)(17) (providing, among other things, that recently disposed target stock cannot be held by an S corporation shareholder immediately after the close of the disposition date).

[142] *Id*. at (b)(18).

For the same reasons as were noted in **Examples 11** and **12**, in the gain recognition formula, A and C equal 0 while B equals 100, and the fraction B/C (*i.e.*, 100/0) is undefined. Thus, it is unclear how Fred implements the gain recognition election, what his basis amount should be, and how much gain he should recognize because of the gain recognition election.

The concern raised by both **Examples 12** and **13** could be resolved by treating the stock disposed of (to S2 in **Example 12** and to Fred in **Example 13**) as recently disposed stock. Not only would that treatment resolve the gain recognition concern (by sidestepping it), it would arguably be more consistent with § 338(h)(10) principles.[143]

c. The deemed liquidation of the old target

After the deemed asset sale but before the close of the disposition date and "while [old] target [is] owned by the seller or S corporation shareholders," the old target and seller (or S corporation shareholders) are treated as if the old target transferred all of its assets to the seller or the S corporation shareholders and ceased to exist.[144] For federal income tax purposes, the seller or S corporation shareholders apparently are treated as retaining the old target stock actually disposed of in the qualified

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[143] *See* § 338(b)(6) (defining recently purchased stock as stock that was purchased and held by the purchasing corporation on the acquisition date). *See also* P.L.R. 201145007 (Nov. 10, 2011) (for an intercompany sale for which a § 338(h)(10) election was made); P.L.R. 201203004 (Jan. 12, 2012) (for another intercompany sale for which a § 338(h)(10) election was made). It may also avoid the creation of non-economic gain or loss. *See infra* notes 201-236 (and accompanying text).

[144] *Id*. at (b)(1)(iii)(A). The composition of the assets transferred in the deemed distribution is not specified, but presumably the assets are deemed to have a basis equal to value.

If § 336(e) elections are made for a parent-subsidiary chain of target corporations, "the deemed liquidation of a lower-tier subsidiary corporation is considered to precede the deemed liquidation of a higher-tier subsidiary." *Id.* at (b)(1)(iii)(B) Oddly, the regulation does not specify the timing of the deemed liquidation of the parent in that chain. *Cf*. § 1.338(h)(10)-1(d)(4)(ii) (providing that the deemed liquidation of a subsidiary corporation is deemed to precede the deemed liquidation of its parent). The regulation should be amended to expressly provide that the parent's deemed liquidation follows the deemed liquidation of the highest-tier subsidiary.

If the parent's deemed liquidation precedes the deemed liquidation of the highest-tier subsidiary's deemed liquidation, the liquidation of the highest-tier subsidiary may not be described in § 332. Further, excess loss accounts ("ELAs") in consolidated target subsidiary stock may be triggered. *Cf*. § 1.1502-19(b)(2) (providing non-recognition for an ELA in subsidiary stock if the subsidiary liquidates and the exchange of the consolidated parent's subsidiary stock is subject to § 332); *id*. at (b)(1)(i) (providing that a member must take an ELA in subsidiary stock into account if it is treated as disposing of the subsidiary stock); *id*. at (c)(1)(ii) (a member is generally treated as disposing of subsidiary stock when the subsidiary becomes a nonmember).

stock disposition.[145] Further, the deemed transfer of the old target assets to the seller or S corporation shareholders is treated in the same manner as if the parties had engaged in the transactions deemed to occur.[146] Thus, the distribution may be considered part of a reorganization, a redemption, or a liquidation. In most cases, the deemed distribution for a non-S corporation target should be treated as a § 332 liquidation and for an S corporation target should be treated as a § 331 liquidation.[147]

3. The seller and S corporation shareholders

"In general," the seller or S corporation shareholders are treated as not having sold, exchanged, or disposed of the target stock disposed of in the qualified stock disposition.[148] Further, if the seller or an S corporation shareholder retain any target stock after the disposition date, he, she or it is treated as having purchased the stock (as new target stock) from an unrelated person on the day after the disposition date for a value that reflects the grossed-up amount realized of recently disposed of target stock.[149]

Because an S corporation shareholder cannot be a corporation, only a seller may distribute target stock in the qualified stock disposition. If the seller does, it is deemed to purchase new target stock from an unrelated person on the disposition date but immediately after the deemed liquidation of the old target and then distribute that stock to its shareholders.[150] It recognizes no gain or loss on that distribution.[151]

The seller or S corporation shareholders are treated as if, before the close of the disposition date

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[145] *See* § 1.336-2(k), *Ex. 6(ii)* (for an example involving a seller). *See also id*. at (b)(1)(i)(A) (stating that "[i]n general, if a section 336(e) election is made, seller (or S corporation shareholders) are treated as not having sold, exchanged or distributed the stock disposed of in the qualified stock disposition").

[146] *Id*. at (b)(1)(iii)(A).

[147] *Id*. For example, the deemed sale and distribution could be part of a reorganization described in § 368(a)(1)(C) in which a target transfers substantially all of its assets to its parent. Further, if an affiliated subsidiary adopts a plan to make pre-sale distributions, the qualified stock disposition and the § 336(e) election, its parent receives distributions of some subsidiary assets, and its parent transfers subsidiary stock in a qualified stock disposition, making a § 336(e) election for the disposition, both the actual distributions and the distribution deemed to arise because of the election may be part of a § 332 liquidation.

[148] § 1.336-2(b)(1)(i)(A). It is not clear in what circumstances this general rule does not apply.

[149] *Id.* at (b)(1)(v) (referring to § 1.336-3(c) for the determination of the grossed-up amount realized); *id*. at (g)(2) (treating all members of the seller's consolidated group as a single seller). The holding period for the stock also begins on the day after the disposition date. *Id.* at (b)(1)(v).

[150] *Id.* at (b)(1)(iv).

[151] *Id.*

but after the deemed sale, while the seller or S corporation shareholders still own target, old target transferred to them the consideration deemed received in the deemed asset sale.[152] Before this deemed transfer, the S corporation shareholders take into account their pro rata share of the gain or loss on the deemed sale under § 1366 and adjust their bases in old target stock under § 1367.[153] Generally, the seller or S corporation shareholders should treat the amount deemed received from the old target as a liquidating distribution to which § 331 (for the S corporation shareholders) or § 332 (for a seller) apply.[154]

4. Minority shareholders

Form governs the consequences to a minority shareholder (*i.e.*, a shareholder other than the seller, a member of the seller's consolidated group, or an S corporation shareholder).[155] As permitted under general principles of law, a minority shareholder recognizes gain or loss on its sale, exchange, or distribution of target stock.[156] If, instead, the shareholder retains target stock, it recognizes no gain or loss on the target stock and its basis and holding period are unaffected by the § 336(e) election.[157]

5. Purchasers

Even though the seller and S corporation shareholders are treated as retaining target stock through the deemed sale, the purchasers are treated as acquiring the target stock on the date actually acquired.[158] Although a § 336(e) election for a target generally does not affect the purchaser's tax consequences, the target's deemed asset sale may affect those consequences by, for example, increasing

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[152] *Id*. at (b)(1)(iii)(A). This portion of the regulations states that the old target is deemed to receive its consideration in the deemed sale from the new target. *Cf*. *id*. at (b)(1)(i) (merely stating that the old target is deemed to sell its assets to an "unrelated person"). Note that the consideration in the deemed asset sale may include the assumption of target liabilities and the value of the amount deemed received in the old target's liquidation should be the net value of the target's assets.

[153] *Id*. *Cf*. § 1.338(h)(10)-1(d)(5)(i) (for a comparable rule applying § 338(h)(10)).

[154] § 1.336-2(b)(1)(iii)(A).

[155] *Id*. at (d)(1) (providing that the seller, a member of the seller's consolidated group, and S corporation shareholders are not treated as minority shareholders whether or not they sell their target stock).

[156] *Id*. at (d)(2). *Cf*. § 1.338(h)(10)-1(d)(6)(ii) (applying to transfers that are part of the qualified stock purchase and are therefore recognition transfers).

[157] § 1.336-2(d)(3).

[158] *Id*. at 2(c). *But cf*. § 1223(1)(B) (for circumstances in which holding period of the stock acquired may include the holding period of the property exchanged therefor, including following a § 355 distribution)

earnings and profits out of which a dividend may be paid.[159]

6. Some concerns with the general election

a. Ownership of old target stock

If the general § 336(e) election is made, the old target is deemed to sell its assets and liquidate, distributing its assets to the sellers or S corporation shareholders, even if those shareholders may have transferred their target stock before the disposition date.[160] In general, those shareholders are treated as not transferring the old target stock.[161] The purchasers of the target stock, however, are still treated as acquiring the target stock on the date actually acquired.[162] There may be problems, however, if the seller (or S corporation shareholder) and purchaser are treated as both owning the same share simultaneously.

For example, who is treated as owning old target stock could affect whether the old target is a member of the seller's or purchaser's consolidated group.

Example 14 – Dueling consolidation

P owns 80 percent of the only class of T stock outstanding, and P and T join in filing a consolidated return. X, the common parent of another consolidated group, has owned the remaining 20-percent interest in T stock for some time. X and P are not related persons.

On July 1 of Year 1, P sells a 60-percent block of T stock to X, and on that date X actually owns an affiliated interest in the T stock. On June 30 of Year 2, P sells its remaining 20-percent interest in T to Fred, who is related to neither P nor X. Because P has sold an affiliated interest in T stock (*i.e.*, stock that meets the requirements of § 1504(a)(2)) to unrelated persons over a 12-month period, P has made a qualified stock disposition of the T stock on June 30, Year 2, the date that the affiliated interest is first transferred.[163] If no § 336(e) election is made for T's qualified stock disposition, T joins the X group on July 1 of Year 1. Assume, however, that the election is made for the disposition.

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[159] § 1.336-2(c). *See also* § 381(c)(2) (providing that a parent succeeds to a subsidiary's earnings and profits following the subsidiary's § 332 liquidation).

[160] § 1.336-2(b)(1)(iii)(A).

[161] *Id.* at (b)(1)(i) (more precisely providing that a seller or S corporation shareholder is treated as not having sold, exchanged, or distributed the stock *disposed of* in the qualified stock disposition).

[162] *Id.* at (c).

[163] § 1.336-1(b)(6)(i) (defining a qualified stock disposition). P made a qualified stock disposition of T because it sold an affiliated interest (20% to Fred and 60% to X) over a 12-month period, Fred and X are each not related to P, and each took a cost basis in the T stock purchased.

Because of the election, for federal income tax purposes, "[i]n general," P is treated as owning the T stock disposed of in the qualified stock disposition until the disposition date (*i.e.*, June 30 of Year 2).[164] If this general rule applies, P is deemed to own that T stock, which comprises an affiliated interest, until the disposition date, and T remains a member of the P consolidated group until that date.[165] The regulation never states when any exception to this "seller" general rule may apply.

In addition to the seller general rule, the regulation has a general ownership rule for the purchaser: "Generally," the § 336(e) election will not affect the federal income tax consequences to which a purchaser would have been subject, and a purchaser is treated as acquiring target stock when actually acquired.[166] Because X actually owns an affiliated interest in the T stock beginning on July 1 of Year 1, if this general rule applies, T also becomes a member of the X consolidated group on July 1 of Year 1.[167] The regulation never states when any exception to this "purchaser" general rule may apply.

One thing is certain -- these two general rules cannot both apply, because T cannot be a member of two consolidated groups at the same time. There are at least three ways to coordinate the two rules. First, T could remain a P group member through the disposition date, June 30, Year 2. Second, T could become a member of the X group at the close of July 1, Year 1. Finally, T could become a member of the X group at the close of July 1, Year 1, but the consequences of T's deemed sale could be taken into account by the P group.

In an example, the regulation appears to adopt the first approach. In that example, two members of a consolidated group each own half of the shares of the single class of stock of another group member, the Target.[168] The first member sells its Target shares and one month later, the other member sells its Target shares, and the sales constitute a qualified stock disposition for which a

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[164] *See* § 1.336-2(b)(1)(i)(A) (providing that in general the seller is treated as not having sold, exchanged, or distributed the target stock disposed of in the qualified stock disposition); *id*. at (b)(1)(iii)(A) (treating the sellers as owning the old target stock to determine the consequences of the deemed liquidation to the sellers and old target). *See also id*. at (k), *Ex. 6(ii)*.

[165] *Id*. (implying that result).

[166] *Id*. at (c).

[167] Note that if T does not then become an X group member, the § 336(e) election could affect the income tax consequences of X, for example, if T and X engage in what otherwise would be an intercompany transaction or if T or X has income that may be offset by the other's losses. If the election prevents T from being a member of the X group until July 1 of Year 2, it will also affect the group's tax liability, a liability for which each member, including X, is severally liable. *See* § 1.1502-6 (for several liability).

[168] § 1.336-2(k), *Ex. 6(i)*.

§ 336(e) election is made.[169] The example states unconditionally that the two members are not treated as selling the Target stock for federal income tax purposes.[170] Thus, for federal income tax purposes, the Target remained a member of the sellers' consolidated group through the disposition date.

