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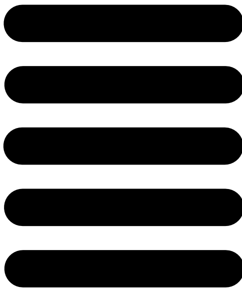

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Code Sec. 338(h)(10) and the Step Transaction Doctrine

By Richard C. Morris • Wood & Porter • San Francisco

On July 5, 2006, the IRS released final regulations under Code Sec. 338(h)(10) that provide guidance in certain multi-step transactions. [*See* T.D. 9271 (July 5, 2006).] Although final regulations have existed under Code Sec. 338(h)(10) for years, this update was necessary to clarify the interaction of a Code Sec. 338(h)(10) election with the step transaction doctrine. In particular, there has been lingering concern that the step transaction doctrine could cause individual steps in a multi-step transaction to be integrated. The step transaction doctrine, the economic substance doctrine and the close sibling the notion of substance over form all get lots of play these days, particularly given our post-tax shelter milieu.

As a result, some have worried that integration of a purchase and election could nullify a qualified stock purchase ("QSP") and an accompanying Code Sec. 338 election, and instead cause a stock purchase to be treated as a reorganization. With the enactment of these final regulations, taxpayers undertaking multi-step transactions can now be certain that the IRS will respect their Code Sec. 338(h)(10) elections.

Background

The newly issued final regulations hopefully solve the dilemma surrounding the interaction of the step transaction doctrine and a Code Sec. 338(h)(10) election. To understand this dilemma, it is necessary to review the basics of QSPs, to focus on Code Sec. 338(h)(10) elections and to review a bit of history.

All Code Sec. 338 elections start with a taxpayer making a QSP. A QSP is any transaction (or series of transactions) in which a corporation acquires 80 percent or more of the stock of another corporation by purchase during a 12-month period. A "purchase" is generally defined as any acquisition of stock, but it excludes acquisitions in exchanges to which

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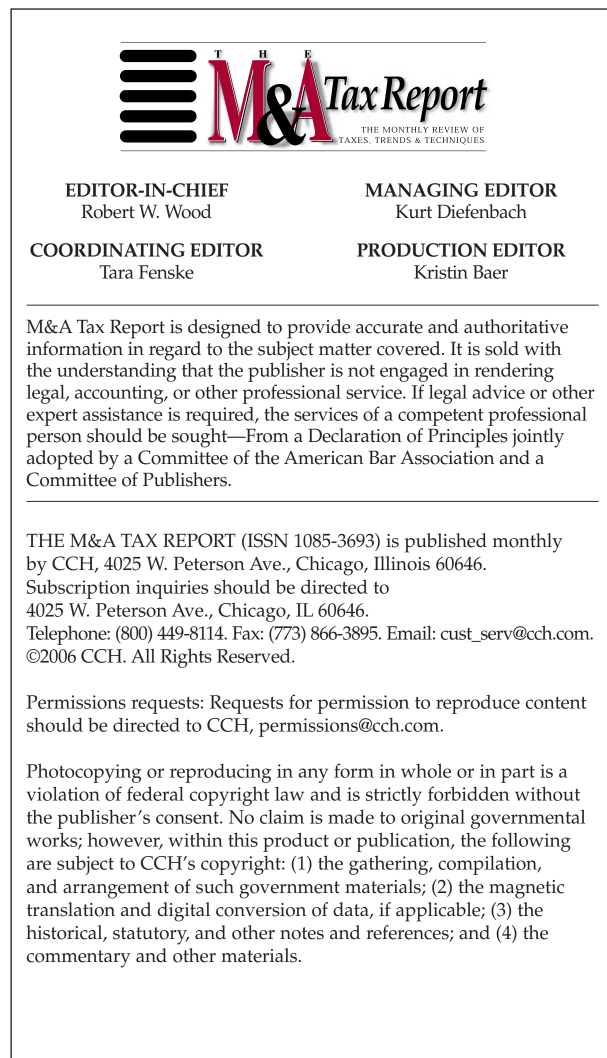
Code Secs. 351, 354, 355 or 356 apply. Essentially, stock must be purchased for consideration and can't be acquired in a tax-deferred exchange.

If a purchaser makes a QSP, it has the ability to make a Code Sec. 338 election to treat the target as having sold all of its assets at fair market value ("fmv") to "new" target at the close of the acquisition date. New target is treated as a new corporation which purchased all of its assets as of the beginning of the day after the acquisition date. This allows the purchaser to treat a stock acquisition as an asset acquisition, effectively getting a basis step up to fmv for the target's assets.

There are two types of Code Sec. 338 elections. A Code Sec. 338(g) election—which is commonly referred to as a "Code Sec. 338" election—is an election that is made solely by the acquirer. A Code Sec. 338(g) election is fairly uncommon these days, and has had limited viability in the post–*General Utilities* world. The reason for this lack of popularity is the price tag. Since 1987, the deemed sale of assets by old target to new target is treated as a taxable sale. Prior to 1987, old target generally did not recognize gain on the deemed sale.



