
# NEW TEMP. REG. SECTION 1.338-6T: ONLY ONE-AND-A-HALF TRAPS FOR THE UNWARY

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*In this paper, the authors discuss recently issued Temp. Reg. section 1.338-6T, which provides limited relief from the duplicative taxation of the same economic gain or loss that occurs when a code section 338 election is made with respect to a target corporation that has subsidiaries. The authors point out that, although Temp. Reg. section 1.338-6T clearly represents a step in the right direction, it is flawed in two important respects. First, the temporary regulation inappropriately sanctions duplicative taxation of the same economic gain in one significant class of cases. Second, the temporary regulation leaves wholly unclear whether duplicative taxation occurs in a second significant class of cases.*

*The authors suggest that substantial revisions be made to the scope of Temp. Reg. section 1.338-6T. In the absence of such revisions, the authors explain practical ways to avoid the problems of exorbitant taxation inherent in the temporary regulation.*

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## I. INTRODUCTION

In March 1991, the IRS issued Temp. Reg. section 1.338-6T, granting limited relief from the duplicative taxation of the same economic gain or loss when a section 338 election is made with respect to a target corporation ("T") that has subsidiaries. Although Temp. Reg. section 1.338-6T is surely a step in the right direction, it is flawed in important respects. Explicitly, the temporary regulation sanctions double taxation of a single economic gain in one significant class of cases. Additionally, the temporary regulation leaves wholly unclear whether double taxation occurs in a second significant class of cases.

We begin by illustrating the duplication of gain or loss that can occur when a section 338 election is made with respect to a target that has subsidiaries. Next, we analyze Temp. Reg. section 1.338-6T, including the circumstances in which the temporary regulation either clearly fails or possibly fails to eliminate gain or loss duplication. Finally, we identify practical ways of avoiding these problems of exorbitant taxation that reside in Temp. Reg. section 1.338-6T.

## II. SECTION 338 ELECTION: SUBSIDIARIES

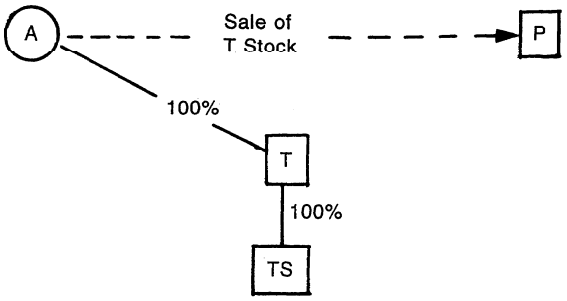
Where T holds at least 80 percent[1] of the stock of a subsidiary ("TS"), an express or deemed section 338 election with respect to T automatically triggers a deemed section 338 election with respect to TS.[2]

**(Continued on next page.)**

[1]Eighty percent in both voting power and value, excluding nonvoting straight preferred stock described in section 1504(a)(4). *See* sections 338(d)(3) and 1504(a)(4).

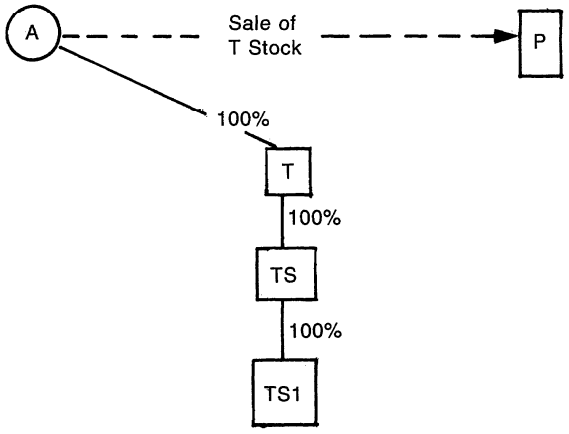
[2]Temp. Reg. section 1.338-4T(c)(3). The deemed section 338 election with respect to TS occurs as follows: As a result of P's actual section 338 election with respect to T, T is deemed to have sold all its assets, including its TS stock, to New T. New T's deemed purchase of T's TS stock constitutes a qualified stock purchase ("QSP") with respect to TS and, under the consistency rules of section 338(f)(1) and (h)(8), triggers a deemed section 338 election with respect to TS.

**Example (1):** T owns and at all times has owned 100 percent of TS' outstanding stock. On 4/1/91, P buys 100 percent of T's stock for cash from individual A and makes a section 338 election with respect to T.




P's section 338 election with respect to T triggers a deemed section 338 election with respect to TS. As a result, (i) T is deemed to have sold all its assets, including its TS stock, to New T; and (ii) TS is deemed to have sold all its assets to New TS.[3]

**Example (2):** Same as example (1), except that TS owns 100 percent of TS1's outstanding stock.




P's section 338 election with respect to T triggers a deemed section 338 election with respect to TS and TS1. As a result, (i) T is deemed to have sold all its assets, including its TS stock, to New T; (ii) TS is deemed to have sold all its assets, including its TS1 stock, to New TS; and (iii) TS1 is deemed to have sold all its assets to New TS1.[4]

In examples (1) and (2), a literal application of the section 338 deemed sale rule would trigger multiple levels of gain or loss recognition with respect to the same economic gain or loss. Specifically, in example (1), (i) T would be taxed on the deemed sale of its TS stock, and (ii) TS would be taxed on the deemed sale of its assets. In example (2), (i) T would be taxed on the deemed sale of its TS stock; (ii) TS would be taxed on the deemed sale of its assets, including its TS1 stock; and (iii) TS1 would be taxed on the deemed sale of its assets.[5]

Recognizing that this duplicative taxation made no sense at all, the subchapter C tax bar, in a triumph of faith over experience, rather uniformly believed that, sooner or later and with retroactive effect, either the IRS or Congress would fix it. Faith, for a change, has been rewarded, mostly. On March 14, 1991, the IRS issued Temp. Reg. section 1.338-6T granting relief from duplicative taxation in some, but unfortunately not all, circumstances, and leaving the outcome in one significant circumstance shrouded in mystery.

