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Report No. 1317

February 13, 2015

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
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The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
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Re: **Proposal to Modify Regulations Under Section 336(e) and Section 338**[1]

Dear Messrs. Mazur, Koskinen and Wilkins:

The Tax Section of the New York State Bar Association (the "Tax Section") is pleased to submit the recommendations set forth below to modify the regulations implementing the statutory consistency rules under Section 336(e) [2] and Section 338.

Background

Under Treasury Regulations Section 1.338-8, if (i) a corporation acquires an asset in a taxable transaction from a member of a consolidated group, (ii) the gain from the asset sale is reflected in the stock basis of target[3] by reason of the consolidated return regulations' investment

[1] The principal drafter of this letter was Neil J. Barr. Substantial contributions were made by Craig A. Phillips and Joseph Pahl. Helpful comments were received from Kathleen L. Ferrell, Stephen B. Land, Michael Schler, David H. Schnabel, David R. Sicular, Eric Sloan, Eric Solomon, Linda Swartz and Joseph Toce. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Section references herein, unless otherwise specified, are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] Throughout this letter, we refer to the entity that is acquired in a QSP or QSD as "target," to any person acquiring target assets during the consistency period as an "asset acquirer" and to any person acquiring target stock in the QSD or QSP as a "stock acquirer." We refer to the consolidated group of which the target is a member immediately prior to the QSD or QSP as the "seller group."

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adjustment rules[4] and (iii) within the 12 month "target consistency period," the asset acquirer makes a "qualified stock purchase" (a "QSP") of target, then the acquirer must take a carryover basis in the acquired assets unless a Section 338 election is made for target (the "Section 338 Consistency Rule").[5] Likewise, Treasury Regulations Section 1.336-1(a)(2) applies "the principles of § 1.338-8, concerning asset and stock consistency" (the "Section 336(e) Consistency Rule," together with the Section 338 Consistency Rule, the "Consistency Rules") by requiring the acquirer to take a carryover basis in assets acquired in a taxable transaction from a member of a consolidated group where the asset acquirer (or a "related person") also acquires five percent or more, by value, of the stock in target in a transaction that qualifies as a "qualified stock disposition" (a "QSD") for which a Section 336(e) election is not made.[6]

Uncertainty exists as to the application of the Section 336(e) Consistency Rule because it is often unclear (a) whether a QSD will occur at the time of the asset sale by target and (b) if a QSD does occur, whether the asset acquirer will acquire (or be "related" to another person that acquires) five percent or more of target stock. The latter uncertainty is particularly extant in the private investment fund context, where there may be significant overlapping ownership among investors. Indeed, in light of the strict confidentiality in which many private equity funds hold their investors' identities, it may be impossible, as a practical matter, to disprove the application of the Section 336(e) Consistency Rule in certain fact patterns. As a result, considerable uncertainty remains as to the tax consequences of many asset sales by members of a U.S. consolidated group because of the practical difficulties of applying the Section 336(e) Consistency Rules.

This uncertainty is particularly troublesome in light of the fact that the remedy for violation of the Consistency Rules is carryover basis to the asset acquirer, a party who may have no reason to know of the potential Consistency Rule issues (or even the occurrence of a QSD).[7] We believe that more certainty can and should be provided and that this objective can be accomplished without undermining the integrity of the Consistency Rules. Specifically, we propose that the Treasury Department promulgate regulations allowing the parties to a taxable asset sale to make an election (the "Investment Adjustment Election"), including on a protective basis, by which the seller group would forgo any positive investment adjustment under Treasury Regulations Section 1.1502-32 resulting from the asset sale in the event that a subsequent transaction occurs that would otherwise implicate the carryover basis remedy of the Consistency Rules.

As discussed below, requiring the seller group to forgo the investment adjustment with respect to target stock achieves the objectives of the modern Consistency Rules, while providing certainty to an asset acquirer as to its cost basis in the acquired assets. While we believe that the Investment Adjustment Election is particularly necessary to address uncertainties arising from the breadth of the Section 336(e) Consistency Rule and the likely lack of coordination among the

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[4] See Treas. Reg. § 1.1502-32.