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A variation on a Code Sec. 338(g) election is a Code Sec. 338(h)(10) election. A Code Sec. 338(h)(10) election is a joint election made by both the acquirer and the target. It can only be made when the target is part of a consolidated group or the target is an S corporation. When part of a consolidated group, the selling corporate shareholder must own 80 percent or more of the target. The newly issued final regulations only apply to Code Sec. 338(h)(10) elections.

Rev. Rul. 90-95

The confusion surrounding the interaction of the step transaction doctrine and a Code Sec. 338(h)(10) election stems from Rev. Rul. 90-95, 1990-2 CB 67, Situation 2. There, the acquirer corporation formed a wholly owned domestic subsidiary and merged it into a target corporation. In the merger, the target shareholders received only cash in exchange for their target stock. Immediately following this first merger, there was an upstream merger of the target into the acquirer. The IRS ruled that these two mergers were treated as if the acquirer had made a QSP of the target, followed by a Code Sec. 332 liquidation.

As a result, the acquirer's basis in the target's assets was the same as the target's basis in its assets prior to the merger. The ruling explains that even though "the step-transaction doctrine is properly applied to disregard the existence" of the merged subsidiary so that the first step is treated as a stock purchase, the acquisition of the target's stock is accorded independent significance from the subsequent liquidation of the target. Thus, the first step was treated as a QSP regardless of whether a Code Sec. 338 election was made.

The IRS has incorporated the approach of Rev. Rul. 90-95 into the regulations. [*See* Reg. §1.338-3(d).] The regulations require the acquiring corporation (or a member of its affiliated group) to treat certain asset transfers following a QSP (where no Code Sec. 338 election is made) independently of the QSP. For example, in Reg. §1.338-3(d)(5), a cash purchase of 85 percent of the stock of a target corporation, immediately followed by the merger of the target into a

wholly owned subsidiary of the acquiring corporation, is generally treated as a QSP of the target followed by a reorganization of the target into the subsidiary. As a result, the subsidiary's basis in the target's assets was the same as the basis of the assets in the target's hands.

Rev. Rul. 2001-46

Although the regulations appear to have settled this issue, the IRS may have inadvertently brought the issue back to the surface when it issued Rev. Rul. 2001-46, 2001-2 CB 321. In Situation 1 of that ruling, a newly formed wholly owned subsidiary of an acquiring corporation merged into a target corporation. Pursuant to an integrated plan, the first merger was immediately followed by an upstream merger of the target into the acquirer. The target shareholders exchanged their stock for consideration consisting of cash (30 percent) and voting stock of the acquirer (70 percent).

The IRS ruled that the step transaction doctrine applied. That meant the two mergers were not treated as a QSP followed by a liquidation under Code Sec. 332 (as in Rev. Rul. 90-95). Instead, the transaction was treated as an acquisition of the target's assets through a statutory merger of the target into the acquirer that qualified as an A reorganization. Thus, a Code Sec. 338 election could not be made. After all, there was no QSP.

Situation 2 of Rev. Rul. 2001-46 contained the same facts, except for the fact that the target shareholders received solely voting stock and no cash. Nonetheless, the IRS still applied the step transaction doctrine, treating the transaction as a statutory merger of the target into the acquirer that qualified as an A reorganization. In this manner, Rev. Rul. 2001-46 distinguished Rev. Rul. 90-95 (and amplified Rev. Rul. 67-274, 1967-2 CB 141, one of the foundations of the step transaction doctrine in the mergers and acquisitions area).

The IRS Response

If you're confused over determining when the step transaction doctrine applies and when it doesn't, you're not alone. Since the issuance of Rev. Rul. 2001-46, practitioners have been wondering how to structure multi-step transactions to ensure that a Code Sec. 338 election would be respected. Realizing the disturbance created by these rulings, three years ago the IRS published temporary and proposed regulations to give taxpayers the choice whether a Code Sec. 338(h)(10) election would apply, or whether a transaction would be stepped together and treated as a reorganization. [*See* 68 FR 40766 and REG-143679-02 (July 9, 2003).]

In effect, the choice gives you an election to have your election take effect (there's irony for you). Yet oddly, as will be discussed more fully below, the IRS has not spoken on this topic concerning a Code Sec. 338(g) election.

Generally speaking, the temporary and proposed regulations provided that notwithstanding anything to the contrary in Reg. §1.338-3(c)(1)(I), a Code Sec. 338(h)(10) election could be made for the target if the acquirer's acquisition of target stock, when viewed independently, constituted a QSP and, after the stock acquisition, if the target either merged or liquidated into the acquirer (or another member of the acquirer's affiliated group).