***The subchapter C tax bar . . . rather uniformly believed that . . . either the IRS or Congress would . . . grant . . . relief from duplicative taxation . . . .***

## III. OVERVIEW

Temp. Reg. section 1.338-6T contains two primary rules, discussed below, and a number of ancillary rules, discussed in VII below.[6]

Under the first primary rule ("-6T Rule #1"), where an actual or deemed section 338 election is made with respect to a target corporation (e.g., T in examples (1) and (2)), and T directly owns at least 80 percent[7] of the stock of a subsidiary (e.g., TS in examples (1) and (2)), T will recognize no gain or loss on the deemed sale of its TS stock.[8] This is so regardless of whether T and TS

[3]The result would be the same if P had purchased T's stock (i) from a number of holders (rather than from a single individual), or (ii) from a single corporation ("Bigco"). However, if immediately prior to the purchase, T is not the common parent of an affiliated group filing a consolidated return, T and its subsidiaries are treated less favorably under Temp. Reg. section 1.338-6T than if T is the common parent of an affiliated group filing a consolidated return, as discussed and illustrated in the examples below.

[4]*Id.*

[5]The concerns illustrated in examples (1) and (2) generally were not an issue prior to the 1986 repeal of the *General Utilities* doctrine because, under old section 337, which applied to section 338 transactions under the pre-1986 act version of section 338, neither T nor TS recognized gain or loss on the deemed sale of its nonrecapture assets, including corporate stock (whether portfolio stock or stock of a subsidiary). *See* Temp. Reg. section 1.338-4T(k).

[6]The discussion that follows focuses on the federal income tax consequences under Temp. Reg. section 1.338-6T. Because some states either have not accepted the section 338 regime or have accepted the regime only in part, the state tax consequences may differ substantially from the federal income tax consequences.

[7]Eighty percent in both voting power and value, excluding nonvoting straight preferred stock described in section 1504(a)(4). *See* sections 338(d)(3) and 1504(a)(4).

[8]Temp. Reg. section 1.338-6T(a), (b)(2) (first sentence), (c). The determination and allocation of the ADSP (*see* Ginsburg & Levin, *Mergers, Acquisition and Leveraged Buyouts* (CCH Tax Transactions Library), at Para. 205.04) and the adjusted grossed-up basis (*Id.*, at Para. 205.07) is made by taking into account T's TS stock, notwithstanding that T recognizes no gain or loss on its deemed sale of that stock under Temp. Reg. section 1.338-6T. *See* preamble to Temp. Reg. section 1.338-6T (TD 8339).

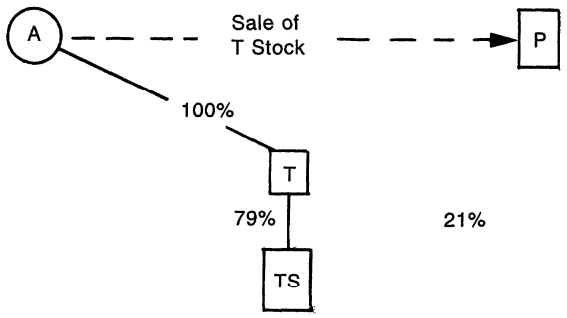
join in filing a consolidated return and whether T is the common parent of the affiliated group.

Similarly, although the definitional language of Temp. Reg. section 1.338-6T is somewhat ambiguous, examples in and the preamble to -6T indicate that, by virtue of the deemed section 338 election with respect to TS that is triggered by the section 338 election with respect to T, TS is treated as a "target" for purposes of applying -6T Rule #1.[9] Accordingly, in example (2) TS will recognize no gain or loss on the deemed sale of its TS1 stock, because TS directly owns at least 80 percent of TS1's outstanding stock.

**Example (3):** Same as example (1). T and TS recognize gain or loss on the deemed sale of their assets, except that T recognizes no gain or loss on the deemed sale of its TS stock.[10]

**Example (4):** Same as example (2). T, TS, and TS1 recognize gain or loss on the deemed sale of their assets, except that T recognizes no gain or loss on the deemed sale of its TS stock and TS recognizes no gain or loss on the deemed sale of its TS1 stock.[11]

**Example (5):** Same as example (1), except that T owns only 79 percent of TS' outstanding stock, and the remaining 21 percent of TS' outstanding stock is held by the public.




In this case, T is taxed on the deemed sale of its 79-percent stock interest in TS.[12] However, P's section 338 election with respect to T does not trigger a section 338 election with respect to TS, because T does not hold the requisite 80 percent of TS' outstanding stock.[13] As a result, TS is not deemed to have sold its assets, and thus recognizes no gain or loss.