[5] Treas. Reg. § 1.338-8(a)(2).

[6] Treas. Reg. § 1.336-1(a)(2).

[7] See T.D. 9619, 74 (May 15, 2013). The overall policy considerations of the carryover basis remedy are beyond the scope of this letter, however, were the IRS and Treasury ever to reconsider the overall design of the Consistency Rules, we would welcome the opportunity in that context to submit a report regarding the carryover basis remedy.

purchasers in a QSD, we do not believe there is any compelling reason to limit the Investment Adjustment Election to Section 336(e).[8] Instead, we believe that the Investment Adjustment Election should be permitted in the case of both the Section 336(e) Consistency Rule and the Section 338 Consistency Rule.

Nevertheless, if the IRS and Treasury are reluctant to provide an election to all asset acquirers and believe it should be limited in some manner, we recommend that the Investment Adjustment Election be made available in cases where the Section 336(e) Consistency Rules would otherwise apply so long as the asset acquirer and the purchaser in a QSD are not "related persons" within the meaning of Treasury Regulations Section 1.336-1(b)(12) (the "Related Party Limitation"). However, in applying the Related Party Limitation to determine eligibility for the Investment Adjustment Election, we believe the attribution rules should be modified to further increase the level of ownership by a partner that is required in order for Section 318(a)(2) and Section 318(a)(3) to attribute shares to or from such partner. While we do not recommend the specific level of ownership that should be required for this limited purpose, we think it should be at least 25% and note that setting the percentage at 50% would create consistency with the rule applicable to attribution to and from corporations. While this more limited approach would not address all instances in which taxpayers lacked information or control with respect to a subsequent QSD, it would significantly mitigate the concerns expressed herein, which are less acute where there is significant relatedness.

We briefly describe below the history of the modern Consistency Rules, some particular problems that arise as a result of their application in the context of a QSD, and the manner by which those problems would be addressed through the Investment Adjustment Election.

The Origin of the Modern Consistency Rules

As is explained in detail in our 1990 Report,[9] the Section 338 Consistency Rule has its origin in the period preceding the repeal of the General Utilities doctrine.[10] At the time of its enactment, Section 338 incorporated principles of former Section 337, which allowed a corporation to sell certain assets without recognition of gain during a 12-month period beginning on the date on which it adopted a plan of complete liquidation, so long as corporation distributed all of its assets by the end of the 12-month period. This nonrecognition treatment was not available for certain assets, such as inventory and recapture property.

The nonrecognition rule of former Section 337 did not prevent an asset acquirer from obtaining a cost basis in the acquired assets. Thus, any built-in gain in the acquired assets that was not excluded from the application of Section 337 would permanently escape corporate-level tax. By "cherrypicking" selected assets to be acquired from a corporate target and subsequently acquiring the target directly, a taxpayer could escape corporate-level tax altogether for assets

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[8] While we believe that the Investment Adjustment Election should be available for both Section 336(e) and Section 338, the need for the Investment Adjustment Election is more immediate with respect to Section 336(e) because of the breadth of its related party rules. Therefore, if the IRS and Treasury are reluctant to allow the Investment Adjustment Election under Section 338, we nonetheless support implementing the Investment Adjustment Election for Section 336(e).

[9] See New York State Bar Association, Tax Section, Report on the Role of Section 338 Consistency Rules After Repeal of the General Utilities Doctrine, Part IV.A (November 29, 1990) (hereinafter, the "1990 Report").

[10] General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935). For a more detailed discussion of the relationship between the General Utilities doctrine and the Consistency Rules, see Part IV.A of the 1990 Report.

entitled to nonrecognition treatment under former Section 337, while deferring tax with respect to the built-in gain on the remaining assets.[11] This was viewed as unduly eroding the exceptions under Section 337, an issue that the statutory consistency rules were intended to address.

