

Background

A. Section 338 Generally

In the case of any qualified stock purchase, section 338 allows a purchasing corporation to elect to treat the target corporation as having sold all of its assets at the close of the acquisition date at fair market value and then treats the target corporation as a new corporation that purchased all of its assets as of the beginning of the day after the acquisition date. Section 338 was enacted to replace former section 334(b)(2) and to repeal the Kimbell-Diamond doctrine. See H.R. Rep. No. 97-760 at 536 (1982), 1982-2 C.B. 600, 632 (reflecting that section 338 replaces “any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine”). In *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, aff’d per curiam, 342 U.S. 827 (1951), the court held that the purchase of the stock of a target corporation for the purpose of obtaining its assets through a prompt liquidation should be treated by the purchaser as a purchase of the target corporation’s assets with the purchaser receiving a cost basis in the assets.

B. Revenue Ruling 2001-46

Rev. Rul. 2001-46 (2001-2 C.B. 321) considers whether the step transaction doctrine should apply to treat certain acquisitions of stock of a target corporation followed by mergers of the target corporation into the acquiring corporation as reorganizations under section 368(a)(1)(A). In Situation 1 of that ruling, Corporation X owns all of the stock of Corporation Y. Pursuant to an integrated plan, X acquires all of the stock of Corporation T in a statutory merger of Y into T (the “Acquisition Merger”), with T surviving. In the Acquisition Merger, the T shareholders exchange their T stock for consideration, 70 percent of which is X voting stock and 30 percent of which is cash. Following the Acquisition Merger and as part of the plan, T merges into X in a statutory merger (the “Upstream Merger”). If viewed separately from the Upstream Merger, the Acquisition Merger would qualify as a qualified stock purchase. If viewed separately from the Acquisition Merger, the Upstream Merger would qualify as a liquidation described in section 332. However, if the step transaction doctrine were applied to the Acquisition Merger and the Upstream Merger, the integrated transaction would be treated as an integrated acquisition of T’s assets by X in a single statutory merger qualifying as a reorganization under section 368(a).

Considering the appropriate treatment of the Acquisition Merger and the Upstream Merger, Rev. Rul. 2001-46 examines, among other authorities, Rev. Rul. 67-274 (1967-2 C.B. 141) and Rev. Rul. 90-95 (1990-2 C.B. 67). In Rev. Rul. 67-274, a corporation’s acquisition of stock of a target corporation that, viewed independently, qualifies as a reorganization under section 368(a)(1)(B), is followed by a liquidation of the target corporation into the acquiring corporation that, viewed independently, qualifies as a liquidation described in section 332. Rev. Rul. 67-274 holds that the transaction is an acquisition by the acquiring corporation of the target corporation’s assets in a reorganization under section 368(a)(1)(C). In Rev. Rul. 90-95, a subsidiary of the acquiring corporation merges into the target corporation with the target corporation shareholders receiving solely cash in exchange for their stock. Immediately following this merger, the target corporation merges into the acquiring corporation. Rev. Rul. 90-95 rules that the first step is accorded independent significance from the subsequent liquidation of the target corporation and, therefore, is treated as a qualified stock purchase, regardless of whether an election under section 338 is made.

In Rev. Rul. 2001-46, the IRS concluded that treating the Acquisition Merger and the Upstream Merger as a single statutory merger of T into X would not violate the policy underlying section 338 because that treatment results in a transaction that qualifies as a reorganization under section 368(a)(1)(A) in which X acquires the assets of T with a carryover basis under section 362, not a cost basis under section 1012. Finally, Rev. Rul. 2001-46 states that the IRS and Treasury are considering whether to issue regulations that would reflect the general principles of the revenue ruling, but would allow taxpayers to make an election under section 338(h)(10) with respect to a step in a multi-step transaction that, viewed independently, is a qualified stock purchase and is pursuant to a written agreement that requires, or permits, the purchasing corporation to cause a section 338(h)(10) election in respect of such step to be made. The IRS requested and received comments on this issue.

Explanation of Provisions

The IRS and Treasury have studied the comments received in response to the request made in Rev. Rul. 2001-46, all of which urge the IRS and Treasury to allow taxpayers to make section 338(h)(10) elections in certain transactions as contemplated by Rev.

Rul. 2001-46. These final and temporary regulations adopt this recommendation and provide that the step transaction doctrine will not be applied if a taxpayer makes a valid section 338(h)(10) election with respect to a step in a multi-step transaction, even if the transaction would otherwise qualify as a reorganization, if the step, standing alone, is a qualified stock purchase. The IRS and Treasury are continuing to study the other comments received. In particular, the IRS and Treasury are considering whether any amendments to the portion of the regulations under section 338 related to the corporate purchaser requirement are appropriate.

Effective Date

These final and temporary regulations are applicable to acquisitions of stock occurring on or after the date of publication of the regulations.

Special Analyses

These final and temporary regulations are necessary in order to provide taxpayers with immediate guidance regarding the validity of certain elections made under section 338(h)(10). Accordingly, good cause is found for dispensing with the notice and public procedure pursuant to 5 U.S.C. 553(b)(B) and with providing a delayed effective date pursuant to 5 U.S.C. 553(d)(1) and (3). For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the **Federal Register**. These final and temporary regulations have been submitted to the Chief Counsel of Advocacy of the Small Business Administration for comment on their impact on small businesses.

Drafting Information

The principal authors of these final and temporary regulations are Daniel Heins and Mary Goode, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ 1. The authority citation for part 1 is amended by adding an entry in