Under the second primary rule of Temp. Reg. section 1.338-6T ("-6T Rule #2"), if (i) T is the common parent of an affiliated group filing a consolidated return, (ii) P makes an actual or deemed section 338 election with respect to T, and (iii) the final return for T and the members of its affiliated group is a consolidated return under Temp. Reg. section 1.338-1T(f)(2)(ii), neither T nor any member of its consolidated group will recognize gain or loss on the deemed sale of *any* stock in any member of the group.[14] That is, if T is the common parent of an affiliated group that files its final return on a consolidated basis,[15] the T group obtains the benefit of -6T nonrecognition treatment with respect to stock that any T group member owns in any other T group member, even if no member of the T group owns an 80 percent or more *direct* stock interest in such other member. Thus, -6T Rule #2 protects T or a T subsidiary from recognizing gain on the stock of a lower-tier subsidiary even where no one T group member *directly* owns 80 percent or more of the lower-tier subsidiary's stock.[16]

**Example (6): Diamond Pattern.** T (which is 100-percent-owned by individual A) owns all the outstanding stock of TS1 and TS2, and TS1 and TS2 each own 50 percent of the outstanding stock of TS3.[17] T, TS1, TS2, and TS3 join in filing a con-

[9] *See* Temp. Reg. section 1.338-6T(c)(2) example (2), (d)(7) example; preamble to Temp. Reg. section 1.338-6T (TD 8339). It appears from the excessively confusing statutory/regulatory framework that, where P purchases T's stock, T is an "original target" and each subsidiary in which T directly or indirectly owns 80 percent of the stock (TS in examples (1) and (2)) is an "affected target," but that for purposes of applying -6T Rule #1, both the original target and each affected target is a "target." *See* section 338(d)(2), (d)(3), and (h)(3)(B); Temp. Reg. section 1.338-4T(b)(3) and (b)(4); and Temp. Reg. section 1.338-1T(b)(7).

[10] Temp. Reg. section 1.338-6T(c)(2) example (1). This result follows whether T's stock is owned (i) 100 percent by individual A, (ii) by a number of persons, or (iii) 100 percent by Bigco.

[11] Temp. Reg. section 1.338-6T(c)(2) examples (1) and (2), (d)(7) example. This result follows whether T's stock is owned (i) 100 percent by individual A, (ii) by a number of persons, or (iii) 100 percent by Bigco.

[12] *See* Temp. Reg. section 1.338-6T(b)(2); preamble to Temp. Reg. section 1.338-6T (TD 8339).

[13] *See* section 338(h)(6)(A).

[14] *See* Temp. Reg. section 1.338-6T(b)(2) (second sentence), (c)(2) example (2); preamble to Temp. Reg. section 1.338-6T(c)(2) (TD 8339).

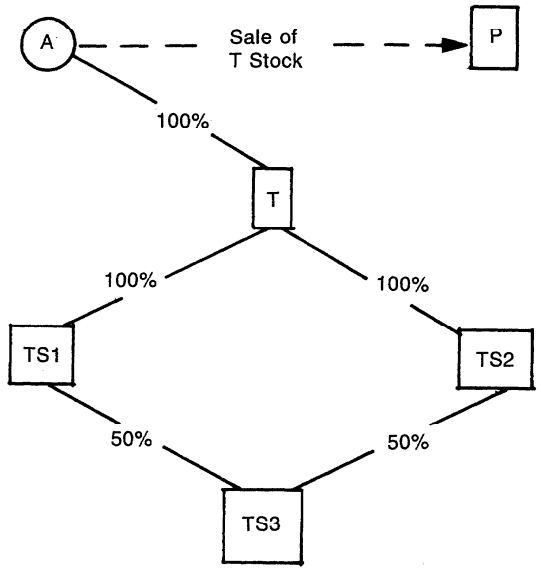
[15] The tax year of the T group will end on the date that P makes a QSP of T's stock. *See* Temp. Reg. section 1.338-1T(b)(8), (f).

[16] Although the definition of "section 1.338-6T shareholder" in Temp. Reg. section 1.338-6T(a)(2) (second sentence) is less than completely clear in this regard, it appears that -6T Rule #2 also applies to stock that a lower-tier member owns in an upper-tier member. For instance, if T owns 90 percent of the stock of TS, TS owns 100 percent of the stock of TS1, and TS1 owns the remaining 10 percent of the outstanding TS stock, -6T Rule #2 apparently accords TS1 nonrecognition treatment on the deemed sale of its 10-percent stock interest in TS. The same result apparently obtains even with respect to stock in T, the common parent of the group. Thus, if T owns 100 percent of the outstanding stock of TS, and TS owns five percent of the outstanding stock of T, -6T Rule #2 apparently accords TS nonrecognition treatment on the deemed sale of its five-percent stock interest in T.

[17] The result in this example (6) would be the same if P had purchased T's stock (i) from a number of holders, or (ii) from a foreign Bigco, but would not be the same if P had purchased T's stock from a domestic Bigco (whether or not T was filing a consolidated return with the domestic Bigco) or if the T group did not file a consolidated return. *See* Part V below.

solidated return, with T as the common parent of the group.

On 4/1/91, P buys 100 percent of T's stock from individual A for cash and makes a section 338 election with respect to T. The T group's final return (for the short taxable year ending 4/1/91) is a consolidated return.