Following that example, between July 1, Year 1 and June 30, Year 2, T should remain a P group member, so that (i) transactions between T and the P group would be treated as intercompany transactions, while transactions between T and the X group would not be, (ii) X would not adjust its T stock basis to account for T's tax items for that period, (iii) T would be a member of the P group, not the X group, for purposes of applying § 1.1502-28, (iv) T and X could engage in a § 1031 exchange,[171] and (v) T would be severally liable for the P group's Year 2 tax.[172]

It is also not clear how X would take into account a distribution received from T on the T stock on or before June 30, Year 2. Because X and T are actually affiliated, § 301 (and § 243) might apply to the distribution and, if appropriate, the distribution might be treated as a qualifying dividend eligible for a 100-percent dividends received deduction. On the other hand, it may be treated (at least for the 60-percent block) as a purchase price reduction.[173] That treatment may affect not only the deemed sale gain or loss but also the basis of the assets following the deemed purchase.

Finally, note that if another group acquires an X group member (other than T) from the X group during that period, it may assume that T is a member of the group and that any loss generated by T during that period may be taken into account by the group. In the acquisition agreement, the buyer may be well served to require a stipulation about the corporations that are members of the X group.[174]

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[169] *Id.*

[170] *Id*. at (k), *Ex. 6(ii)*.

[171] *Cf*. § 1.1502-80(f); § 1031(f).

[172] *See* § 1.1502-6(a).

[173] Perhaps the treatment should depend on whether the distribution is out of earnings and profits that had economically accrued before or after the stock acquisition. *Cf*.§ 1059(e)(2)(B) (providing that extraordinary dividends do not include qualifying dividends except to the extent the dividend is attributable to earnings and profits that are attributable to gain accrued while the distributing and distributee corporation were not affiliated).

[174] Note as well that the aggregate amount realized for the old T assets (*i.e.*, the ADADP) and the aggregate basis of the new T assets (*i.e.*, the AGUB) may differ. Disregarding buying and selling costs, those two amounts may differ in significant part because nonrecently disposed target stock is a summative factor in the AGUB but not the ADADP. As one consequence, if a § 336(e) election is made for a qualified stock disposition but a purchaser owns nonrecently disposed target stock, gain or loss may

Who is treated as owning old target stock is also relevant in allocating an S corporation target's tax items. If the target is an S corporation target, the regulation states that the S corporation shareholders take into account the portion of the tax items from the deemed sale under § 1366 and adjust their stock bases for those items under § 1367.[175] "S corporation shareholders" are the S corporation target's shareholders, whether or not they dispose of target stock.[176] The S corporation target is a target that was an S corporation immediately before the disposition date.[177]

Although an S corporation shareholder must be a shareholder of an S corporation target, the regulations do not precisely specify when or how these shareholders should be identified. Nevertheless, they strongly suggest that the shareholder disposing of S corporation target stock in the qualified stock disposition should be the S corporation shareholder, not the purchaser of that stock. For example, assume that Fred owns all stock of an S corporation, T, and on one day sells that stock to Mary, a person not related to Fred. Fred has made a qualified stock disposition of T, because he has sold all T stock to Mary, a person not related to Fred, within a 12-month period. On the disposition date, both Mary and Fred are T shareholders, and each fits the literal definition of an S corporation shareholder.

The regulations strongly suggest that Fred, not Mary, is the S corporation shareholder. First, the

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be duplicated. For instance, in the textual example, if the T stock changed in value between P's sales of the stock to X and Fred, a portion of that change would be reflected in both old T's recognized gain or loss on its deemed asset sale and new T's asset bases, in effect duplicating economic gain or loss.

For similar reasons, duplication may also occur when a § 338 election is made for a qualified stock purchase and the purchasing corporation owns nonrecently purchased target stock. *Compare* § 1.338-4(b)(1) (describing the adjusted deemed sales price) *with* § 1.338-5(b)(1) (describing the adjusted grossed-up basis). In a § 338 transaction, however, significant differences are more likely to occur when a regular, rather than § 338(h)(10), election is made, because the target stock purchase is more likely to be spread out over time when the regular election is made. *Cf.* § 1.338(h)(10)-1(c)(1) (requiring the target to be a subsidiary of a consolidated group, to be owned by a selling affiliate on the acquisition date, or to be an S corporation immediately before the acquisition date). Since the repeal of the *General Utilities* doctrine, most § 338 elections involving domestic targets have been under § 338(h)(10) and most qualified stock purchases have occurred over a relatively short period. Thus, the potential for gain or loss duplication because of a § 338 election, at least for a domestic target, has been minimized (or at least obscured). In contrast, § 336(e) elections are more likely to be made for dispositions spread out over time, increasing the likelihood (and visibility) of gain or loss duplication.

[175] § 1.336-2(b)(1)(iii) (providing that the S corporation shareholders take their pro rata share of the deemed disposition tax consequences into account); § 1.336-1(b)(15) (defining the deemed disposition tax consequences as the federal income tax consequences of the deemed asset disposition); *id.* at (b)(14) (defining the deemed asset disposition as the deemed sale of old target's assets).

[176] *Id.* at (b)(4). *See also id.* at (b)(6)(i) (referring to the disposition of target stock by S corporation shareholders).

[177] *Id.* at (b)(3).

definition of an S corporation shareholder refers to shareholders who dispose of S corporation stock, and only Fred makes such a disposition.[178] Second, the regulations refer to S corporation shareholders in conjunction with sellers, illustrating that those shareholders should include the ones who dispose of their target shares, not the ones acquiring those shares in the disposition.[179] Finally, in illustrating the responsibilities of the S corporation shareholders in making a § 336(e) election, those disposing of the target stock in the qualified stock purchase are treated as the S corporation shareholders, not those purchasing it.[180] Thus, the S corporation shareholders should include those disposing of the S corporation stock in the qualified stock disposition, but not those purchasing it.[181]

Note that a qualified stock disposition may occur through a series of dispositions over a 12-month disposition period.[182] The regulations offer no real guidance to identify the S corporation shareholders when the qualified stock disposition occurs over more than one day.[183] For example, suppose that Fred owned all stock of T, an S corporation and that he sells blocks of that stock on separate days to Mary, Alice, and John, completing the qualified stock disposition with his sale to John. If Mary sold her T stock to Peter before Fred made his sale to John, the S corporation shareholders may include

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[178] *Id*. at (b)(4).

[179] *See, e.g., id.* at (b)(17) (defining recently disposed stock); § 1.336-2(a) (describing the availability of the election); *id.* at (b)(1)(i)(A) (describing the deemed asset disposition); *id.* at (b)(1)(iii) (describing the deemed liquidation of old target); *id*. at (b)(1)(v) (describing the retention of target stock); *id*. at (h)(4), (h)(6)(i), and (h)(6)(vii)-(xii) (describing making the § 336(e) election); § 1.336-3(c)(1)(i)(A) and (iii) (describing the computation of the ADADP).

[180] § 1.336-2(h), *Ex. (2)(ii)* and *(iii)*.

[181] A person who acquires S corporation stock other than in a disposition (*i.e.*, in a related person or transferred basis acquisition) should be treated as a shareholder on the date of the acquisition. An S corporation shareholder is treated as not selling, exchanging or disposing target stock only if the shareholder disposes of that stock. *Id*. at (b)(1)(i)(A).

[182] In contrast, for a § 338(h)(10) election to be made for the qualified stock purchase of an S corporation, that purchase must occur on one day. The purchase must be made by a corporation, a purchase that results in the termination of the target's S status. § 1362(d)(2)((a) (providing that an S election terminates when the corporation ceases to be a small business corporation); § 1361(b)(1)(B) (providing that a small business corporation cannot have a corporate shareholder). For purposes of § 338(h)(10), an S corporation target must be an S corporation immediately before the acquisition date. § 1.338(h)(10)-1(b)(4). Therefore, no portion of the S corporation target's stock can be acquired in the qualified stock purchase before the acquisition date, because the target would otherwise lose its S status before the acquisition date.

[183] Section 1.336-1 adopts verbatim the definitions of S corporation shareholders and S corporation target found in § 1.338(h)(10)-1. However, for the reasons noted in the previous footnote, § 338(h)(10) looks to the target shareholders (other than the purchasing corporation) on the acquisition date, avoiding the issue identified in the text.

just John or may include John and Mary.

The answer may depend on how the S corporation target allocates its deemed sale gain and loss (*i.e.*, pro rata to each day of the taxable year or using the closing of the books method).[184] If a shareholder is allocated a portion of the S corporations items from the old target's deemed sale, it makes sense to treat the shareholder as an S corporation shareholder. The regulation should be amended to verify this result or to more precisely identify S corporation shareholders.[185]

Although the regulation provides that the deemed sale gain must be allocated to S corporation shareholders, it does not describe how to account for other S corporation items that arise between the beginning of the 12-month disposition period and the disposition date. There are at least two ways. First, the S corporation shareholders could be deemed to own the target stock through the disposition date. Second, except for accounting for the deemed sale gain or loss, a purchaser could be treated for all federal income tax purposes as acquiring the target stock when actually acquired. As described in **Example 14**, the regulation appears to adopt the first approach,[186] an approach that **Example 15** illustrates for an S corporation target.[187]

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[184] *See* § 1.1377-1(a) (for the proration method); § 1377(a)(2) (for the election to terminate the taxable year); § 1.1377-1(b). *See also* § 1.1368-1(g) (for a special election to close the books).

[185] Presumably as well, only the last transfer of a share before the disposition date would be taken into account in determining whether the target stock has been disposed of in a qualified stock disposition. For example, assume that Fred owns all 100 shares of the only class of T stock. He sells 50 shares to Mary on one day and 50 shares to John on a subsequent day, but Mary gives 30 of the shares to Alice before the sale to John. Even if Mary and John are not related to Fred, the transfers would not constitute a qualified stock disposition if only the last transfer of each share before the disposition date were taken into account, because 30% of the T stock (*i.e.*, Alice's stock) would not have been disposed of. The regulations could be amended to address this point.

[186] *See* § 1.336-2(k), *Ex. 6(ii)* and *(iii)*. The first approach may be administratively simpler as well, because the S corporation tax items are not split between the S corporation shareholders and purchasers.

[187] If the first approach applies, a target's status as an S corporation target may depend on whether a § 336(e) election is made for its qualified stock disposition. Note that an S corporation target is a target that is an S corporation immediately before the disposition date. § 1.336-1(b)(3).

To illustrate this point, consider the following facts: Fred owns all shares of T, an S corporation, and that T has one class of stock. On one day, he sells 20% of the T stock to X, a corporation. One week later, he sells the remaining T stock to Alice. Assuming that neither Alice nor X is not related to Fred, Fred has made a qualified stock disposition of T, because he has sold an affiliated interest in the T stock to unrelated persons over a one-week (and therefore a 12-month) period. *Id*. at (b)(6)(i).

If a § 336(e) election is not made for the disposition, T cannot be a S corporation target, because

Example 15 – S corporation target stock sold over time

Fred owns all 100 shares of the only class of T stock and T is an S corporation. He has a $200 basis in his T stock, T's assets have a $200 basis and $200 value, and T has no liabilities. On July 1, Year 1, Fred sells 50 of the T shares to Mary for $100. Over the next year, T's assets increase in value to $1,000, and on June 30, Year 2, Fred sells his remaining 50 T shares to Tom for $500. Assume that Tom and Mary are not related to Fred. Therefore, Fred has made a qualified stock disposition of the T stock, because over a 12-month period, Fred has disposed of an affiliated in interest in T, selling the T stock to unrelated persons. Assume that a § 336(e) election is made for T.

Assuming that Fred has no selling costs for his T stock sales, T is deemed to sell its assets for $600, the aggregate amount realized by Fred for the T stock.[188] Old T recognizes a $400 aggregate gain ($600 amount realized minus $200 basis), and Fred takes that gain into account under § 1366, increasing his old T stock basis by $400 under § 1367.[189] On the deemed liquidation, Fred recognizes no gain or loss, because he is deemed to receive consideration worth $600 (*i.e.*, the value deemed received in the deemed asset sale) and has a $600 basis in the old T stock. Assuming that Mary and Tom had no buying costs for their purchase of T stock, new T takes an aggregate basis in its assets of $600, equal to the amount that they paid for the T stock.[190]

With or without the § 336(e) election, Fred would have recognized an overall $400 gain, although without the election, the gain would have been entirely capital gain and with the election, Fred may recognize some ordinary income (and perhaps some ordinary loss). The election eliminated $400 of built-in gain in the T assets, equally benefitting Tom and Mary, and also eliminated a corresponding potential basis increase for each individual. Thus, the election may provide a timing benefit to each (less income in the near term at the cost of greater income in the longer term).

b. Intercompany sale

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its status as an S corporation terminated on the day Fred sold the T stock to X. § 1362(d)(2) (providing the S status of a corporation terminates on the day it ceases to be a small business corporation); § 1361(b)(1) (providing that a small business corporation cannot have a corporate shareholder). However, if a § 336(e) election is made for the disposition, under the first approach, Fred is treated as owning all of the old T stock through the deemed sale, T's S status is not terminated, T is an S corporation immediately before the disposition date, and it appears that T is an S corporation target.

Thus, the § 336(e) election may cause a corporation to transform into an S corporation target. Stated differently, the election could retroactively revoke the termination of S status.

[188] § 1.336-3(b)(1).