The Code contains two separate "consistency rules"—the "asset consistency rule" and the "stock consistency rule." The "asset consistency rule" set forth in Section 338(e) provides that, if the purchasing corporation in a QSP, during a specified "consistency period," acquires an asset of the target corporation (or a target affiliate) without making an election under Section 338 with respect to the target, a Section 338 election is deemed made with respect to the target.[12] The "stock consistency rule" set forth in Section 338(f) applies where a taxpayer acquires multiple corporate targets through QSPs out of a single affiliated group. In order to prevent taxpayers from "cherrypicking" assets for tax-free step-up by isolating them into a single corporate entity, this rule deems a Section 338 election to have been made (or not made) depending on whether an election was made in the case of the first applicable QSP.[13]

In its initial implementation of the asset consistency rules, Treasury invoked its broad rulemaking authority under Section 338(e)(2)(D) and Section 338(i) to modify the statutory framework.[14] Proposed and temporary regulations under Section 338 provided taxpayers with electivity as to the remedy for what was called a "tainted asset acquisition" (*i.e.*, an acquisition of an asset of the target (or a target affiliate) during the consistency period). Either a statutory Section 338 election could be made or, alternatively, the purchaser in the QSP could elect to take a carryover basis in the acquired assets. If neither election was made, the default consequence was carryover basis in the acquired assets. The Service retained discretion to deem a Section 338 election to have been made if doing so was more appropriate to carry out the purposes of the Consistency Rules.

When the General Utilities doctrine was fully repealed by the Tax Reform Act of 1986, including through the enactment of Section 311(b) and the repeal of former Section 337, the statutory Consistency Rules under Section 338 were not modified. Recognizing the change in the legislative backdrop, however, Treasury promulgated new regulations curtailing the application of the Consistency Rules.[15] Rather than address abuse under former Section 337, the new regulations backstopped the repeal of the General Utilities doctrine by preventing taxpayers from avoiding gain on an asset sale in the context of a QSP for which a Section 338 election was not made when (i) application of the investment adjustment rules of Treasury Regulations Section 1.1502-32 offset gain on the sale of the target stock by creating a positive investment adjustment in the target's stock or (ii) the distribution of sales proceeds by way of a dividend subject to the 100% dividends received deduction resulted in avoidance of corporate level tax with respect to the asset sale. It is thus in those limited circumstances that the modern

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[11] For a description of this concern, see S. 2687, 97th Cong., 2d Sess., 128 Cong. Rec. S7589 (1982) (Mr. David Glickman, then Deputy Assistant Secretary for Tax, describing this issue).

[12] Section 338(e).

[13] Section 338(f).

[14] Treas. Reg. § 1.338-4T (repealed); Treas. Reg. § 1.338-5T (repealed). For a more complete description of the framework under the proposed and Temporary Regulations under Section 338, see T.D. 8021 (April 25, 1985).

[15] See T.D. 8515 (January 20, 1994).

Consistency Rules apply.[16] The current regulations also limit the stock consistency rule "to cases in which the rules are necessary to prevent avoidance of the asset consistency rules."[17] These rules are generally incorporated into the Section 336(e) Consistency Rules by the regulations under Section 336(e).[18]

The exclusive remedy under the current regulations, for both Section 336(e) and Section 338, is mandated carryover basis treatment for the asset acquirer. Unlike the prior regulations, the Service is no longer entitled to apply the statutory remedy of deeming a Section 338 (or Section 336(e)) election to have been made.[19] The parties to a QSP or a QSD thus retain the discretion to make an election under Section 338 or Section 336(e), in the manner provided by the applicable regulations, or to allow the carryover basis remedy to be imposed on the asset acquirer.