The section 338 election with respect to T triggers a deemed section 338 election with respect to TS1, TS2, and TS3. As a result, (i) T is deemed to have sold all its assets, including its TS1 and TS2 stock, to New T, (ii) TS1 and TS2 are deemed to have sold all their assets, including their TS3 stock, to New TS1 and New TS2, and (iii) TS3 is deemed to have sold all its assets to New TS3. As illustrated in examples (3) and (4), T recognizes no gain or loss on the deemed sale of its TS1 and TS2 stock. This result follows under both -6T Rule #1 and -6T Rule #2.

***The flaw in Temp. Reg. section 1.338-6T . . . is not relevant if a section 338(h)(10) election is made . . . .***

However, -6T Rule #1 does not exempt TS1 and TS2 from gain or loss recognition on the deemed sale of their TS3 stock, because neither TS1 nor TS2 directly owns 80 percent of TS3. Nevertheless, -6T Rule #2 applies to exempt TS1 and TS2 from recognizing gain or loss on the deemed sale of their TS3 stock, even though neither TS1 nor TS2 directly owns 80 percent of the outstanding TS3 stock. The -6T Rule #2 applies only because TS1, TS2, and TS3 are members of a consolidated return group of which T (the entity whose stock P acquired in a QSP) is the common parent.[18]

For reasons discussed in Part V below, it is important to bear in mind that -6T Rule #1 accords nonrecognition treatment only to a T group member that *directly* holds at least 80 percent of the outstanding stock of another member. That is, if a single T group member directly owns at least 80 percent, but less than 100 percent, of the outstanding stock of a lower-tier member, and other T group members own the remaining shares of the lower-tier member, -6T Rule #1 applies only to the member that owns the 80-percent-or-more stock interest, and does not apply to the members that own the minority interests.

**Example (7):** Same as example (6), except that TS1 owns 80 percent of TS3's stock, and TS2 owns the remaining 20 percent of TS3's stock. As illustrated in example (6), T recognizes no gain or loss on the deemed sale of its TS1 and TS2 stock. This result follows under both -6T Rule #1 and -6T Rule #2. Similarly, TS1 recognizes no gain or loss on the deemed sale of its TS3 stock, under both -6T Rule #1 and -6T Rule #2.

However, notwithstanding that TS1 owns at least 80 percent of TS3's stock, -6T Rule #1 does not accord TS2 nonrecognition treatment on the deemed sale of its 20 percent of TS3's stock (i.e., -6T Rule #1 applies only to 80 percent or more shareholders). Thus, as in example (6), TS2 is accorded nonrecognition treatment with respect to its TS3 stock only under -6T Rule #2, which applies only because TS2 and TS3 are members of a consolidated return group of which T (the corporation whose stock P acquired in a QSP) is the common parent.

## IV. SECTION 338(h)(10) ELECTION

Temp. Reg. section 1.338-6T by its terms does not apply where P purchases T's stock out of a consolidated group and joins with T's ultimate parent in making a section 338(h)(10) election with respect to T.[19] Temporary regulations under section 338(h)(10) long have provided that, in all circumstances, T and the members of its con-

[18]The definitional language of Temp. Reg. section 1.338-6T is somewhat ambiguous regarding whether -6T Rule #2 accords nonrecognition treatment to TS1 and TS2, and one must look to Temp. Reg. section 1.338-6T(c)(2), example (2) and, the preamble (TD 8339) to discern the drafters' intent.

Specifically, Temp. Reg. section 1.338-6T(b)(2) states that "[a] section 1.338-6T shareholder is also a *target* that directly owns stock in an *affected target* if both the target and the affected target are members of a consolidated group filing a final consolidated return described in section 1.338-1T(f)(2)(ii)" (emphasis added). It appears from the excessively confusing statutory/regulatory framework that, where P purchases T's stock, T is an "original target" and each T subsidiary in which T directly or indirectly owns 80 percent of the stock (here TS1, TS2, and TS3) is an "affected target," but that for purposes of applying the -6T nonrecognition rules both the original target and each of the affected targets are "targets." *See* section 338(d)(2), (d)(3), and (h)(3)(B); Temp. Reg. section 1.338-4T(b)(3) and (b)(4); and Temp. Reg. section 1.338-1T(b)(7). Temp. Reg. section 1.338-6T(c)(2), example (2) and the preamble (TD 8339) confirm that where T is the common parent of a consolidated group, -6T Rule #2 applies to stock held by affected targets, e.g., the TS3 stock held by TS1 and TS2.

[19]*See* Temp. Reg. section 1.338-6T(a).

solidated group recognize no gain or loss on the deemed sale of stock in any other member of the group.[20] Accordingly, the flaw in Temp. Reg. section 1.338-6T discussed in Part V below is not relevant if a section 338(h)(10) election is made with respect to T.

**Example (8):** Same as example (6), except that P purchases 100 percent of T's stock from Bigco, the common parent of the Bigco consolidated group, and P and Bigco join in making a section 338(h)(10) election with respect to T.

Temp. Reg. section 1.338-6T by its terms does not apply in this example (8). However, the temporary regulations under section 338(h)(10) accord T nonrecognition treatment with respect to the deemed sale of its TS1 and TS2 stock, and accord TS1 and TS2 nonrecognition treatment with respect to the deemed sale of their TS3 stock.