[189] § 1.336-2(b)(1)(iii)(A).

[190] § 1.336-4(b); § 1.338-5(b) (defining AGUB).

Somewhat surprisingly, an intercompany transfer of stock can be part of a qualified stock disposition, and in an appropriate case if a § 336(e) election is made for the disposition, the deemed sale and purchase may be part of an intercompany transaction, so that the gain or loss on the target's deemed asset sale may be deferred.[191]

Example 16 – Intercompany sale

P, S, B, and T are members of a consolidated group. P owns all S stock and also owns all B stock except for § 1504(a)(4) stock owned by Fred. Assume that the § 1504(a)(4) stock comprises 52 percent of the total B stock value. T has one class of stock outstanding, and S owns 80 percent of that stock while B owns the remaining 20 percent of the stock.

S sells a 60-percent block of the T stock to B and sells its remaining T stock to an unrelated non-member. S has made a qualified stock disposition of the T stock, because it sells an affiliated interest in T to persons not related to S over a 12-month period.[192] B is not related to S, because P owns less than 50 percent of the total B stock, and no stock can be attributed from B through P to S or S through P to B under § 318(a) (other than (a)(4)).[193]

S makes a § 336(e) election for the disposition. At the close of the disposition date, "old" T is treated as selling its assets to an unrelated person[194] and "new" T is treated as buying those assets from an unrelated person.[195] Because "old" and "new" T are unrelated, "new" T may be the buyer of the assets sold by "old" T in the deemed sale and "old" T may be the seller of the assets purchased by "new" T in the deemed purchase.[196] Even if "old" T is not deemed to sell its assets directly to "new" T, any intermediaries deemed to hold the T assets would hold them for less

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[191] *See* § 1.1502-13(c) and (d). Note that in appropriate cases a deemed sale and purchase pursuant to a § 338(h)(10) election may also be characterized as an intercompany transaction. *See* P.L.R. 201145007 (Nov. 10, 2011) (for an intercompany sale for which a § 338(h)(10) election was made); P.L.R. 201203004 (Jan. 12, 2012) (for another intercompany sale for which a § 338(h)(10) election was made).

[192] § 1.336-1(b)(6)(i).

[193] *Cf.* § 318(a)(2)(C) and (a)(3)(C) (requiring that a shareholder own 50% (by value) of the stock of a corporation for stock to be attributed from the shareholder to the corporation or the corporation to the shareholder). Note as well that § 304 does not apply to the sale and transfer. *See* § 1.1502-80(b).

[194] § 1.336-2(b)(1)(i)(A).

[195] *Id.* at (b)(1)(ii).

[196] *See id.* at (b)(1)(iii)(A) (treating the old target as distributing the consideration received from new target in the deemed sale, implying that the deemed sale and purchase is between old and new target). As this example illustrates, members of the same consolidated group may not be related.

than an instant, and under general tax principles, that evanescent holding should be disregarded. In substance, therefore, "new" T should be treated as buying the T assets from "old" T.[197]

That deemed sale is an intercompany transaction. An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction.[198] Immediately after transaction (*i.e.*, the deemed sale by "old" T, the deemed purchase by "new" T and the deemed liquidation by "old" T), "old" T's successors (S and B) and "new" T are members of the P group,[199] so that the deemed sale is an intercompany transaction.

On its deemed sale of its assets, "old" T recognizes gain or loss. Because that sale is an intercompany transaction, that gain or loss is deferred and taken into account as provided under § 1.1502-13.[200]

c. Intercompany dispositions and sales to S corporation shareholders

Generally, recently disposed stock is stock disposed of by the seller, a member of the seller's consolidated group, or an S corporation shareholder during the 12-month disposition period.[201] However, if that stock is held by one of those persons immediately after the close of the disposition date, the stock is not recently disposed stock.[202] Then, if the holder is a purchaser, that stock may be nonrecently disposed stock, even if the stock was disposed of as part of a qualified stock disposition.[203]

That oddity may lead to a non-intuitive result when a seller sells target stock to a member of its consolidated group or an S corporation sells target stock to another S corporation shareholder. The reason is that the stock sold may be nonrecently disposed stock, so that the gain or loss on the deemed sale will be determined by disregarding those sales, possibly shifting gain or loss between the seller and buyer of target stock and creating non-economic gain or loss.

Example 17 – Sales to S corporation shareholders

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[197] *Cf*. § 1.336-2(e) (treating the deemed sale and purchase as if they actually had occurred).

[198] § 1.1502-13(b)(1).

[199] Because S and B owned all of "old" T stock (and therefore owned an affiliated interest in that stock), "old" T's deemed liquidation should be described in § 332 and § 381(a). S and B are the successors to "old" T, because they are deemed to receive its assets in a § 381(a) transaction. *Id*. at (j)(2)(i)(A); *id*. at (j)(9), *Ex. 6.*

[200] As appropriate, S or B will succeed to those deferred items. *See* § 1.1502-13(j)(2).

[201] § 1.336-1(b)(17).

[202] *Id.*

[203] *Id*.; *id.* at (b)(18) (defining nonrecently disposed stock).

Mary and Fred, who are not related to each other, each own 15 shares of the sole class of T stock. T, an S corporation, has 100 shares outstanding. George, who is related to neither Mary nor Fred, owns the remaining T stock. On July 1, Year 1, Mary and Fred each buy 35 shares of the T stock from George for $350. Assume for convenience, that immediately before these purchases, the T stock is worth $1,000 in the aggregate, T has assets with a $1,000 basis and $1,000 value, T has no liabilities, and each shareholder has a fair market value basis in his or her T stock. Thus, after the purchases, Mary and Fred own T shares with an aggregate $500 basis, a $150 basis in the original T shares and a $350 basis in the newly purchased T stock.

T's fortunes reverse, and the value of its assets plummets to just $100. Mary and Fred sell their original 30 T shares to Alice, a person related to neither Mary nor Fred, for $30 on June 30, Year 2. That sale completes a qualified stock disposition of the T stock. In two sales over a 12-month period (one on July 1, Year 1, the second on June 30, Year 2), all of the T stock (and thus an affiliated interest in that stock) was sold by disposition by the S corporation shareholders. Each sale was a disposition, because in each sale, the buyer and seller were unrelated. Assume that a § 336(e) election is made for the qualified stock disposition.

"Old" T's aggregate amount realized on the deemed asset sale equals the ADADP, and to compute that amount, it is necessary to identify the recently disposed T stock. Only the T stock sold by Mary and Fred to Alice is recently disposed stock, because it was disposed over during the 12-month disposition period and is not held by an S corporation shareholder immediately after the disposition date. The T stock sold by George cannot be recently disposed T stock, because it is held by Mary and Fred, both S corporation shareholders, immediately after the disposition date.[204] It is, however, nonrecently disposed stock, because it is held by purchasers (Fred and Mary) on the disposition date, and each holder owns at least 10 percent of the T stock on that date, in fact, owning 35 percent of that stock.[205]

Thus, assuming that George, Mary, and Fred had no selling costs on their sales of T stock, because T has no liabilities, the ADADP equals the grossed-up amount realized on the sale of the recently disposed T stock, or $100, (i) $30 (the amount realized on Mary and Fred's sale of T stock to Mary) divided by (ii) 30 percent (the percentage of T stock by value attributable to recently disposed stock).[206] Thus, "old" T is deemed to sell its assets for $100 and recognizes a

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[204] *See id*. at (b)(17) (defining recently disposed stock). Although the regulations do not clearly identify who S corporation shareholders are, they should include those who dispose of the S corporation stock in the qualified stock disposition (such as George, Mary, and Fred), not those (like Alice) who acquire the stock in the disposition but do not already own stock in the S corporation target. *See supra* notes 178-185 and accompanying text (for a discussion of who should be an S corporation shareholder).

[205] § 1.336-1(b)(18) (defining nonrecently disposed stock); *id*. at (b)(2) (defining a purchaser as a person who acquires stock of the target in a qualified stock disposition).

[206] § 1.336-3(b)(1) (for the definition of the ADADP); *id*. at (c)(1) (for the computation of the grossed-up amount realized).

$900 loss.

In allocating that loss, George, Fred, and Mary are treated as not having sold the T stock disposed of in the qualified stock disposition.[207] Thus, under § 1366, $630 of the loss is allocated to George (70 percent of $900) and $135 is allocated to each of Mary and Fred (15 percent of $900). That allocable loss reduces each shareholder's basis in his or her T stock under § 1367, George's from $700 to $70, and Mary's and Fred's each from $150 to $15.[208] Finally, each of those shareholders is deemed to receive as a liquidating distribution a pro rata share of the $100 consideration deemed received by "old" T in the deemed sale.[209] Because each is deemed to receive consideration with a value equal to his or her T stock basis, none of them recognizes gain or loss on the deemed liquidation.[210]

"New" T is treated as purchasing its assets *at the close of the disposition date but before "old" T's liquidation*.[211] "New" T takes an aggregate basis in its assets equal to the AGUB, which equals the grossed-up basis of recently disposed T stock plus the aggregate basis of nonrecently disposed T stock.[212] (Recall that T has no liabilities.) Because all of the T stock is either recently disposed or nonrecently disposed stock, the grossed-up basis of the recently disposed T stock equals the amount paid by Alice for that stock or $30.[213] Further, immediately before the close of the disposition date, Mary and Fred's basis in the nonrecently disposed T stock is $700, the amount that they paid for the T stock. Thus, the AGUB and aggregate basis of the T assets

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[207] Although Fred and Mary are the actual T shareholders on the disposition date, 70% of the loss on the deemed sale should be allocated to Fred, because for federal income tax purposes, Fred is not treated as having sold his T stock. § 1.336-2(b)(1)(i)(A) (providing, in general, that an S corporation shareholder is not treated as selling, exchanging, or distributing target stock disposed of in the qualified stock disposition); *id*. at (b)(1)(iii) (providing without qualification that S corporation shareholders take their pro rate sale of the deemed disposition tax consequences into account).

[208] *Id*.

[209] *Id.*

[210] § 331(a).

[211] § 1.336-1(b)(1)(ii).

[212] § 1.336-4(b) (applying § 1.338-5 with modifications); § 1.338-5(b) (defining AGUB). Note that neither Mary nor Fred is required to make a gain recognition election for their T stock, because neither is a 80-percent purchaser. § 1.336-4(c)(2). Assume that neither makes that election.

[213] § 1.338-5(c). This conclusion assumes that Alice had no acquisition costs incurred in connection with her purchase of that stock. *See id*. at (c)(3).

equals $730, duplicating $630 of the loss taken into account by George, Fred, and Mary.[214]

Note that Fred and Mary's basis in their T stock will be reduced to $70 *on the day after the disposition date*.[215] If a seller or S corporation shareholder retains target stock after the disposition date, that shareholder is treated as purchasing that stock on the day after the disposition date for its fair market value.[216] For this purpose, the fair market value of all target stock equals the grossed-up amount realized of recently disposed target stock. Because Fred and Mary are S corporation shareholders and retain their T stock, on the day after the disposition date, they are treated as buying the stock for $35 each (35 percent of $100). Thus, § 1366(d) may limit their use of the built-in loss in the T assets.

Nevertheless, that built-in loss offers the T shareholders a potential tax benefit, since the loss may be taken into account up to their bases in the T stock and may also offset future T income. This tax benefit is inconsistent with what would have occurred if Mary, Fred, and Alice had formed a new corporation and that corporation had acquired the T assets, and generally no provision in § 1.336-2 may produce results inconsistent with what would happen if the transactions deemed to occur actually occurred.[217] That anti-avoidance rule arguably should not apply, however, because the inconsistency arises not because of § 1.336-2, but because of the odd definition of nonrecently disposed stock in § 1.336-1(b)(18). To reach a result more consistent with a comparable actual transaction, stock transferred in a disposition included in a qualified stock disposition should be recently disposed target stock, even if it is acquired by an S corporation shareholder, the seller, or a member of the seller's consolidated group.[218]

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[214] The § 336(e) election provides a tax windfall to George. Without the election, George would recognize no gain or loss in connection with the sale of his stock to Fred and Mary. Because of the election, he recognizes a $630 loss. Fred and Mary must agree to the election, however, and as a condition of their agreement, they may require a payment from George, which presumably would be treated as a purchase price reduction. § 1.336-2(h)(3)(i) (providing that all S corporation shareholders must agree to the election).

[215] *Cf.* § 1.336-4(c) and § 1.338-5(d)(3)(i)(B) (providing that if a gain recognition election is made or deemed made for nonrecently disposed stock, that stock's basis is adjusted on the disposition date immediately after the deemed sale).

[216] § 1.336-2(b)(1)(v). That reduction should not result in a redetermination of the AGUB, because that reduction is not one required under general principles of tax law. *Cf.* § 1.336-4(a) (providing that the AGUB may be redetermined "i[f] a subsequent increase or decrease with respect to an element of AGUB is required under general principles of tax law"); § 1.338-5(b)(2)(ii) (for a similar rule).

[217] § 1.336-2(e).

[218] If the definition of recently disposed stock were revised as suggested in the text, the stock purchased by Mary and Fred from George would be recently disposed T stock, the ADADP and AGUB would both be $730 ($30, for the amount paid by Alice) plus $700, for the amount paid by Fred and Mary), and no non-economic loss would be created.