Special Issues Under Section 336(e)

Under Section 338, consistency rules apply only to assets acquired by a purchaser in a QSP.[20] Given the Section 1504(a) affiliation threshold required in the context of a QSP,[21] one can reasonably expect the parties to an asset deal potentially implicating the Section 338 Consistency Rules to be on notice of potential for Section 338 Consistency Rule issues. By contrast, the carryover basis consequences of the Section 336(e) Consistency Rules may apply to any asset acquirer if the acquirer (or a "related person") acquires five percent or more, by value, of the target stock in the QSD for which no Section 336(e) election is made.[22] The 2008 proposed regulations under Section 336(e) did not contain a five percent threshold, and we recommended several approaches to liberalizing the related party rules in the final regulations, including an anti-abuse rule or an ownership threshold.[23] The five percent threshold in the current regulations is a laudable step by the Treasury Department to address the need for narrower application of the Section 336(e) Consistency Rule.[24] However, for the reasons noted above, it remains uncertain in many cases as to whether the Section 336(e) Consistency Rule applies. We believe that the availability of the Investment Adjustment Election would create more certainty for parties to a transaction without undermining the repeal of the General Utilities doctrine. Moreover, the Investment Adjustment Election would have the effect of allowing the

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[16] Treas. Reg. § 1.338-8(a)(2); Treas. Reg. § 1.338-8(g).

[17] Treas. Reg. § 1.338-8(a)(6).

[18] Treas. Reg. § 1.336-1(a)(2).

[19] See 57 FR 1409 (January 14, 1992) (explaining that this change would "simplify the consistency and mitigation rules" in eliminating the previous optionality); T.D. 8515 (explaining that the structure of the new Regulations under Section 338(e) were based on a desire for "simplification and administrative convenience").

[20] Treas. Reg. §§ 1.338-8(b)(1)(iii), -2(c)(3).

[21] Section 338(d)(3).

[22] Treas. Reg. § 1.336-1(a)(2).

[23] See New York State Bar Association, Tax Section, Report on Proposed Regulations Implementing Section 336(e), Part V (December 31, 2008). The report suggested several choices for possible revised ownership thresholds including "50% (by analogy to Section 318(a)(3)(C)), 25% (by analogy to the PFIC lookthrough rules), 10% (by analogy to Section 902 (indirect foreign tax credit) and 871(h)/881(c) (portfolio interest)), or even 5% (by analogy to Section 267(e)(3) and Section 1563(e)(2))."

[24] Although it is beyond the scope of this letter, we support reconsideration of the ownership threshold for "related person" status under Section 336(e). However, because the application of these rules depends on facts that may be unknown or unknowable to an asset acquirer, we believe that the introduction of the Investment Adjustment Election is advisable even in the context of a revised ownership threshold.

parties to place the remedy on the seller of the asset—the party as to which the underlying General Utilities concern is most directly applicable. The Investment Adjustment Election would generally result in an increase in the amount of capital gain recognized by the seller group upon the QSD or QSP, thus preserving the full corporate-level gain associated with the asset sale. Consider the following examples:

> Example 1. S and T are members of the same consolidated group. S owns 100% of the stock of T. T operates two independent businesses, X and Y, through separate entities that are disregarded for U.S. federal income tax purposes. The fair market value of the X business assets exceeds their tax basis. S wishes to dispose of both of T's businesses but wishes, for valid business reasons, to do so in separate taxable transactions. In June of Year 1, S causes T to sell the disregarded entity conducting the X business to PS1, a private equity fund. Then, in March of Year 2, S sells the remaining Y business for cash to another private equity fund, PS2, by selling its T stock. No Section 336(e) election is made with respect to the sale of T stock.
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> A is a passive institutional investor, directly owning 5% (by value) of PS1 and 4% (by value) of PS2. In addition, A owns 1% (by value) of PS2 through a fund-of-funds, PS3, in which A owns 7% (by value). PS1, PS2 and PS3 are partnerships for U.S. federal income tax purposes, are managed independently from each other and maintain strict confidentiality as to the identities of their investors.
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> PS1's acquisition of the X business occurs during the target consistency period. In addition, because S and T file a consolidated return at the time of the sale of the X business, S receives a positive investment adjustment with respect to its T stock for the gain recognized by T on the sale of X. Finally, because A owns 5%, by value, of PS1 and PS2, PS1 and PS2 are "related persons" under Treasury Regulations Section 1.336-1(b)(12). As a result, under current law, PS1 takes a carryover basis in any built-in gain assets that it is treated as having acquired from T.
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> Example 2. The same facts as Example 1, except that T sells the X business to P1, a corporation, and within twelve months thereafter, S distributes all of its T stock in a QSD to its shareholders. P (P1's sole shareholder) is a 5% shareholder of S and receives 5% of the T stock in the distribution. P is unrelated to the other S shareholders receiving T stock, except through their common ownership of S stock. No Section 336(e) election is made with respect to the distribution of T stock.
>
> P1's acquisition of the X business occurs during the target consistency period.[25] In addition, because S and T file a consolidated return at the time of the sale of the X business, S receives a positive investment adjustment with respect to its T stock for the gain recognized by T on the sale of the X business. Finally, because P owns 100% of the P1 stock, P and P1 are "related persons" under Treasury Regulations Section 1.336-1(b)(12). As a result, under current law, P1 takes a carryover basis in the X business.