## V. FLAW IN TEMPORARY REGULATION

In important respects, Temp. Reg. section 1.338-6T is in our view flawed. That is, in certain situations (where no section 338(h)(10) election is made) the temporary regulation inappropriately sanctions duplicative taxation of the same economic gain or loss. This flaw, as discussed below, generally becomes relevant where T (the corporation whose stock P acquires in a QSP) is not the common parent of a consolidated group.

### A. Duplicative Taxation Clearly Results

Duplicative taxation clearly results in one important situation: if the affiliated group of which T is a member (either as common parent or subsidiary) does *not* file a consolidated return. In this situation, -6T Rule #1 applies, but -6T Rule #2 does not, so that nonrecognition treatment with respect to a subsidiary's stock is accorded only where T or a single T subsidiary *directly* owns at least 80 percent of the lower-tier subsidiary's stock.[21] That is, T or a T subsidiary that holds some stock, but less than 80 percent of the stock, in a lower-tier subsidiary will recognize gain or loss with respect to that stock.

**Example (9): Diamond Pattern (no consolidated return).** Same as example (6) (i.e., A owns all of T's stock, on 4/1/91 A sells the T stock to P, and P makes a section 338 election with respect to T) except that the T affiliated group does not file a consolidated return for its final year ending 4/1/91.

The results with respect to T are the same as in example (6). That is, because T *directly* owns at least 80 percent of the stock of TS1 and TS2, -6T Rule #1 accords T nonrecognition treatment on the deemed sale of its TS1 and TS2 stock. The results with respect to TS1 and TS2, on the other hand, are not the same as in example (6). Specifically, because neither TS1 nor TS2 directly owns at least 80 percent of TS3's stock, -6T Rule #1 does not apply. Moreover, because T is not the common parent of an affiliated group filing a consolidated return, -6T Rule #2 does not apply. As a result, TS1 and TS2 *will* recognize gain or loss on the deemed sale of their TS3 stock notwithstanding that TS3 also will recognize gain or loss on the deemed sale of its assets. This results in duplicative gain recognition with respect to TS3's stock and assets.[22]

### B. Duplicative Taxation May Not Result

There is an important, related situation where, read literally, -6T Rule #2 does not apply, but, good sense argues, the drafters of Temp. Reg. section 1.338-6T should have intended the application of -6T Rule #2. Here is the case: T is a member, but not the common parent, of an affiliated group filing a consolidated return, *and* "old" T, TS1, TS2, and TS3 report their section 338 gain or loss by filing a "combined deemed sale return" (a "combined return") under section 338(h)(15).[23]

**Example (10): Diamond Pattern (Bigco group consolidated return).** Same as example (6), except that Bigco, rather than individual A, owns all of T's stock. Thus Bigco (not T) is the common parent of the Bigco-T-TS1-TS2-TS3 affiliated group. Moreover, the Bigco group files a consolidated return.[24] Bigco sells all of T's stock to P

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[20]Temp. Reg. section 1.338(h)(10)-1T(e)(2).

[21]Temp. Reg. section 1.338-6T(b)(2) (second sentence) (limiting -6T Rule #2 to members of a consolidated group that files a final consolidated return described in Temp. Reg. section 1.338-1T(f)(2)(ii)); preamble to Temp. Reg. section 1.338-6T (TD 8339) ("New section 1.338-6T does not provide an exception from multiple gain taxation in the case of a deemed sale of stock of [a subsidiary] by a target that does not meet the definition of a section 1.338-6T shareholder. One case not covered by the new temporary regulation arises where [T or a T subsidiary does not *directly* own at least 80 percent of a lower-tier subsidiary and T] is not the common parent of an affiliated group filing a consolidated return.").

As noted in III above, -6T Rule #1 accords nonrecognition treatment only to the T group member that directly owns an 80-percent-or-more stock interest in a lower-tier subsidiary. For example, if T owns 80 percent of the outstanding stock of TS1, and another T subsidiary, TS2, owns the remaining 20 percent of TS1's stock, -6T Rule #1 accords nonrecognition treatment only to T, and not to TS2. *See* example (7) above.

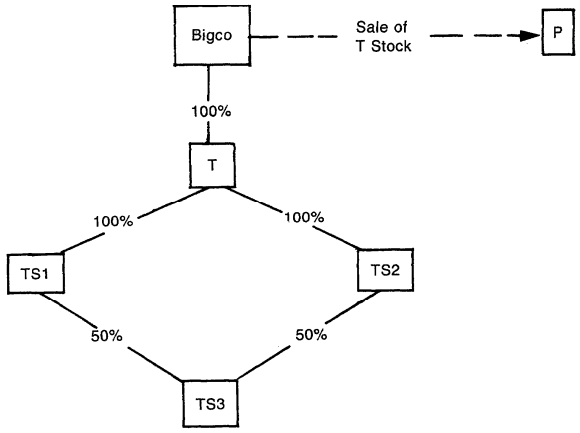
In the preamble (TD 8339), the IRS implies that further regulations may provide that "in some cases" TS1 and TS2 will not recognize gain or loss with respect to a deemed sale of their TS3 stock. The preamble states, however, that IRS expects any such further relief to "apply only to transactions occurring after the [relevant] regulations are issued."