If the definition of recently disposed stock were amended in that fashion, the amendment may also prevent the creation of non-economic gain, preventing a trap for the unwary shareholder. For instance, assume that in **Example 17**, Mary and Fred each buy 35 shares of the T stock from George for $35 when all T stock is worth just $100, T has assets with a $100 basis and $100 value, T has no liabilities, and each shareholder has a fair market value basis in his or her T stock. Assume as well that T's fortunes dramatically improve, the value of its assets skyrockets to $1,000 and Mary and Fred sell their original 30 T shares to Alice for $300. Finally assume that the sales are part of a qualified stock disposition and a § 336(e) election is made for the disposition. Under the same rationale described in **Example 17**, the ADADP is $1,000 ($300/30 percent), so that T recognizes a $900 gain on its deemed sale. However, T's aggregate asset basis, the AGUB, is only $370 ($300, Alice's T stock basis, plus $70, Mary and Fred's T stock basis), duplicating $630 of the $900 gain taken into account by George, Mary, and Fred on T's deemed asset sale.[219]

As **Example 18** illustrates, consolidated groups could also exploit (or be trapped) by the current definition of recently disposed stock.

Example 18 – Creating non-economic loss; non-S corporation target

P, S, B, and T are members of a consolidated group. P owns all S stock and all B common stock, but Fred, a person not related to any member of the P group, owns all B preferred stock, which is § 1504(a)(4) stock and comprises more than 50 percent of the total value of B's stock. S owns all 100 shares of the only class of T stock, with a $1,000 basis and $1,000 value, T has assets with a $1,000 basis and $1,000 value and also has no liabilities. On July 1, Year 1, S sells 79 T shares to B for $790.

T's fortunes reverse, and the value of its assets plummets to just $100. S sells 12 T shares to Mary, a person not related to any P group member, for $12. Thus, S retains 9 T shares. The sales to B and Mary are a qualified stock disposition, because S disposed of an affiliated interest in the T stock over a 12-month period (79 percent on July 1, Year 1 and 12 percent on June 30, Year 2). Each sale is a disposition, because S is related to neither B nor Mary. S is not related to B, because P owns less than 50 percent of the total B stock, and no stock can be attributed from B to S or S to B under § 318(a) (other than (a)(4)).[220] Assume that a § 336(e) election is made for

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If that stock is treated as recently disposed stock, its basis should also not be adjusted under § 1.336-2(b)(1)(v) merely because a seller, member of the seller's consolidated group, or S corporation shareholder retains that stock. Thus, § 1.336-2(b)(1)(v) should also be amended to prevent an basis adjustment for that stock.

[219] Under § 1.336-2(b)(1)(v), Fred and Mary will each increase their T stock bases to $350, but T will retain its $370 aggregate asset basis.

[220] *Cf.* § 318(a)(2)(C) and (a)(3)(C) (requiring that a shareholder own 50% (by value) of the stock of a corporation for stock to be attributed from the shareholder to the corporation or the corporation to the shareholder). Note as well that § 304 does not apply to the sale to B. *See* § 1.1502-80(b).

the qualified stock disposition.

"Old " T's aggregate amount realized on the deemed asset sale equals the ADADP, and to compute that amount, it is necessary to identify the recently disposed T stock. Only the T stock sold by S to Mary is recently disposed stock, because it was disposed of during the 12-month disposition period and is not held by seller or a member of the seller's consolidated group immediately after the disposition date.[221] The T stock sold by S to B cannot be recently disposed T stock, because it is held by B, a member of S's consolidated group, immediately after the disposition date.[222] It is, however, nonrecently disposed stock, because it is held on the disposition date by a purchaser (B) owning at least 10 percent (and in fact 79 percent) of the T stock.[223]

Thus, assuming that S had no selling costs on its sales of T stock, because T has no liabilities, the ADADP equals the grossed-up amount realized on the sale of the recently disposed T stock, or $100, (i) $12 (the amount realized on S's sale of T stock to Mary) divided by (ii) 12 percent (the percentage of T stock by value attributable to recently disposed stock).[224] Thus, "old" T is deemed to sell its assets for $100 and recognizes a $900 loss.

The deemed sale should be an intercompany transaction, however. An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction.[225] Immediately after transaction (*i.e.*, the deemed sale by "old" T, the deemed purchase by "new" T and the deemed liquidation by "old" T), "old" T's successor (S) and "new" T are members of the P group,[226] so that the deemed sale is an intercompany transaction. Thus, the $900 loss is taken into account as provided in § 1.1502-13 and § 1.267(f)-1.

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[221] § 1.336-1(b)(17) (providing that recently disposed stock includes stock disposed of by the seller during the 12-month disposition period unless it is held by the seller or a member of the seller's group immediately after the close of the disposition date).

[222] *See* § 1.336-1(b)(17) (defining recently disposed stock).

[223] § 1.336-1(b)(18) (defining recently purchased stock); *id*. at (b)(2) (defining a purchaser as a person who acquires stock of the target in a qualified stock disposition).

[224] § 1.336-3(b)(1) (for the definition of the ADADP); *id*. at (c)(1) (for the computation of the grossed-up amount realized).

[225] § 1.1502-13(b)(1).

[226] Because S owned all of "old" T's stock (and therefore owned an affiliated interest in that stock), "old" T's deemed liquidation should be described in § 332 and § 381(a). S is the successor to "old" T, because it is deemed to receive its assets in a § 381(a) transaction. *Id*. at (j)(2)(i)(A); *id*. at (j)(9), *Ex. 6*.

"New" T takes an aggregate basis in its assets equal to the AGUB, which equals the grossed-up basis of recently disposed T stock plus the aggregate basis of nonrecently disposed T stock.[227] (T has no liabilities.) All of the T stock, except for the stock held by S is recently disposed or nonrecently disposed stock. S's T stock is not recently disposed T stock, because it was not disposed of. It is not nonrecently disposed stock because it is not held by a purchaser or a person related to the purchaser. Thus, the grossed-up basis of the recently disposed T stock equals $21, the amount paid by Mary for that stock or $12, multiplied by the fraction 21/12.[228] Further, because the basis of the nonrecently purchased stock is $790 (*i.e.*, what B paid for that stock), the AGUB and aggregate basis of the "new" T assets equals $811, duplicating $711 of the loss taken into account by "old" T.

Because "new" T's $811 basis reflects only $189 of the $900 loss on the deemed sale, "old" T immediately takes into account the remaining $711 loss.[229] S, as the successor to "old" T takes the remaining deferred $189 loss into account.[230]

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[227] § 1.336-4(b) (applying § 1.338-5 with modifications); § 1.338-5(b) (defining AGUB). Note that neither S nor B is required to make a gain recognition election for its T stock, because neither is a 80-percent purchaser. § 1.336-4(c)(2). Assume that neither makes that election.

[228] § 1.336-4(b); § 1.338-5(c). The numerator of the fraction equals 21, or 100 minus 79, the percentage of the target stock (by value, determined on the disposition date) attributable to the purchasers' nonrecently disposed target stock. The denominator of the fraction equals 12, the percentage of the target stock (by value, determined on the disposition date) attributable to the purchasers' recently disposed target stock. *Id.* This conclusion assumes that Mary had no acquisition costs incurred in connection with the purchase of that stock. *See id*. at (c)(3).

[229] § 1.1502-13(d) (providing that the selling member's intercompany items and buying member's corresponding items are taken into account to they extent they cannot be taken into account to produce the effect of treating the selling and buying members as divisions of a single corporation); *id*. at (c)(2) (providing that the selling member takes its intercompany item into account to reflect the difference between the buying member's corresponding item (*i.e.*, "new" T's $811 asset basis) and its recomputed corresponding item); *id*. at (b)(4) (providing that the recomputed corresponding item is the corresponding item that the buying member would take into account if the selling and buying members were divisions of a single corporation (*i.e.*, a $1,000 asset basis)).

[230] Note that S's and B's bases in their T stock will be reduced to $9 and $79, respectively, on the day after the disposition date. If a seller or S corporation shareholder retains target stock after the disposition date, that shareholder is treated as purchasing that stock on the day after the disposition date for its fair market value. § 1.336-2(b)(1)(v). *See also id*. at (g)(2) (treating all members of the seller's consolidated group as a single seller). For this purpose, the fair market value of all target stock equals the grossed-up amount realized on recently disposed target stock. *Id*. Because B and S retain their T stock, on the day after the disposition date, they are treated as buying the stock for $9 (9% of $100) and $79 (79% of $100), respectively.

The duplication of loss illustrated by **Example 18** presumes that no anti-avoidance rule applies, but at least two likely would apply. First, appropriate adjustments may be made if a transaction is engaged in with a principal purpose to avoid the purposes of § 1.1502-13.[231] Those purposes include preventing intercompany transactions from avoiding or deferring consolidated taxable income (or consolidated tax liability).[232] Second, appropriate adjustments must be made to carry out the purposes of § 1.267(f)-1 "[i]f a transaction is engaged in or structured with a principal purpose to avoid the purposes of [that] section (including . . . by distorting the timing of losses or deductions)."[233] The purpose of § 1.267(f)-1 is to prevent a controlled group from taking a loss into account "solely as the result of a transfer of property between a selling member (S) and buying member (B)."[234]

These anti-avoidance rules should apply in the same way as if S and B actually engaged in the transactions deemed to occur because of the § 336(e) election.[235] Because a principal purpose of the deemed sale and purchase (an intercompany transaction) likely was to take the loss into account and to duplicate the loss, each anti-avoidance rule likely would apply. However, their application is not absolutely certain, because the loss could arise only because of S's sale of T stock to Mary, which was neither an intercompany nor intra-controlled group transaction. These questions could be readily avoided if the regulatory amendment proposed above were adopted and B's T stock were treated as recently disposed stock.[236]

d. Intercompany stock gain

If one member of a consolidated group ("S") sells stock of another member ("T") to a third member ("B") in an intercompany transaction at a gain, that gain may be duplicated if B later sells or distributes the T stock to a non-member and a § 336(e) election is made for the latter sale or distribution. That duplication may be minimized if a rule such as § 1.1502-13(f)(5)(ii)(C) applies. The final regulations clarify that § 1.1502-13(f)(5)(ii)(C) may apply if a general § 336(e) election is made and also provide that it may apply if a § 336(e) election is made for a transaction to which § 355(d)(2) or (e)(2) applies, in whole or in part.[237]

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[231] § 1.1502-13(h).

[232] *Id*. at (a).

[233] § 1.267(f)-1(h).

[234] *Id*. at (a).

[235] § 1.336-2(e).

[236] Note as well that if the anti-avoidance rules applied, the appropriate adjustments likely would have the same effect as treating B's T stock as recently disposed T stock, because that treatment prevents the creation of non-economic loss.

[237] § 1.1502-13(f)(5)(ii)(C) (for the general election); § 1.336-2(b)(2)(i)(A)(*2*) (if a § 336(e) election is made for a distribution described in § 355(d)(2) or (e)(2), in whole or in part, providing that if

Section 1.1502-13(f)(5)(ii)(C) provides elective relief to mitigate gain duplication that applies when a § 336(e) (or § 338(h)(10)) election is made if (i) T is a member of the consolidated group for the period beginning with S's intercompany transfer and ending with T's deemed liquidation and (ii) the liquidation is described in § 332.[238] If the group elects to apply § 1.1502-13(f)(5)(ii)(C), for each share of T stock, "B is treated . . . as recognizing as a corresponding loss any loss or deduction (determined after adjusting stock basis under § 1.1502-32) that it would recognize if § 331 applied to the deemed liquidation."[239] For all other purposes, the liquidation is treated as one to which § 332 applies.[240] Note that B's loss is limited in the following two ways:

(i) The aggregate loss recognized by B on T stock cannot exceed the selling member's (*i.e.*, S's) net intercompany income (*i.e.*, income and gain minus deductions and loss) on shares of T stock having the same materials terms as the shares giving rise to S's intercompany income or gain; and

(ii) The aggregate amount of loss recognized by B under § 1.1502-13(f)(5)(ii)(C) cannot exceed the net loss on the T stock that would be taken into account if § 331 applied to all T shares.[241]

Example 19 – Section 1.1502-13(f)(5)(ii)(C)

P, the common parent of a consolidated group, owns all S and B stock. S owns all 100 shares of the single class of T stock, with a basis of $10 per share or $1,000 in the aggregate. T has no liabilities and its one asset has a $1,000 basis and $1,500 value. S sells its T stock to B for $1,500, recognizing a $500 gain, which is deferred under § 1.1502-13. B takes a $1,500 basis in the T stock ($15 per share).

Later, when the T asset still has a $1,000 basis and $1,500 value, B sells the T stock on one day to Fred, a person not related to any P group member, for $1,500. Because B has sold the T stock to a person not related to B on one day, B has made a qualified stock disposition of the T stock. Assume that a § 336(e) election is made for the disposition.

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an election is made under § 1.1502-13(f)(5)(ii)(E), solely for purposes of § 1.1502-13(f)(5)(ii)(C), T is deemed to liquidate).

[238] § 1.1502-13(f)(ii)(A); *id.* at (f)(5)(ii)(C) (providing that the liquidation must be described in § 332 and that § 1.1502-13(f)(5)(ii)(C) does not apply if § 1.1502-13(f)(5)(ii)(B) is applied to the deemed liquidation).