Under the temporary and proposed regulations, a Code Sec. 338(h)(10) election would be respected whether or not the acquisition of the target stock together with the subsequent merger or liquidation of the target qualified as a reorganization. This determination would be made including all relevant provisions of law, including the step transaction doctrine. In other words, if a Code Sec. 338(h)(10) election was made where the acquisition of the target, followed by its merger or liquidation into the acquirer, qualified as a reorganization, the acquisition would have been treated as a QSP, *not* as part of a reorganization.

On July 5, 2006, the IRS adopted the temporary and proposed regulations. The new final regulations allow a Code Sec. 338(h)(10) election to be made for the target if the acquirer's acquisition of the target stock, when viewed independently, constitutes a QSP, and after the stock acquisition the target merges or liquidates into the acquirer (or another member of the acquirer's affiliated group). Given that these rules are complicated, they can probably be best understood by reviewing the new examples in the regulations.

Example: No Code Sec. 338(h)(10) Election

P owns all the stock of Y, a newly formed subsidiary. S owns all the stock of T. All are domestic corporations. P acquires all of the T stock in a statutory merger of Y into T, with T surviving. In the merger, S receives consideration

consisting of 50 percent P voting stock and 50 percent cash. Viewed independently of any other step, P's acquisition of T stock constitutes a QSP.

As part of the plan that includes P's acquisition of the T stock, T subsequently merges into P. Viewed independently of any other step, T's merger into P qualifies as a Code Sec. 332 liquidation. Absent the application of the new regulations, the step transaction doctrine would apply to treat P's acquisition of the T stock and T's subsequent merger into P as P's acquisition of T's assets in a reorganization. P and S do not make a Code Sec. 338(h)(10) election. Thus, P's acquisition of the T stock and T's merger into P is treated as a reorganization.

Example: Code Sec. 338(h)(10) Election

The facts are the same as in the example above, except that P and S jointly make a Code Sec. 338(h)(10) election. As a result of the Code Sec. 338(h)(10) election, P's acquisition of the T stock is treated as a QSP, and P's acquisition of the T stock is not treated as part of a reorganization.

Example: Brother-Sister Merger

The facts are the same as in the previous examples, except that following P's acquisition of the T stock, T merges into X, a domestic corporation that is a wholly owned subsidiary of P. Viewed independently of any other step, T's merger into X qualifies as a reorganization. Absent the application of these new rules, the step transaction doctrine would apply to treat P's acquisition of the T stock and T's merger into X as an acquisition by X of T's assets in a reorganization. However, under the new regulations, if a Code Sec. 338(h)(10) election is made, P's acquisition of the T stock is treated as a QSP, and not part of a reorganization.

Example: No QSP

The facts are the same as in the first example, except that in the statutory merger of Y into T, S receives only P voting stock. In this situation, the parties cannot make a Code Sec. 338(h)(10) election, since there has been no QSP. Indeed, there has been no purchase, since all of the consideration used to acquire the T stock was P stock. Pursuant to relevant provisions of law, including the step transaction doctrine, P's acquisition of T stock followed by T's merger into P is treated as an A reorganization.

Effective Date

The final regulations apply to stock acquisitions occurring on or after July 5, 2006, the publication date of the final regulations. However, they effectively apply to transactions on or after July 9, 2003, the publication date of the former temporary and proposed regulations, since these former regulations are virtually identical to the final ones.

Code Sec. 338(g) Elections

The final regulations only apply to Code Sec. 338(h)(10) elections. The IRS considered whether it should also create regulations that would allow a Code Sec. 338(g) election to turn off the step transaction doctrine in a multi-step transaction. However, the IRS chose not to enact such regulations. Thus, there is no opportunity to turn off the step transaction doctrine to make a Code Sec. 338(g) election.

Unlike a Code Sec. 338(h)(10) election, which is a joint election made by both the acquirer and the target, a Code Sec. 338(g) election is made only by the acquirer. Neither Target nor its shareholders consent to the regular 338 election. Thus, the IRS believes that if it were to extend the final regulations to Code Sec. 338(g) elections, this would allow an acquirer to unilaterally elect to treat a transaction as a nonreorganization. Of course, this treatment would apply to all parties to the deal. In the IRS's view, this would create the potential for taxpayers to whipsaw the IRS.

Conclusion

No one can legitimately say that making a Code Sec. 338(h)(10) election is simple. Before considering how to account for such an election, taxpayers face the difficult question of determining whether they can even make the election. Although the new regulations are taxpayer favorable, they hardly make the decision-making process easy.

Granted, the poles may be well defined (*i.e.*, taxpayers involved in all cash mergers can make a Code Sec. 338(h)(10) election, while taxpayers involved in all stock mergers cannot). Yet, the middle ground more commonly traveled appears to be comprised of shades of grey. Practitioners will have to tread carefully through this complex area, giving due regard to the new regulations and the old rulings.