[22]The result would be the same if T's stock were owned by a number of shareholders or were owned 100 percent by Bigco, so long as no consolidated return is filed by the sold group (if T is the common parent) or by the selling group (if Bigco is the common parent). The uncertain tax results that follow when the Bigco selling group is filing a consolidated return are explored in Part V.B immediately below.

[23]As discussed in more detail below, Temp. Reg. section 1.338-4T(k)(6), which implements the combined return provision of section 338(h)(15), in effect treats "old" T and its subsidiaries as a consolidated group for purposes of reporting their section 338 gain or loss. A combined return can be filed for "old" T, TS1, TS2, and TS3 only if, on the date P makes a QSP of T's stock, T is a member of an affiliated group filing a consolidated return. *See* section 338(h)(15); Temp. Reg. section 1.338-4T(k)(6) Q&A 1.

[24]If the Bigco group does not file a consolidated return, the tax results clearly are the same as in example (9), i.e., duplicative taxation of TS3 asset gain and stock gain.

for cash and P makes a section 338 election. No election is made under section 338(h)(10).[25]




If, in example (10), "old" T, TS1, TS2, and TS3 do not report their section 338 gain or loss by filing a combined return, the results clearly are duplicative taxation as set out in example (9). That is, (i) -6T Rule #1 accords T nonrecognition treatment with respect to its TS1 and TS2 stock, but (ii) neither -6T Rule #1 nor -6T Rule #2 protects TS1 and TS2 from gain or loss recognition with respect to their TS3 stock. Again, duplicative taxation of the same economic gain or loss results, because TS1 and TS2 recognize gain or loss with respect to their TS3 stock and TS3 recognizes gain or loss with respect to its assets.

## *Duplicative taxation of the same economic gain or loss results . . . .*

If, on the other hand, "old" T, TS1, TS2, and TS3 do file a combined return, the tax results in example (10) *may* be beneficially altered. Explicitly, if a combined return is filed, T and its subsidiaries in effect are treated, for purposes of reporting their section 338 gain or loss, either as a single corporation or, more precisely perhaps, as a consolidated group. This follows not from the words of Temp. Reg. section 1.338-6T, but rather from Temp. Reg. section 1.338-4T(k)(6), which states that:

> The combined return is made by filing a single corporation income tax return in lieu of separate deemed sale returns for all of the targets required to be included in the combined return. The combined return reflects the deemed sales of all of the targets required to be included in the combined return.
>
> Gains and losses recognized on the deemed sale of assets by targets included in the combined return are treated as gains and losses of a single target. In addition, loss carryovers of a target that were not subject to the [SRLY limitations] while that target was a member of the selling consolidated group may be applied without limitation to the gains of other targets included in the combined return.[26]

Where T, TS1, TS2, and TS3 are reporting all their "gains and losses recognized on the deemed sale of assets . . . as gains and losses of a single target," it is wholly inconsistent for this "single target" to recognize gain or loss on the deemed sale of the stock of any one of the entities (e.g., TS3) that is a constituent part of the "single target." Therefore, whatever the IRS' rationale is for limiting -6T Rule #2 only to instances where T is the common parent of a consolidated group (see Part V.C below), that rationale ought to apply as well where T and its subsidiaries file a combined return. Hence, in example (10), -6T Rule #2 should accord TS2 and TS3 nonrecognition treatment with respect to their TS3 stock.

Why, however, does -6T Rule #2 refer only to a consolidated return and not to a combined return? The reason, we believe, is uncomplicated. The drafters of Temp. Reg. section 1.338-6T simply did not see the combined return issue. Since (as discussed in Part V.C below) there is no valid reason to treat TS2 and TS3 differently in example (6) (where T is the common parent of a consolidated group) and in example (10) (where T and its subsidiaries file a combined return), we hope and, in fact, expect that sooner or later and with retroactive effect the IRS will announce that the filing of a combined return avoids duplicative taxation of the same economic gain.[27]

### C. Possible Rationale for the Flaw

It is barely possible to conjure up two arguments in support of the disparate treatment of TS3's stock in examples (6), (9), and (10), i.e., the sensible result of no gain recognition on TS3's stock in example (6) versus the unnecessarily harsh duplicative gain recognition on TS3's stock in example (9) (and in example (10) as well, should the IRS mistakenly reject our combined return analysis). Neither argument, however, suffices to justify the harsh treatment in example (9) (and possibly in example (10)).

The first argument runs as follows: in example (6) T, TS1, TS2, and TS3 (filing a consolidated return with T as

[25] If Bigco and P join in a section 338(h)(10) election, TS1 and TS2 would *not* recognize gain or loss on the deemed sale of their TS3 stock. Temp. Reg. section 1.338(h)(10)-1T(a)(2). *See* Part IV above.

Some state income tax laws do not recognize a section 338(h)(10) election but rather treat it as a regular section 338 election, in which case (depending on state tax law) a section 338(h)(10) election as to T may result at the state tax level in the adverse tax results described in the text where T and its subsidiaries own one or more subsidiaries in a diamond pattern and T is not the common parent of a consolidated group. For a thorough discussion of the state income tax consequences of a section 338(h)(10) election, *see* Needham, "Consequences of a Section 338(h)(10) Election at the State Level," *Tax Notes*, Sept. 24, 1990, at 1681.

[26] Temp. Reg. section 1.338-4T(k)(6), Answers 2 and 3.