[239] *Id*. at (f)(5)(ii)(C)(*1*) (providing that B's loss is determined after adjusting its basis in the T stock under § 1.1502-32 to account for the deemed asset sale).

[240] *Id.*

[241] *Id*. at (f)(5)(ii)(C)(*2*).

T is deemed to sell its assets for $1,500, the ADADP, recognizing a $500 gain.[242] S must also take its $500 gain on the T stock into account on the sale.[243] Unless the P group makes the election under § 1.1502-13(f)(5)(ii)(C), however, B recognizes no loss on the deemed liquidation of "old" T, because § 332 applies to the liquidation.

If the group elects to apply § 1.1502-13(f)(5)(ii)(C), B will recognize a $500 loss, so that overall, the group will take into account only a net $500 gain. B computes its loss as follows. First, it adjusts its basis in the "old" T stock to account for the gain on the deemed asset sale, increasing its T stock basis by $500, from $1,500 to $2,000.[244] Next, it determines the loss that it would recognize on T's deemed liquidation if § 331 applied to the liquidation. Because B's basis in the T stock is $2,000 and B is deemed to receive consideration worth $1,500, B would recognize a $500 loss.[245] Because T has only one class of stock, all of which B sold, and B's loss does not exceed S's net intercompany income and gain on the same stock, B takes the full $500 loss into account.[246]

Note that in **Example 19**, B succeeds to attributes of "old" T, such as its earnings and profits and net operating loss carryovers.[247] However, S may sell its T stock to B as a part of an overall plan to dispose of the T stock to a non-member. If a principal purpose of the intercompany sale is to allow B, rather than S, to succeed to the T attributes, under an anti-avoidance rule, S may be required to succeed to the attributes.[248]

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[242] Because T has no liabilities and assuming that B had no selling costs, the ADADP equals the amount realized by B on its sale of all T stock, or $1,500. § 1.336-3(b) (defining ADADP).

[243] § 1.1502-13(c)(2)(i) (providing that S takes its intercompany item into account (*i.e.*, its $500 gain) to reflect the difference for the year between B's corresponding item ($0, its actual gain on the T stock sale to Fred) and its recomputed corresponding item ($500 or what its gain would have been if S and B were divisions of a single corporation and the intercompany transaction were between those divisions). *See also id*. at (b)(2) (defining intercompany items); *id*. at (b)(3) (defining corresponding items); *id*. at (b)(4) (defining recomputed corresponding items).

[244] § 1.1502-32(b)(2)(i) and (b)(3)(i).

[245] § 331(a); § 1.336-2(b)(1)(ii)(A) (providing that the consideration deemed received in the liquidation is the consideration received from new target in the deemed asset sale).

[246] If, instead, T had a $900 basis in its assets, it would recognize a $600 gain on the deemed asset sale. Although B would be deemed to increase its T stock basis by $600 and recognize a $600 loss if § 331 applied to the deemed liquidation, only $500 of that loss could be taken into, matching S's gain on its intercompany sale of the T stock to B.

[247] § 381(a) and (c).

[248] § 1.1502-13(h)(1) (providing that appropriate adjustments may be made if a transaction is engaged in or structured with a principal purpose to avoid the purposes of § 1.1502-13); *id*. at (a)

It is less clear whether the anti-avoidance rule would apply, however, if, as part of an overall plan, S distributed the T stock to P, which in turn distributed that stock to its shareholders. Assume that P distributed an affiliated interest in the T stock to shareholders not related to P, the distribution was a qualified stock disposition and a § 336(e) election was made for the disposition. If the plan was to place the T stock in the hands of P's shareholders, it may be hard to show that the plan's principal purpose was for P to succeed to T's attributes, even if the group was advantaged by P, rather than S, being the successor. In other words, it may be difficult to apply the anti-avoidance rule.

In any case, if the distributions both occurred on the same day and a § 336(e) election was made, it may be more appropriate to treat T as selling its assets and liquidating into S, rather than P, with S and then P distributing "new" T stock with no recognition. Currently, however, a § 336(e) election could not be made for S's distribution, because P is related to S, so that the distribution would not be a disposition.[249] The regulation could be amended to provide, in the limited case where the two distributions occur on one day, that the intercompany distribution is a qualified stock disposition, eliminating any gain to the distributing subsidiary (and common parent).[250]

e. Streaming dividends

A § 336(e) election may be made for series of distributions of subsidiary target stock by a parent corporation, if the distributions, as a whole, constitute a qualified stock disposition. Because one distribution in a series may precede an adjustment to earnings and profits that may be tied to the series, it may be possible to time the distributions to best take the distributing corporation's earnings and profits (or lack thereof) into account.

Example 20 – Timing distributions to maximize benefits

P, a calendar-year taxpayer, owns all shares of the only class of T stock. Assume that neither P nor T has current or accumulated earnings and profits and that T has assets with a $100 basis and $1,000 value and no liabilities. P's shareholders include X, a corporation, owning 30 percent of P's only class of stock and many individual shareholders. No P shareholder is related to P.

As part of one plan, P distributes its T stock to its shareholders, distributing 70 percent of that

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(providing that those purposes include preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability)).

[249] § 1.336-1(b)(12) (defining related persons). *See also* § 318(a)(2)(C) (providing that stock is attributed from a corporation to a shareholder if the shareholder owns at least 50% (by value) of the corporation's stock); *id*. at (a)(3)(C) (providing that stock is attributed from a shareholder to a corporation if the shareholder owns at least 50% (by value) of the corporation's stock). Because P owns all S stock, stock owned by P or S would be attributed to the other, and P and S are related persons.

[250] This change would also prevent the P group from recognizing duplicate gain in the unlikely case that a § 1.1502-13(f)(5)(ii)(C) election would not offer full relief.

stock to its individual shareholders on December 31 of Year 1, and distributing 30 percent of that stock to X on January 1 of Year 2. Both distributions are described in § 301. Because P has made § 301 distributions of all T stock to persons not related to P over a two-day period, it has disposed of an affiliated interest in the T stock over a 12-month period, making a qualified stock disposition of the T stock. Assume that a § 336(e) election is made for the disposition.

Because of the election, at the close of January 1 of Year 2, "old" T is deemed to sell its assets for $1,000, the ADADP, which in this case is the value of the T stock when distributed.[251] Thus, "old" T recognizes a $900 gain ($1,000 amount realized minus $100 basis) and, disregarding tax, increases its earnings and profits in Year 2 by that amount.[252] "Old T" is deemed to liquidate into P at the close of the disposition date (January 1 of Year 2), and because P is deemed to own all "old" T stock, the liquidation should be described in § 332, so that P recognizes no gain or loss on the liquidation but succeeds to "old" T's earnings and profits.[253]

"New" T is deemed to purchase all of its assets from an unrelated person on the disposition date but before the deemed liquidation.[254] Note that as a new corporation, "new" T has no earnings and profits at the time of P's deemed distribution.

After the deemed liquidation, P is deemed to purchase "new" T stock from an unrelated person and distribute that stock to its shareholders, recognizing no gain or loss on the distribution.[255] Because of this deemed distribution, P reduces its earnings and profits, to the extent thereof, by the greater of the basis or value of each share of "new" T stock deemed distributed.[256] The regulation does not describe the basis that the seller (*i.e.*, P) takes in the distributed stock, but presumably it equals the value of that stock when distributed, which in this case is $1,000. Thus, P reduces its earnings and profits by $900, from $900 to $0.

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[251] § 1.336-3(c)(i)(B). All of the distributed T stock is recently disposed T stock, because it was disposed of by the seller (*i.e.*, P) during the 12-month disposition period and P owned none of that stock immediately after the close of the disposition date (*i.e.*, immediately after January 1 of Year 2).

[252] § 1001(a).

[253] § 332(b); § 381(c)(2). *See also* § 1.336-2(b)(1)(iii)(A). If P and "old" T join in filing consolidated returns, "old" T's $900 of earnings and profits tier up to P and "old" T eliminates those earnings and profits when it liquidates into P. § 1.1502-33(b)(1) (for the tier-up); *id*. at (a)(2) (providing that if a subsidiary ("S") liquidates into a parent ("P") in a 332 liquidation but P's earnings and profits reflect S's earnings and profits under the tier-up rule, the portion of S's earnings and profits to which P succeeds under § 381 must be adjusted to prevent duplication).

[254] § 1.336-2(b)(1)(ii).

[255] *Id*. at (b)(1)(iv).

[256] § 312(a)(3) and (b)(2).

The P shareholders, who are the purchasers, generally determine their tax consequences as if a § 336(e) election is not made.[257] However, the election may increase the seller's earnings and profits, also possibly increasing the portion of any distribution treated as a dividend.[258] When P distributes T stock to 70 percent of its shareholders in Year 1, however, it has no earnings and profits.[259] Thus, each of those shareholders treats the distribution first as a recovery of his or her stock basis and then as gain from the sale or exchange of stock.[260]

The consequences of P's distribution to X may depend on whether P and T join in filing consolidated returns. If they do, P's earnings and profits will be adjusted to reflect changes in T's earnings and profits.[261] Thus, for Year 2, P will have $900 of current earnings and profits, earnings and profits which tier up from T. Because X is the only shareholder actually receiving a distribution in Year 2, it should treat the entire $300 distribution (*i.e.*, the value of the T stock it receives) as paid out of P's earnings and profits.[262] Because X owns more than 20 percent of the sole class of P stock, it would be entitled to a dividends received deduction of $240 (80 percent of $300).[263]

If P and T do not join in filing consolidated returns, the regulation suggests that the answer should be the same, because the distributee shareholder (*i.e.*, X) accounts for the distribution by taking into account the earnings and profits generated by the deemed sale.[264] That result, however, is not free from doubt, because § 381(c)(2) provides that the parent of a corporation liquidating under § 332 *(e.g.*, P) succeeds to the liquidating corporation's (*e.g.*, "old" T's)

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[257] § 1.336-2(c).

[258] *Id.* (stating that the seller's earnings and profits may increase as a result of the old target's deemed asset sale and liquidation, increasing the amount of any distribution to shareholders treated as a dividend under § 301(c)).

[259] Because P is deemed to retain the T stock until the disposition date, for federal income tax purposes, it should not recognize gain or adjust its earnings and profits to account for any distribution of that stock before the disposition date that is part of the qualified stock disposition.

[260] § 301(c)(2) and (3).

[261] § 1.1502-33(b)(1) (providing for the tiering up of earnings and profits).

[262] § 1.336-2(c) (providing that a § 336(e) election generally does not affect the tax consequences to a purchaser). Even if X must treat its distribution as part of a distribution of all T stock on January 1 of Year 2, $270 of the distribution would be treated as paid out of earnings and profits (30% of $900).

[263] § 243(a)(1) and (c).

[264] § 1.336-2(c) (last sentence) (noting that the purchaser's consequences may be affected by the increase in the seller's earnings and profits because of the target's deemed sale and liquidation).

earnings and profits as of the close of the distribution date.[265] If P actually distributes the T stock to X before the close of the distribution date, P may then have no earnings and profits. Then, X would have no dividend income and would treat the distribution first as a recovery of stock basis and then as gain from the sale or exchange of stock.[266]

Note that P reduces its earnings and profits because of the distributions by $900 even though only $300 of the distributions (at most) are treated as dividends.

The regulation does not expressly describe what happens if there are a series of distributions as part of a qualified stock disposition, a § 336(e) election is made for the disposition, but the target makes § 301 distributions on its stock after the first distribution but before the disposition date. Presumably, a purchaser/distributee accounts for any "old" target distribution before the disposition date by taking into account the "old" target attributes.[267] However, because such a distribution will reduce the target's value, if the distribution is out of earnings and profits accrued before the stock dispositions, it should have a corresponding effect on the ADADP and AGUB, and the regulations may need to be amended to achieve that result.[268]

f. Disregarded entities

This section of the article discusses the sale and distribution by corporations of interests in disregarded entities, focusing on the transfer by an S corporation parent of its QSub, which is one type of disregarded entity.[269] Similar principles should apply to the distribution or sale of other disregarded entities, including qualified REIT subsidiaries.[270]

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[265] § 381(c)(2)(A). Further, if P succeeds to T's earnings and profits, those earnings and profits should be treated as accumulated, not current, earnings and profits. § 1.381(c)(2)-1(a)(2) (providing that if the distributor corporation has earnings and profits as of the close of the date of distribution, those earnings and profits become part of the acquiring corporation's earnings and profits as of the close of the distribution date).

[266] § 301(c)(2) and (3).

[267] § 1.336-2(c) (providing that a § 336(e) election generally does not affect the purchaser's federal income tax consequences).

[268] *Cf.* § 1.336-3(b)(2)(ii) (providing for a redetermination of ADADP when required under general principles of tax law); § 1.336-4(b) (adopting the principles of § 1.338-5 with modifications); § 1.338-5 (providing for a redetermination of AGUB when required under general principles of tax law). Those redetermination rules presumably would not apply, because the distributions occur before the disposition date and would affect the initial determinations of ADADP and AGUB.

[269] § 1361(b)(3)(A).

[270] *See* § 856(i). *See generally* § 301.7701-3(g).