Note in Example 1 that, because PS1 and PS2 are independently managed and maintain strict confidentiality as to the identities of their investors, they would likely be unaware that they

[25] See Section 338(h)(4).

were "related persons" for purposes of the Section 336(e) Consistency Rule. Further, because a portion of A's interest in P2 is owned through P3, P2 would likely be unaware that it was a "related person" with respect to A. In the case of Example 2, while the asset acquirer and the stock acquirer are affiliated, P may have no knowledge of the planned T distribution at the time of the asset sale and may furthermore be unable to control or influence the decision with respect to that distribution. Thus, in order to avoid the carryover basis remedy, prior to the distribution, P would be required either to dispose of all or a portion of its S stock or cause P1 to dispose of the X business.

The Investment Adjustment Election

With the Investment Adjustment Election, in the examples above, the parties could contract at the time of the asset sale for S to forgo its positive investment adjustment with respect to the sale of the X business in the event of a subsequent QSD of T stock. As in the case of the Section 336(e) election itself,[26] the parties could contract to make the Investment Adjustment Election on a protective basis, and the election would not have any effect unless a QSD (or a QSP) occurred during the consistency period.[27] As a result, the asset acquirers in the above examples would have certainty as to a basis step-up with respect to the X business assets, and the elimination of the positive investment adjustment would preserve S's gain on the disposition of T (under either Section 1001, in the case of Example 1, or Section 311(b), in the case of Example 2). Because the asset acquirer may be unaware of any intention by S to dispose of its T stock (and, in the case of Example 2, unable to prevent the distribution), the parties may reasonably determine in their negotiations that imposing the remedy on S is the more appropriate result. If the Investment Adjustment Election were adopted with the Related Party Limitation, however, then it would not be available for the taxpayer in Example 2, which would thus be required to take a carryover basis in the X business assets.

We acknowledge that, while the Investment Adjustment Election would generally increase the capital gain of the seller group upon the disposition of the target stock, the seller group may have tax attributes with which to shelter that gain. The selective sale of certain assets, maximizing the absorption of group tax attributes, would thus be an available tax planning technique if the Investment Adjustment Election were adopted by regulation. Consider the following examples.

> P is the common parent of a consolidated group, of which T is a member. T has five assets, X1, X2, X3, X4 and X5, each of which has a fair market value of 100. T's tax bases in its assets are 60 (X1), 90 (X2), 10 (X3), 20 (X4) and 5 (X5). T has no subsidiaries. P has a consolidated net capital loss carryover of 150, none of which is attributable to losses of T. P's stock basis in T is 400 and the T stock has a fair market value of 500.
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> Example 3. Base Case: Stock Sale Only. PS, a partnership, desires to acquire T from P for cash. No election is made under Section 336(e). Where PS only purchases the T stock for cash, P recognizes 100 of gain, all of which is absorbed by its consolidated net

[26] See Treas. Reg. § 1.336-2(j).