[27] This flaw in Temp. Reg. section 1.338-6T might most easily be corrected by amending the second sentence of Temp. Reg. section 1.338-6T(b)(2) to read as follows: "A section 1.338-6T shareholder is also a target that directly owns stock in an affected target if both the target and the affected target either (i) are members of a consolidated group filing a consolidated return described in section 1.338-1T(f)(2)(ii), or (ii) are acquired from a single selling consolidated group (as defined in section 338(h)(10)(B)) and file a combined deemed sale return under section 338(h)(15) and section 1.338-4T(k)(6)."

the common parent) are deemed to have made section 338 asset sales while still members of their pre-section 338 consolidated group; whereas in example (9) T, TS1, TS2, and TS3 (not filing a consolidated return at all) by definition are not deemed to have made a section 338 assets sale while still members of a pre-section 338 consolidated group.[28] This argument, however, if it says anything, argues that in example (9) neither -6T Rule #1 nor -6T Rule #2 should apply. It does not explain why in example (9) -6T Rule #1 does apply but -6T Rule #2 does not apply.

The second argument runs as follows: in example (6) (where T is the common parent of a consolidated group) TS3 could have been liquidated into TS1 and TS2 prior to the sale of T's stock to P without triggering gain or loss to TS1 and TS2 with respect to their respective 50-percent stock interests in TS3;[29] whereas in example (9) (no consolidated return) liquidating TS3 prior to the sale of T's stock to P would have triggered gain or loss to TS1 and TS2 with respect to their respective 50-percent stock interests in TS3.[30] But while this is so, it can not in fact *be* the rationale for the differential treatment accorded in example (6) and example (9). A variation on example (10) (where T is a member of the Bigco consolidated group) demonstrates: Assume P does not file a combined return for T and its subsidiaries. The case now falls squarely within example (9), requiring that TS1 and TS2 recognize gain with respect to their TS3 stock, even though TS3's liquidation into TS1 and TS2 prior to Bigco's sale of T's stock to P would *not* have triggered gain or loss to TS1 and TS2 with respect to their TS3 stock.[31]

***It is difficult to see . . . any justification of the unpalatable duplicative tax result . . . .***

In sum, it is difficult to see why any justification of the unpalatable duplicative tax result that obtains under Temp. Reg. section 1.338-6T in example (9) and that will result in example (10) as well if no combined return is filed or if the IRS rejects the analysis, earlier proffered, keyed to the use of a combined return under the -4T(k)(6) regulation. A manifestly superior regulatory solution, we think, would concentrate on the desirability of avoiding double corporate tax on what is economically the same gain—TS3's stock and TS3's assets—and would declare that whenever the section 338 deemed sale rule requires recognition of asset gain to a corporation, gain will not be recognized under section 338 with respect to the stock of that corporation.[32]

[28]Technically, in example (10), even if "old" T, TS1, TS2, and TS3 file a combined return, they are not deemed to have made their section 338 asset sales while still members of a pre-section 338 consolidated group (i.e., the Bigco group).

[29]*See* section 332; Reg. section 1.1502- 34. Although section 337(c) creates deferred intercompany asset gain at the TS3 level despite the consolidated return, section 337(c) does not override tax-free treatment to TS1 and TS2 on their TS3 stock under section 332.

[30]*See* section 331.

[31]*See* section 332, Reg. section 1.1502-34.

[32]That, after all, is exactly the sensible notion that fuels the nonrecognition conclusion, with respect to target stock, when a section 338(h)(10) election is made. *See* Part IV above.

## VI. METHODS OF AVOIDING THE FLAW

The harsh duplicative gain recognized by TS1 and TS2 in example (9), and in example (10) as well pending favorable IRS clarification of the combined return issue discussed earlier, can be avoided through adequate advance planning, explicitly by combining or reconfiguring corporations prior to P's purchase of T's stock. For instance, TS2 might merge into TS1 in a tax-free reorganization, thereby converting TS3 to TS1's wholly owned subsidiary.[33] Or, if corporate merger is undesirable, T could contribute to TS1 all of TS2's stock, following which TS1 could contribute its 50 percent of TS3's stock to TS2, thereby converting TS2 into TS1's wholly owned subsidiary and converting TS3 into TS2's wholly owned subsidiary.[34] Or, possibly TS2 could sell its TS3 stock to TS1, thereby converting TS3 to TS1's wholly owned subsidiary and enabling TS1 to avoid gain recognition on the subsequent section 338 deemed sale of its 100 percent of TS3's stock.[35]

Alternatively, in example (10) (although not example (9)), gain recognition by TS1 and TS2 with respect to the stock of TS3 unquestionably can be avoided if P and Bigco join in making a section 338(h)(10) election with

[33]Is there any realistic concern that the TS2- into-TS1 merger might fail the continuity of interest, business purpose, and/or continuity of business enterprise requirements necessary for the merger to qualify as a tax-free reorganization, i.e., because (i) T will be deemed to have sold all its TS1 stock (including the TS1 stock T actually or constructively receives in the TS2-into-TS1 merger) as a result of the subsequent section 338 election, (ii) TS1 will be deemed to have sold all of the assets it received from TS2 in the TS2-into-TS1 merger as a result of the subsequent section 338 election, and/or (iii) the TS2-into-TS1 merger is being undertaken to avoid stock gain? We believe that the merger satisfies the requirements of a tax-free reorganization, without regard to the subsequent section 338 election, but we have not located direct confirming authority. For a discussion of the continuity of shareholder interest, business purpose, and continuity of business enterprise requirements, *see* Ginsburg & Levin, *Mergers, Acquisitions and Leveraged Buyouts* (CCH Tax Transactions Library), at chapter 6 (July 1991 revision).