A QSub is a wholly owned domestic subsidiary of an S corporation parent that the parent elects to treat as a disregarded entity.[271] When the election becomes effective, the subsidiary is deemed to liquidate into the parent.[272] Further, while the subsidiary is a QSub, for federal income tax purposes, the subsidiary is not treated as a entity separate from the parent, and all of its assets, liabilities, and tax items are treated as assets, liabilities, and tax items of the parent.[273]

A subsidiary's status as a QSub terminates, for example, if its parent ceases to own all subsidiary stock or the parent ceases to be an S corporation.[274] Upon termination, the former QSub generally is treated as a new corporation that acquires its assets from the S corporation parent in exchange for its stock and the assumption of its liabilities.[275] However, the tax treatment of this exchange (or any larger transaction that includes the exchange) is determined under the Code and general principles of tax law.[276]

General principles apply if an S corporation ("S") sells the stock of a QSub ("Q") to an unrelated person ("X"). Under those principles, S is treated as selling the Q assets to X, and X generally is treated as transferring those assets to Q, as a separate corporation, in exchange for the Q stock, an exchange to which § 351 applies.[277] However, if X is an S corporation and elects to treat Q as a QSub immediately after the purchase, Q's deemed formation and immediate liquidation are disregarded and X is treated simply as acquiring the Q assets.[278] Because in each of these cases, S is treated as transferring Q assets, rather than Q stock, no § 336(e) election may be made for S's sale, even though the transaction, in form, is a sale of the Q stock.[279]

Further, no § 336(e) election may be made if S sells an affiliated interest in the Q stock to X but retains some Q stock. Because of the sale, Q ceases to be a QSub and is treated as a new corporation,

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[271] § 1361(b)(3)(B).

[272] § 1.1361-4(a)(2)(i).

[273] § 1361(b)(3)(A).

[274] *Id*. at (b)(3)(C); § 1.1361-5(a).

[275] § 1361(b)(3)(C). § 1.1361-5(b)(1)(i).

[276] *Id.*

[277] *Id*. at (b)(3), *Ex. 9* (describing a transfer where X is a corporation). *Cf*. Rev. Rul. 70-140, 1970-1 C.B. 73 (adopting a recharacterization of this sort for a similar transaction).

[278] *See* § 1.1361-5(b)(3), *Ex. 9*; Rev. Rul. 2004-85, 2004-2 C.B. 189. *See also* § 1.1361-4(a)(2) (providing that if an S corporation makes a QSub election for a subsidiary, the subsidiary is deemed to liquidate into the S corporation).

[279] Further, no § 338 election can be made by X for its acquisition of Q stock in a § 351 exchange, because stock acquired in a § 351 exchange is not acquired by purchase. § 338(h)(3)(A)(ii).

acquiring all of its assets in exchange for its stock.[280] S is treated as selling an undivided interest in each of the Q assets to X, recognizing gain or loss, and S and X are then deemed to contribute the Q assets to a new corporation in a § 351 exchange.[281] Thus, S again is treated as selling Q assets, not Q stock, and no § 336(e) election may be made for the sale.

The result changes, however, if S distributes the Q stock. Assume that the distribution is not one to which § 355 applies. Because S distributes the Q stock, Q's QSub election terminates, and S is deemed to contribute the Q assets to a new corporation in exchange for that corporation's stock.[282] Because of § 351(c), any asset contribution is treated as a step separate from the stock distribution for federal income tax purposes.[283] Thus, S is treated as distributing Q stock, not Q assets, and in appropriate cases, a § 336(e) election may be made for the distribution.

If a § 336(e) election is made for the distribution, however, the deemed formation and liquidation of Q should be disregarded, and S should be treated as selling the Q assets in the deemed sale. First, the QSub election remains in place for "old" Q, the entity that is deemed to receive the assets, sell them and then liquidate. Thus, "old" Q continues as a disregarded entity. If S actually transferred assets to "old" Q, which in turn sold those assets and then liquidated, all gain or loss from the sale would be taken into account by S. A deemed asset transfer to Q and a deemed sale and liquidation by Q should be treated in exactly the same way.[284] Second, under the step-transaction doctrine, the deemed formation and instantaneous liquidation of "old" Q should be disregarded.[285] Disregarding the formation and liquidation of "old" Q is also entirely consistent with treating S as distributing Q stock, because S is treated as distributing "new" Q stock, stock that S is deemed to purchase from an unrelated person on the disposition date immediately after "old" Q's liquidation.[286] Finally, even if Q were respected as a corporation separate from S, it should be treated as acting as a conduit or agent for S in making the sale,

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[280] § 1361(b)(3)(C)(i).

[281] *Id*. at (b)(3)(C)(ii).

[282] *Id*. at (b)(3)(C)(i).

[283] § 351(c) (providing that in determining control for purposes of § 351, the fact that a corporate transferor distributes part or all of the stock of the controlled corporation to its shareholders is not taken into account).

[284] *See* § 1.336-2(e) (providing generally that no provision in § 1.336-2 should produce a tax result under subtitle A of the Code that would not occur if the parties had actually engaged in the transactions deemed to occur).

[285] *Cf.* § 1.1361-5(b)(3), *Ex. 9* (providing that if an S corporation acquires a QSub from another S corporation, the deemed formation and liquidation of the QSub is disregarded and the acquiring corporation is treated simply as acquiring the QSub's assets). *See also* Rev. Rul. 2004-85, 2004-2 C.B. 189 (reaching the same conclusion).

[286] § 1.336-2(b)(1)(iv).

because the sale occurs instantaneously and inexorably after the Q's deemed formation and therefore can reflect no gain or loss that accrues after the formation and can involve no input from Q as a separate entity.[287]

Note that S is deemed to purchase and then distribute "new" Q stock. Unless S elects to treat "new" Q as a QSub, it may be treated as a C corporation, and the distributee shareholders may be unable to elect to treat "new" Q as an S corporation for its taxable year that includes the disposition date.[288] To prevent this result (likely unintended), the regulation should be amended to provide that S is deemed to make a QSub election for "new" Q or that S's deemed ownership of "new" Q stock is disregarded in applying § 1361(b).

C. Consequences of a § 355(d)(2) and (e)(2) election

If a seller disposes of target stock in a qualified stock disposition to which § 355(d)(2) or (e)(2) applies in whole or in part and a § 336(e) election is made for the disposition, the consequences to a purchaser or minority target shareholder are the same as under the general election. The consequences for the seller and target may differ, because unlike for the general election, the target is not deemed to liquidate and is treated as the same corporation before and after the disposition date.[289] Thus, the target retains historic tax attributes, and it is treated as both the seller and buyer in the deemed sale and purchase (a "sale-to-self" model). More precisely, immediately before the close of the disposition date in two separate transactions, the target is treated as selling its assets to an unrelated person and then buying its assets from an unrelated person.[290]

1. The deemed sale

As under the general election, the target computes its gain or loss on the deemed sale by

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[287] *See* Court Holding Co. v. Comm'r, 334 U.S. 331 (1945). *See also*, *e.g.*, Rollins v. Comm'r, 66 T.C.M. (CCH) 1869 (1993) (discussing the conduit theory and § 482).

[288] § 1362(b)(2) (providing that an S election can be made for a corporation during the first 2½ months of a corporation's taxable year if certain conditions are met, including that the corporation was a small business corporation on each day of the taxable year before the election is made). *See* § 1361(b)(1)(B) (providing that a small business corporation cannot have a corporate shareholder). *See also* § 1374.

[289] § 1.336-2(b)(2)(i)(A)(*1*). The regulations refer to the target as the "old" target, even though there is no "new" target when a § 336(e) election is made for a qualified stock disposition to which § 355(d)(2) or (e)(2) applies in whole or in part.

[290] § 1.336-2(b)(2)(i)(A); *id*. at (b)(2)(ii)(A). In the case of a parent-subsidiary chain of corporations making § 336(e) elections, the deemed asset disposition of a higher-tier subsidiary is considered to precede the deemed asset disposition of a lower-tier subsidiary. *Id.* at (b)(2)(i)(C). Further, the old target's deemed sale and purchase of its assets is considered to precede the deemed asset disposition of a lower-tier subsidiary. *Id*. at (b)(2)(ii)(B).

allocating the ADADP among its disposition date assets using the seven-tier residual method.[291] Thus, on the deemed sale, the target's realized gain or loss on each asset equals the difference between the asset's allocable share of the ADADP and its adjusted basis.[292] The target generally recognizes that realized gain and loss.[293]

It recognizes any realized gain on the disposition date, except to the extent the installment method applies. If the installment method applies, the installment gain should be taken into account over time, presumably by the target, not the seller as under the general election.[294] The target should take that gain into account as the actual installment payments are received by the seller.[295]

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[291] *Id*. at (b)(2)(i)(A). *See supra* notes 41-45 and accompanying text (for descriptions of the seven-tier allocation method and the ADADP). *See also id*. at (b)(2)(i)(C) (providing that if elections are made for tiered targets, the deemed asset disposition of a higher tier subsidiary is considered to precede the deemed asset disposition of a lower-tier subsidiary); *id*. at (b)(2)(iii)(B) (providing that if a § 336(e) election is made for a target subsidiary, its consequences are determined under § 1.336-2(b)(1) (*i.e.*, under the general-election regime), unless the stock of the target subsidiary is actually disposed of in a qualified stock disposition described in whole or in part in § 355(d)(2) or (e)(2)). If § 336(e) elections are made for a chain of target subsidiaries, the deemed liquidation of a lower-tier subsidiary is considered to precede the deemed liquidation of a higher-tier subsidiary, and the deemed liquidation of the highest-tier subsidiary is considered to precede the distribution of old target stock. *Id*.

[292] § 1001(a).

[293] § 1.336-2(b)(2)(i)(A)(*2*).

[294] This conclusion is not certain, however. The regulation states that the old target recognizes any gain, except as provided in § 1.338(h)(10)-1(d)(8), which provides for installment reporting. That exception suggests that the old target does not recognize gain to the extent the installment method applies, implying perhaps that the seller recognizes that gain. However, the exception for installment gain provided in § 1.338(h)(10)-1(d)(8) would shift the installment gain to the seller through old target's liquidation, and old target is not deemed to liquidate when a § 336(e) election is made for a qualified stock disposition described in § 355(d)(2) or (e)(2). Further, the regulation states unconditionally that the seller recognizes no gain or loss on stock sold or exchanged as part of a qualified stock disposition described in § 355(d)(2) or (e)(2). § 1.336-2(b)(2)(iii)(A). *Cf. id*. at (b)(1)(i)(A) (providing that "[i]n general," the seller is not considered to sell, exchange, or distribute the stock disposed of in a qualified stock disposition not described, in whole or in part, in § 355(d)(2) or (e)(2)). *See also supra* note 154 (for a further discussion). Because there is no mechanism to shift the installment gain to the seller, the old target should take that gain into account, and the installment method should merely affect the gain's timing, not whether the old target takes it into account.

[295] *Id*. at (b)(2)(i)(B)(*1*) (referring to § 1.338(h)(10)-1(d)(8) for rules that apply when an installment obligation is received from a purchaser). *See* § 453(c) (providing that installment gain is recognized proportionately as installment payments are received). Because the target is not deemed to distribute the installment obligation, it must recognize the installment gain. Even though the seller actually would receive the installment obligation and subsequent installment payments, it does not

If the old target's realized loss on its deemed asset sale exceeds its realized gain, a portion of that excess (*i.e.*, its net loss) is disallowed using the same method described for the general election.[296] Thus, the disallowed portion equals the net loss multiplied by the following fraction (the "loss disallowance fraction") --

A/(A + B), where --

A	=	The value of the target stock distributed by the seller during the 12-month disposition period, and
B	=	The value of the target stock disposed of by sale or exchange in the qualified stock disposition during the 12-month disposition period.[297]

The disallowed loss is allocated among the target's loss assets in proportion to their realized losses.[298]

If stock of a target subsidiary is deemed sold by the target in its deemed asset sale and a § 336(e) election is also made for the subsidiary, any gain or loss realized on the target's deemed sale of subsidiary stock is disregarded.[299] The target subsidiary determines its disallowed loss in the same manner as a target subsidiary under the general rule.[300]

Note that as a prelude to its distribution of target stock, the seller may transfer built-in gain or

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recognize gain (or loss) on its sale or exchange of target stock as part of the qualified stock disposition. § 1.336-2(b)(2)(iii).

[296] § 1.336-2(b)(2)(i)(B)(*2*). *Cf. id*. at (b)(1)(i)(B)(*2*)(*ii*).

[297] *Id*. at (b)(2)(i)(B)(*2*)(*iii*) (providing that the value of the target stock for these purposes is determined on the disposition date, adding that loss may also be disallowed under other Code provisions or general tax principles "in the same manner as if those assets were actually sold to an unrelated person"). Note that the value of distributed stock is taken into account in the numerator and denominator of the loss disallowance fraction whether or not the distribution is part of the qualified stock disposition. *Id*.

[298] *Id*. For this purpose, a loss asset is an old target asset for which a loss is realized in the deemed asset sale. *See id.*

[299] *Id*. at (b)(2)(i)(B)(*2*)(*iv*). Presumably, if a § 338(g) election is made for the target subsidiary, the old target's gain or loss on its subsidiary stock is not disregarded and loss may be disallowed under the loss disallowance rule. If, instead, a § 338(h)(10) election is made for the subsidiary, however, the old target's gain or loss on subsidiary stock should be disregarded, at least if the subsidiary's deemed liquidation is described in § 332.