[27] If the Service adopted the Related Party Limitation, the election would be subject to the satisfaction of the Related Party Limitation.

capital loss carryover. The tax basis of the T assets remains unaffected, and P has a remaining loss carryover of 50.

Example 4. Partial Asset Sale, No Election. Assume, alternatively, that during the 12-month period preceding PS's acquisition of T stock, PS acquires X1 and X2 from T for 200 in cash, which T promptly distributes to P. PS then acquires all of the T stock from S for 300.

Under current law, T would recognize 50 of gain upon the sale of X1 and X2, as a result of which P would receive an investment adjustment of 50 in its T stock. P's basis would then be reduced under the investment adjustment rules by the amount of the distribution of the sale proceeds (200). Upon the subsequent sale of the stock of T to PS, P would recognize an additional 50 of gain. As in the pure stock sale, the aggregate gain recognized by the P group would be 100, all of which would be absorbed by the loss carryover. Under the Section 336(e) Consistency Rule, PS would take a carryover basis in X1 and X2.[28]

Example 5. Partial Asset Sale, Investment Adjustment Election Available. Assume the same facts as in Example 4, except that the Investment Adjustment Election is available and P elects to forgo its positive investment adjustment with respect to the gain in the sale of X1 and X2. In such a case, T (as a member of the P group) would recognize 50 of gain upon the sale of X1 and X2, but no corresponding investment adjustments would result. Upon the distribution by T, P's basis in its T stock would be reduced, by the amount of the distributed sales proceeds, to 200. Finally, upon its sale of T, P would recognize 100 of gain. The aggregate amount of gain recognized by the S group would thus be 150 (50 more than in the prior two examples). However, the full 150 consolidated net capital loss carryover would be available to offset this gain. PS would have a full cost basis in both X1 and X2. In this example, the Investment Adjustment Election allowed the parties effectively to convert the loss carryover into an asset basis step up in assets X1 and X2, a result not currently sanctioned by either the Section 338 Consistency Rule or the Section 336(e) Consistency Rule.

The Investment Adjustment Election may thus result in the use of tax attributes to create tax basis step-up in the hands of the asset acquirer. Of course, the existing regimes allow parties to QSDs and QSPs to elect, on an "all-or-nothing" basis, whether P in the above example will make its attributes available to offset gain on the sale of S's assets. Indeed tax attributes are often the primary consideration in determining whether to make an election under Section 338(h)(10) or Section 336(e). Thus, if P in the above example has a consolidated net capital loss carryover in an amount sufficient to absorb all of the gain with respect to T's assets, a Section 338(h)(10) election or Section 336(e) election will likely be made. Conversely, where P's tax attributes are insufficient to shelter all of the gain on the sale of T's assets, P will be less likely to make a Section 338(h)(10) or Section 336(e) election. Tax planning is inherent in any tax election, and an important question presented here is whether there is any compelling tax policy, under the consistency regime or otherwise, to force an "all-or-nothing" outcome.

[28] The result would be the same under the Section 338 Consistency Rule if the sale of T were a QSP.

We do not believe that such a policy exists. Instead, we believe that the Investment Adjustment Election substantially mitigates the uncertainties discussed above, without in any way weakening General Utilities repeal. As noted above, the Consistency Rules, in their modern form, are concerned with avoiding corporate level tax through application of the investment adjustment regime. This is the case without regard to the seller group's attributes. Thus, we believe that the Investment Adjustment Election is a reasonable extension of the policy of Consistency Rules and an appropriate method of reducing uncertainties regarding the application of the Consistency Rules. However, if the Service were concerned with the availability of this type of planning, adopting the Related Party Limitation with the Investment Adjustment Election would serve as a substantial mitigant to that issue.

We appreciate your consideration of our recommendations.

Respectfully submitted,

David H. Schnabel
Chair

Attachment

cc: Alison Burns
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