[34]Is there any realistic concern that T's contribution of its TS2 stock to TS1 and TS1's contribution of its TS3 stock to TS2 might fail the "control" "immediately after" requirement of section 351 (or, alternatively, if the contributions are characterized as "B" reorganizations under section 368(a)(1)(B), the continuity of shareholder interest, business purpose, and continuity of business enterprise requirements)? Again, we believe the answer is no. *See* Ginsburg & Levin, *Mergers, Acquisitions and Leveraged Buyouts* (CCH Tax Transactions Library), at Para. 608 (July 1991 revision); Sheffield & Kimball, *Organizing the Corporate Venture* (CCH Tax Transactions Library), at Para. 503 and Para. 504.

[35]TS2's sale of its TS3 stock to TS1 is governed by section 304. As a result of the enactment of section 304(b)(4) in 1987, however, the precise tax results of the sale are unclear. Prior to section 304(b)(4), the tax results of TS2's sale essentially would have been as follows: (i) TS2 would have been taxed on the sale proceeds as dividend income to the extent of the combined earnings and profits of TS1 and TS3 (and this dividend would have been eliminated under Reg. section 1.1502-14 if the T group filed a consolidated return, with stock basis adjustments made in accordance with Reg. section 1.1502-32); and (ii) TS1 would hold the TS3 stock at the same basis as TS2 held the stock.

The IRS has indicated that it might ultimately take the position that section 304 does not apply at all to a sale between members of a consolidated return group of stock of a member of the group.

respect to T.[36] Similarly, in example (10) (although not example (9)), gain recognition by TS1 and TS2 with respect to their TS3 stock can be avoided by liquidating TS3 into TS1 and TS2 prior to P's QSP of T's stock.[37]

Finally, in example (9) (although not example (10)), T and the members of T's affiliated group could elect to file a consolidated return for the group's final tax year (i.e., the tax year that ends on the date of P's QSP of T's stock) and thereby unquestionably avoid recognition of gain with respect to the TS3 stock. See example (6) above.

## VII. OTHER ISSUES AND EFFECTIVE DATES

The -6T temporary regulation does not apply to stock in a foreign corporation owned by a domestic corporation.[38] Thus, in example (1) and example (3), if TS were a foreign corporation, T would recognize gain or loss on the deemed sale of its TS stock.

[36]Temp. Reg. section 1.338(h)(10)-1T(e)(2). *See* Part IV above.

[37]See section 332; Reg. section 1.1502-34. Although section 337(c) creates deferred intercompany asset gain at the TS3 level despite the Bigco consolidated return, section 337(c) does not override tax-free treatment to TS1 and TS2 on their TS3 stock under section 332. Moreover, TS1 and TS2 will hold TS3's assets at an FMV basis, and thus (although the deferred intercompany gain is triggered by Bigco's sale of T's stock) the gain inherent in TS3's assets at the time of the liquidation will not be taxed again as a result of P's section 338 election with respect to T.

[38]Temp. Reg. section 1.338-6T(d)(2), (d)(7). Similarly, gain or loss is recognized by a foreign corporation on any stock it owns in another foreign corporation to the extent the gain or loss is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States. Temp. Reg. section 1.338-6T(d)(3). The temporary regulation also contains special rules applicable to foreign insurance companies that elect under section 953(d) to be treated as domestic corporations and to stock in DISCs and former DISCs. Temp. Reg. section 1.338-6T(d)(4)(5).

The -6T temporary regulation also contains an antistuffing rule.[39] Under this rule, if T contributes a loss asset to TS in a carryover basis transaction, and "a purpose" of the transfer is to reduce the gain (or increase the loss) T otherwise would recognize on the deemed sale of its TS stock (which may be true if TS is a foreign corporation or TS otherwise does not qualify for -6T relief from taxation on the deemed sale of its stock), T's gain or loss on the disposition of TS' stock will be computed as though T had not transferred the asset to TS.

***The -6T temporary regulation . . . contains an antistuffing rule.***

The -6T temporary regulation applies to any QSP with respect to which a section 338 election is made or deemed made on or after March 14, 1991.[40] Additionally, with respect to any QSP made after December 31, 1986, and before March 14, 1991, P generally may elect to have the temporary regulation apply.[41]

## VIII. CONCLUSION

As this paper demonstrates, although Temp. Reg. section 1.338-6T surely represents a positive step, the temporary regulation is flawed in key respects. As the preamble to Temp. Reg. section 1.338-6T suggests that the IRS may, the IRS should expand the temporary regulation to provide that, whenever the section 338 deemed sale rules apply to the assets of a subsidiary (e.g., TS, TS1, TS2, and TS3 in the examples), gain will not be recognized under section 338 with respect to that subsidiary's stock.

[39]Temp. Reg. section 1.338-6T(d)(6).

[40]Temp. Reg. section 1.338-6T(e)(1).

[41]Temp. Reg. section 1.338-6T(e)(2), (g).