[300] *Id*. *See also* § 1.336-2(b)(1)(i)(B)(*2*).

loss assets to the target (*e.g.*, as part of a divisive § 368(a)(1)(D) ("D") reorganization). Following form, the asset transfer and § 336(e) election would shift the recognition of those built-in amounts to the target, a shift that may promise an overall tax benefit to the seller group. In an appropriate case (*e.g.*, where the distribution occurs shortly after the asset transfer), under the anticipatory assignment of income doctrine, the target should be treated as a conduit or agent for the seller, so that the seller, rather than the target, takes the gain or loss on the contributed assets into account.[301]

2. The deemed purchase

Immediately after the target is deemed to sell its assets to an unrelated person, the same target is deemed to purchase the same assets from an unrelated person in a single, separate transaction.[302] It determines its basis in the assets after the deemed purchase by allocating the AGUB among its assets, also by using the seven-tier residual method.[303]

Because the target is deemed to sell and purchase its assets, commentators were concerned that

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[301] *See* Court Holding Co. v. Comm'r, 334 U.S. 331 (1945). *See also*, *e.g.*, Rollins v. Comm'r, 66 T.C.M. (CCH) 1869 (1993) (discussing the conduit theory and § 482). *See also* § 1.336-2(e) (providing generally that no provision in § 1.336-2 should produce a tax result under subtitle A of the Code that would not occur if the parties had actually engaged in the transactions deemed to occur).

[302] *Id*. at (b)(2)(ii)(A). Thus, unlike for the general election, the target is not treated as a separate corporation for federal income tax purposes in making the deemed asset purchase and following the disposition date. Accordingly, it retains its tax attributes, although its earnings and profits may be adjusted as provided in § 1.312-10 and § 1.1502-33.

[303] *Id*. *See also id.* at (b)(2)(ii)(B) (providing that for tiered targets, old target's deemed purchase is considered to precede the deemed asset disposition of a lower-tier subsidiary). *See supra* notes 98-126 and accompanying text (for a description of the AGUB).

Note that in computing the AGUB, the purchaser's basis in recently disposed stock is deemed to equal the stock's value when acquired. § 1.336-4(b)(5). Because of that rule, essentially the same amounts are taken into account in computing the amount realized for recently disposed stock for the ADADP and in computing the basis in recently disposed stock for the AGUB. However, that rule will not apply if stock is distributed by one consolidated group member to another as part of a qualified stock distribution to which § 355(d)(2) applies, because the distributed stock will be nonrecently disposed stock. See supra notes 220-230 and accompanying text (for an example that illustrates when stock transferred from one member of a consolidated group to another member may be treated as disposed of in a qualified stock disposition and why that stock would be nonrecently disposed stock). In that limited (and unusual) case, the AGUB may exceed (or fall short of) the ADADP even if all stock is disposed of in the qualified stock disposition, potentially creating built-in gain or loss in the target assets after the disposition. That concern would be avoided if the stock distributed to the member in a disposition were treated as recently disposed stock. *See supra* notes 201-236 and accompanying text (for a broader discussion of why this change makes sense).

the anti-churning rules of § 197(f)(9) or the wash sale rules of § 1091 may apply.[304] The final regulations make clear that those rules do not apply.[305]

3. The seller

Immediately after the target's deemed asset purchase, the seller is treated as distributing the target stock actually distributed to its shareholders.[306] The seller recognizes no gain or loss on its distribution of target stock or on its sale or exchange of target stock as part of the qualified stock disposition.[307]

If the seller (or a member of its consolidated group) retains any target stock after the disposition date, it is treated selling that stock on the disposition date and buying it back the next day. It recognizes no gain or loss on the deemed sale, its holding period for the stock deemed purchased begins on the day after the disposition date, and its basis in that stock will reflect the grossed-up amount realized on recently disposed target stock.[308]

The application of § 355 to the seller's distribution of target stock is essentially unaffected by the § 336(e) election. The deemed sale and purchase of the assets of the target or its subsidiary will not prevent the target stock distribution from qualifying under § 355.[309] Further, § 355(a)(1)(D) is applied by taking into account when the seller actually sold, exchanged, or distributed target stock and by disregarding the seller's deemed disposition of any retained stock.[310]

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[304] *See* NYSBA report, *supra* note 55, at *15-*16 (noting that there may be additional, unidentified problems).

[305] § 1.336-2(b)(2)(ii)(C) (treating the target in its capacities as the seller and buyer of the assets in the deemed sale and purchase as "separate and distinct" taxpayers for purposes of § 197(f)(9), § 1091, and any other provision designated in the Internal Revenue Bulletin).

[306] § 1.336-2(b)(2)(iii)(A). If a § 336(e) election is made for a target subsidiary, its consequences are determined under § 1.336-2(b)(1) (*i.e.*, under the general-election regime), unless the stock of the target subsidiary is actually disposed of in a qualified stock disposition described in § 355(d)(2) or (e)(2), in whole or in part. *Id.* at (b)(2)(iii)(B). If elections are made for a chain of those subsidiaries, the deemed liquidation for a lower-tier subsidiary precedes the deemed liquidation of a higher-tier subsidiary, and the deemed liquidation of the highest-tier subsidiary is considered to occur before the seller distributes the target stock. *Id*.

[307] *Id*. at (b)(2)(iii)(B).

[308] *Id.* at (b)(2)(iv); *id*. at (g)(2) (treating all members of the seller's consolidated group as a single seller).

[309] § 1.336-2(b)(2)(v).

[310] *Id*.

4. Earnings and profits

Finally, the allocation of earnings and profits between the seller and the target is determined under § 1.312-10 and, if applicable, § 1.1502-33(e).[311] For this purpose, the target is *not* treated as a newly created controlled corporation (even if it is) and its earnings and profits are adjusted for the deemed sale and taken into account in making the § 1.312-10 allocation.[312]

Commentators argued that the allocation of earnings and profits was made unnecessarily complex by the "sale-to-self" model, suggesting that the old target be deemed to liquidate and the seller be deemed to distribute the stock of a newly created corporation (*i.e.*, new target).[313] Despite that criticism, the final regulations retained the "sale-to-self" model.[314] The discussion below spotlights the potential complexity, which arises not because of the § 336(e) regulations, but because of ambiguities in applying § 1.1502-33(e).

Section 312(h) and § 1.312-10 provide the operative rules to allocate and adjust the earnings of the distributing and controlled corporations following a § 355 distribution of controlled stock. Section 312(h) requires a "proper allocation," an allocation described in § 1.312-10. Section 1.312-10 distinguishes between newly created and existing controlled corporations.

If the controlled corporation is newly created (*i.e.*, as part of a divisive "D" reorganization), the earnings and profits of the distributing corporation are generally allocated between the two corporations in proportion to the values of the distributing and controlled corporations immediately after the distribution.[315] In a "proper case," the allocation of earnings and profits may be in proportion to the net basis of the assets transferred and retained or under another method "appropriate under the facts and

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[311] *Id.* at (b)(2)(vi).

[312] *Id.*

[313] NYSBA report, *supra* note 55 at *12-*15 (suggesting that the sale-to-self model be scuttled and the general model adopted for qualified stock dispositions to which § 355(d)(2) or (e)(2) applied in whole or in part).

[314] *See* 78 Fed. Reg. 28469 (May 15, 2013). The preamble justified retaining the "sale-to-self" model, rather than adopting the general model, rationalizing that if there were an actual sale of target assets (as under the general model), a distribution of target stock could not qualify under § 355. *Id.* Perhaps for that reason, the "sale-to-self" model is misnamed and more accurately could be called a "mark-to-market" model.

[315] § 1.312-10(a) (looking to the value of the businesses (and other properties) retained by the distributing corporation and the value of the businesses (and other properties) held by the controlled corporation immediately after the distribution).

circumstances of the case."[316] If earnings and profits of the distributing corporation for the taxable year of the distribution are allocated to the controlled corporation, those earnings and profits become earnings and profits of the controlled corporation for its first taxable year ending after the distribution.[317]

If the § 355 distribution is not part of a divisive "D" reorganization, the earnings and profits of the distributing corporation are reduced by the smaller of the following amounts:

> (i) The amount by which its earnings and profits would have been reduced if it had transferred the stock of the controlled corporation to a new corporation as part of a divisive "D" reorganization and immediately distributed the stock of the new corporation; or
>
> (ii) The controlled corporation's net basis (*i.e.*, its aggregate asset basis (including cash) minus its liabilities).[318]

If the earnings and profits of the controlled corporation immediately before the transaction are less than the decrease in the distributing corporation's earnings and profits, the controlled corporation's earnings and profits immediately after the transaction equal that decrease.[319] Otherwise, its earnings and profits remain the same.[320]

The principles of § 1.312-10, which use a separate-corporation approach, are inconsistent with the general approach of § 1.1502-33, which applies a single-entity approach to determine the earnings and profits of consolidated group members. Under the general approach of § 1.1502-33, the earnings and profits of a subsidiary are eliminated immediately before it becomes a nonmember to the extent they

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[316] *Id.* (defining net basis as the aggregate basis of the assets less liabilities assumed or taken subject to). The regulations do not provide a principle to determine whether the general rule or an exception should apply, and it is not clear when the exception may apply. *See* Bryan P. Collins, Andrew W. Cordonnier, and Darin A. Zywan, Allocation of E&P in a Spin-Off by a Consolidated Group; New Developments Answer Some Questions But Leave Many Unanswered, 840 PLI/Tax 619, 642-649 (2008). *See also* Bennett v. United States, 427 F.2d 1202 (Ct.Cl. 1970) (rejecting the taxpayer's attempt to allocate earnings and profits in proportion to net basis).

[317] § 1.312-10(a).

[318] § 1.312-10(b) (describing the net basis as the "net worth" of the controlled corporation). Note that the regulation does not describe how earnings and profits should be allocated if assets are transferred to an existing corporation and the stock of that corporation is distributed as part of a combined D/§ 355 transaction.

[319] *Id.* (essentially providing for this purpose that a deficit in earnings and profits is treated like a negative number).

[320] *Id. See also id.* at (c) (providing that in no case will a distributing corporation's deficit in earnings and profits be allocated to the controlled corporation).

were taken into account by any member under § 1.1502-33.[321] This general approach is modified to account for § 312(h) and § 1.312-10: The distributing corporation's ("P's") earnings and profits "are eliminated to the extent that its earnings and profits reflect [the controlled corporation's ("S's")] earnings and profits after applying § 312(h) immediately after the controlled corporation becomes a nonmember (determined without taking [§ 1.1502-33(e)] into account)."[322] An example provides "to the extent P's earnings and profits are reduced, S's earnings and profits are not eliminated under [§ 1.1502-33(e)(1)]."[323]

It is not clear, however, how § 1.312-10 and § 1.1502-33(e) are coordinated, particularly when the distribution involves an existing controlled corporation. For example, the allocation under § 312(h) and § 1.312-10 may be made first, before eliminating all or a portion of the distributing corporation's "(P's") remaining earnings and profits under § 1.1502-33(e)(3) to the extent they reflect the controlled corporation's ("S's") earnings and profits.[324] It is not clear, however, when P's earnings and profits reflect S's earnings and profits.[325]

Those interpretive issues arguably would be avoided if the target were deemed to liquidate immediately after the deemed sale and the distributing corporation were deemed to contribute the target assets (subject to its liabilities) to a new target immediately before the distribution. The earnings and profits would then be allocated under § 1.312-10(a), likely in proportion to the relative values of the

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[321] § 1.1502-33(e)(1). *See also id.* at (b)(1) (providing that the earnings and profits of a member are adjusted under the principles of § 1.1502-32 to reflect changes in its subsidiary's earnings and profits).

[322] *Id.* at (e)(3).

[323] *See id.* at (e)(5), *Ex. (f)*.

[324] *See id.* at (e)(5), *Ex. (f)* (for an example without numbers that suggests that the earnings and profits of both the controlled and distributing corporations may be reduced, stating "[t]o the extent that [the distributing corporation's] earnings and profit are reduced, [the controlled corporation's] earnings and profits are not eliminated under [§ 1.1502-33(e)(1)]").

[325] *See* NYSBA report, *supra* note 55 at *14-*15 (making and illustrating this point). It is also possible that after P's earnings and profits are reduced under § 1.1502-33(e)(3), S's earnings and profits may be reduced under § 1.1502-33(e)(1).

Note that, as an alternative, § 1.312-10 and § 1.1502-33(e)(1) and (3) could be applied in the following order: First, § 1.1502-33(e)(1) could apply to eliminate the controlled corporation's earnings and profits to the extent that they were taken into account by another member under § 1.1502-33 (*i.e.*, to the extent that they tiered up to that member). Next, the allocation under § 312(h) and § 1.312-10 could be made. Finally, the distributing corporation's earnings and profits could be reduced under § 1.1502-33(e)(3) to the extent its earnings and profits reflect the controlled corporation's earnings and profits immediately after the distribution.

distributing and target corporations immediately after the distribution.[326]

III. The election

A. Regular and protective elections

A § 336(e) election may be made for a qualified stock disposition.[327] Once made, the election is irrevocable.[328]

In certain cases it may be unclear whether a transaction is a qualified stock disposition. In those cases, the appropriate persons may make a "protective" § 336(e) election in connection with the transaction. The protective election will be binding if the transaction turns out to be a qualified stock disposition; otherwise, it will have no effect.[329]

Note that although a § 336(e) election is irrevocable in form, a seller or other person may "transactionally" revoke the election by re-acquiring target stock. If the seller or a member of its consolidated group (or the S corporation shareholder or related person) re-acquires target stock during the 12-month disposition period, that stock is not considered disposed of.[330] Because a § 336(e) election can only be made if an affiliated interest in target stock has been disposed of during a 12-month disposition period,[331] if an appropriate person re-acquires enough target stock after the disposition date but during the 12-month disposition period, the re-acquisition will retroactively foreclose an affiliated

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[326] § 1.312-10(a)

[327] § 1.336-2(a).

[328] *Id*.

[329] *Id*. at (j). For example, a protective § 336(e) election may be made for a distribution of controlled corporation stock intended to qualify under § 355. If it qualifies under § 355 but neither § 355(d)(2) nor (e)(2) applies the distribution will not be a qualified stock disposition, because the distributed stock will not be disposed of. § 1.336-1(b)(5)(i)(B). Then, the protective § 336(e) election will have no effect. If, however, the distribution is one to which § 355(d)(2) or (e)(2) applies, the stock will be disposed of and the distribution may be a qualified stock disposition. *Id*. at (b)(5)(ii). If it is, the election will be binding and irrevocable.

[330] § 1.336-1(b)(5)(v) (providing that stock reacquired by the seller or a member of the seller's consolidated group (or by the S corporation shareholder or related person) is not considered disposed of); *id*. at (5)(i) (stating that the term disposed of refers to a transfer in a disposition; thus if stock is not disposed of, it is not considered transferred in a disposition).

[331] § 1.336-2(a) (providing that a § 336(e) election can only be made if a seller or S corporation shareholders dispose of target stock in a qualified stock disposition); § 1.336-1(b)(6)(i) (defining a qualified stock disposition as the disposition by a seller or S corporation shareholders of an affiliated interest in target stock during a 12-month disposition period).

transfer, effectively revoking the § 336(e) election.

B. Making the election

1. Consolidated target

If the seller (or sellers) and target are members of the same consolidated group, the election is made as follows: The seller (or sellers) and target must enter into a written, binding agreement to make a § 336(e) election.[332] This agreement must be entered into on or before the due date (including extensions) for the group's return for the taxable year that includes the disposition date and a copy of the agreement must be retained by the common parent.[333] The common parent must attach the § 336(e) election statement, described below, to its timely filed return for the taxable year that includes the disposition date.[334] Finally, on or before the due date (including extensions) for that return, the common parent must provide a copy of the § 336(e) election statement to the target.[335]

2. Non-consolidated, non-S corporation target

If the target is neither a member of a consolidated group nor an S corporation, the § 336(e) election is made as follows: The seller and target must enter into a written, binding agreement to make a § 336(e) election on or before the earlier of the due dates (including extensions) of the seller's and target's federal income tax returns for the taxable year that include the disposition date.[336] The seller and target each must retain a copy of that agreement.[337] Finally, each must attach the § 336(e) election statement to its timely filed return for the taxable year that includes the disposition date.[338]

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[332] Under the proposed regulations, a § 336(e) election was made unilaterally by the seller or sellers. Prop. § 1.336-2(h) (2009). Commentators strenuously argued that the election should be made jointly. *See* NYSBA report, *supra* note 55 at *41 (arguing that the target should be a party to the election); Wendy Richards, Comments on Proposed Regulations issued under section 336(e), 2008 TNT 232-66 (suggesting that the sellers and buyers make a joint election).

[333] § 1.336-2(h)(1)(i)-(ii).

[334] *Id*. at (h)(1)(ii).

[335] *Id*. at (h)(1)(iv).

[336] *Id*. at (h)(2)(i).

[337] *Id*. at (h)(2)(ii).

[338] *Id*. at (h)(2)(iii) (providing that the seller's statement may disregard § 1.336-2(h)(6)(xii), concerning gain recognition elections).

If § 336(e) elections are made for a parent-subsidiary chain of target corporations, the requirements, spelled out in the text, that must be met for a consolidated or non-consolidated target, as

3. S corporation target

If the target is an S corporation, the election is made as follows: The target and all S corporation shareholders, whether or not they dispose of stock in the qualified stock purchase, must enter into a written, binding agreement to make a § 336(e) election on or before the due date (including extensions) of the federal income tax return for the target that includes the disposition date.[339] The target must retain a copy of that agreement and it must attach the § 336(e) election statement to its timely filed federal income tax return (including extensions) for taxable year that includes the disposition date.[340]

C. The § 336(e) election statement

The § 336(e) statement must be entitled –

> THIS IS AN ELECTION UNDER SECTION 336(e) TO TREAT THE DISPOSITION OF THE STOCK OF [insert name and employer identification number of the target] AS A DEEMED SALE OF SUCH CORPORATION'S ASSETS[341]

The statement must include the following information:

> (i) The name, address, taxpayer identification number, taxable year, and state of incorporation (if any) of the target, each seller, any common parent of a seller, each S corporation shareholder, any 80-percent purchaser, and any purchaser that holds nonrecently disposed target stock;
>
> (ii) The disposition date;
>
> (iii) The percentage of target stock that was disposed of by each seller or S corporation shareholder in the qualified stock disposition,
>
> (iv) The percentage of target stock that was disposed of by each seller or S corporation shareholder in the qualified stock disposition on or before the disposition date;

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appropriate, must be met for each target subsidiary for which an election is made. *Id*. at (h)(4). To satisfy the requirement for a written, binding agreement, there must be either a separate written agreement between the target subsidiary and the corporation deemed to dispose of its stock or the relevant provisions must be included in the written agreement between the seller (or sellers) or S corporation shareholders and target. *Id.*

[339] *Id*. at (h)(3)(i).

[340] *Id*. at (h)(3)(ii)-(iii).

[341] *Id*. at (h)(5)(i). Note that a separate § 336(e) statement must be filed for each target subsidiary for which a § 336(e) election is made. *Id*. at (h)(5)(ii).

(v) The percentage of target stock that was retained by each seller or S corporation shareholder immediately after the disposition date;

(vi) A statement about whether the target realized a net loss on the deemed asset sale;

(a) If the target realized a net loss, a statement about whether any stock of the target (or a higher-tier corporation for which a § 336(e) election was made) was distributed during the 12-month disposition period; and

(b) If the target realized a net loss and such a distribution was made, a statement about whether any stock of the target (or a higher-tier corporation for which a § 336(e) election was made) was actually sold or exchanged in a qualified stock disposition;

(vii) When required, the name, address, and taxpayer identification number of each purchaser that made a gain recognition election; and

(viii) A statement that each of the sellers or S corporation shareholders and the target have executed a written, binding agreement to make a § 336(e) election.[342]

The old target and new target must also report the information concerning the deemed sale and purchase of the target assets, each filing a Form 8883 (or a successor form).[343] Because Form 8883 describes asset allocations for a § 338 election, appropriate adjustments must be made in completing that form to accommodate a § 336(e) election. Note that if a § 336(e) election is made for a qualified stock disposition to which § 335(d)(2) or (e)(2) applies, the old target must file two Forms 8883, one in its capacity as the buyer and one in its capacity as the seller.[344]

IV. The consistency rules

In general, the principles of § 1.338-8 apply for a qualified stock disposition for which no § 336(e) election is made.[345] Those principles are modified in one important respect: The asset consistency rules may apply to an asset that is owned immediately after the acquisition and on the disposition date by a person that acquires at least five percent, by value, of the target stock in the

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[342] *Id*. at (h)(6). Further, a copy of any gain recognition statement must be retained by the appropriate party designated in § 1.336-4(c). *Id*. *See supra* note 120 (for a discussion of gain recognition statements and appropriate parties). Note that a gain recognition statement is not required if the gain recognition election is deemed made. *See* § 1.336-4(c)(3). Presumably, no statement must be retained for any election for which a statement is not required.

[343] *Id*. at (h)(7).

[344] *Id*.

[345] § 1.336-1(a)(2).

qualified stock disposition or to a person related to such a five-percent purchaser.[346]

Broadly speaking, the § 338 consistency rules apply if (i) a purchasing corporation has made a qualified stock purchase of a target, (ii) the purchasing corporation (or corporate affiliate) acquires a target asset during the consistency period, (iii) the target recognizes a gain reflected in the basis of its stock under the investment adjustment rules of § 1.1502-32, but (iv) no § 338 election is made for that purchase.[347] If those rules apply, the asset purchaser takes a carryover basis in the purchased asset.[348]

Applying those principles as modified, the § 336(e) consistency rules should apply if (i) stock of a target is sold, exchanged, or distributed in a qualified stock disposition, (ii) a purchaser of the target stock (or a related person) acquires a target asset during the consistency period, (iii) the target recognizes a gain reflected in the basis of its stock under the investment adjustment rules of § 1.1502-32, but (iv) no § 336(e) election is made for the disposition.[349]

In one important, troubling respect, the consistency rules under § 336(e) are broader than under § 338.

Example 21 – Consistency rules

P owns all T stock, and P and T file consolidated returns. Fred owns all stock of corporation X. T sells an asset to Fred at a gain, and P reflects that gain in the basis of its T stock under the investment adjustment rules of § 1.1502-32. Shortly thereafter, on one day, P sells the T stock to either Fred or X. Assume that neither Fred nor X is related to P.

If P sells the T stock to X, the sale is a qualified stock purchase, because P has sold an affiliated interest in T to P over a 12-month acquisition period.[350] Because Fred is not the purchasing

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[346] *Id*. (defining a related person by reference to § 1.336-1(b)(12)); *id*. at (b)(12) (defining two persons as related if stock owned by one person would be attributed to the other under § 318(a) (other than (a)(4)), except that neither § 318(a)(2)(A) or (a)(3)(A) apply to attribute stock to or from a partner if the partner owns less than 5% by value of the partnership).

[347] *See* § 1.338-8(a)(2); *id*. at (g) (extending the consistency rules in certain cases if the target paid dividends qualifying for a 100% dividends received deduction under § 243(a)(3)). *See also* § 338(h)(4)(A) (providing that the consistency period generally starts one year before the beginning of the 12-month acquisition period and ends one year after the acquisition date).

[348] § 1.338-8(a)(2).

[349] § 1.336-1(a)(2). For this purpose, the consistency period generally should start one year before the beginning of the 12-month disposition period and end one year after the disposition date. *Cf.* § 338(h)(4)(A).

[350] § 338(d)(3) (defining a qualified stock purchase); *See also* § 1.336-1(b)(6)(ii)(A) (providing that if a transaction is both a qualified stock purchase and qualified stock disposition, it is treated as a

corporation or a corporate affiliate of the purchasing corporation, the § 338 consistency rules do not apply. Thus, Fred takes a cost basis in the asset purchased from T.

If, instead, P sells the T stock to Fred, the sale is a qualified stock disposition, because P has sold an affiliated interest in T to an unrelated individual over a 12-month period.[351] However, because Fred is a purchaser of at least five percent of the T stock, the § 336(e) consistency rules apply, and Fred could take a carryover basis in the asset purchased from T. Note that the result should be the same even if Fred dropped the T stock down to X.

It is not clear why the § 336(e) consistency rules apply to the second case in **Example 21**, while the § 338 consistency rules do not apply in the first case. The policies that implicate the rules should be the same in either case, and following § 338 (and the limitations imposed by Congress), they should apply in neither case.[352]

V. Conclusion

Final regulations implementing § 336(e) were issued on May 15, 2013 welcomed after more than a quarter-century wait. The regulations employ a structure and principles like those under the § 338(h)(10) regulations, using those regulations as a template. Despite many similarities, the two regulatory regimes differ in several important respects. For example, although both require the transfer of an affiliated interest in target stock by a corporation, § 338(h)(10) looks to the purchase of that stock interest, while § 336(e) focuses on its disposition. In addition, for § 338(h)(10) to apply to a non-S corporation target, on the date that the affiliated interest in the target is first acquired by purchase, the target must be a member of the consolidated group or affiliated with a selling domestic corporation. In contrast, under the § 336(e) regulations, a § 336(e) election may be made for the target even if it is not affiliated with the selling corporation or a member of the selling consolidated group on the corresponding date.

Because of those differences, the regulatory approach for § 338(h)(10) sometimes fits uncomfortably with § 336(e). This article identifies a number of those poor fits and also a few gaps in the § 336(e) regulations, making some suggestions to amend those regulations. In the main, however, the regulations offer a solid framework and a § 336(e) election is bound to be an important tool in any transactional tax practice.

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qualified stock purchase).

[351] *Id.* at (b)(6)(i).

[352] Note that it may make sense to expand the consistency rules in either case to subject an asset or stock acquisition by a partnership to those rules if a purchasing corporation or its consolidated group owns an "affiliated" interest in the partnership. *Cf.* P.L.R. 201213013 (Mar. 30, 2012).