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INTERNAL REVENUE SERVICE
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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
Attorney

FROM: JASPER L CUMMINGS
Assistant Chief Counsel

SUBJECT: Section 338 election.

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LEGEND

Area1 =

Parent =

Month1	=
CorpA	=
CorpB	=
CorpC	=
CorpD	=
PartE	=
CorpF	= .
CorpG	=
CorpH	=
CorpI	=
A	=
B	=
C	=
Date1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Year 1	=
Year 2	=
Year 3	=
business 1	=
#a	=
#b	=
#c	=
#d	=
#e	=
#f	=

#g	=
#h	=
#i	=
#j	=
#k	=
#l	=
#m	=
#n	=
#o	=
#p	=

ISSUES

(1) Was CorpH's election to treat the purchase of the stock of CorpB, and its wholly owned subsidiary CorpC, as an asset acquisition, valid under I.R.C. § 338.

(2) Whether any gain realized by CorpB on the sale of CorpC stock is foreign base company income under I.R.C. § 954.

(3) Whether CorpF's income should be increased under I.R.C. § 951, to reflect any additional subpart F income realized by CorpB on the sale of the CorpC stock.

CONCLUSIONS

(1) CorpH's election to treat the purchase of the stock of CorpB, and its wholly owned subsidiary, CorpC, as an asset acquisition, is valid under I.R.C. § 338, because CorpH was the purchaser of stock of CorpB.

(2) CorpB will have foreign base company income to the extent of any gain realized by CorpB on the sale of CorpC stock.

(3) To the extent CorpB realizes gain on the sale of CorpC stock, CorpF's income should be increased under I.R.C. § 951, to reflect that additional subpart F income realized by CorpB on the sale of the CorpC stock.

FACTS

During the years under examination, CorpA was the U.S. holding company and a common parent for a group of U.S subsidiaries. CorpA was a third tier subsidiary of CorpD, an Area1 corporation which was also the parent of a group of Area1 corporations.

The Parent group decided to acquire a Area1 corporation, CorpB, and its sole subsidiary, an Area1corporation, CorpC. The stock of CorpC was the only significant asset of CorpB.

CorpC's principal assets were intangible assets which, while valuable, had minimal book value. CorpC was in the business of selling A in B. Its most valuable assets were its contracts with the B and C.

Formation of PartE

PartE was formed on Date 1. PartE was a partnership for U.S. tax purposes and a corporation for Area1 tax purposes. PartE had two partner shareholders, CorpF, a U.S. corporation and subsidiary of CorpA, and CorpG, an Area1 corporation, and subsidiary of CorpD.

Formation of CorpH

On Date 2, PartE formed CorpH as an Area1 corporation for the purpose of acquiring CorpB. Using a capital contribution and a loan in the amount of #a million from PartE, CorpH acquired all of the stock of CorpB on Date 3, for a headline price before adjustments of #b. CorpB's only asset of value was CorpC.

It was stated in PartE's board minutes, that it was intended that CorpH would transfer ownership of the shares of CorpC to PartE, and that the purpose of this transaction was to acquire the CorpC stock.

The Section 338 election

Under I.R.C. § 338(d), the term "qualified stock purchase" means any transaction or series of transactions in which stock (meeting the requirements of section 1504(a)(2)) of 1 corporation is acquired by another corporation by purchase during the 12 month acquisition period. Under I.R.C. § 338(a), if a purchasing corporation makes an election, then in the case of any qualified stock purchase, the target corporation shall be treated as (1) having sold all its assets at the close of the acquisition date at the fair market value in a single transaction, and (2) shall be treated as a new corporation which purchased all of the assets referred to in (1), as of the beginning of the day after the acquisition date. Under I.R.C. § 338(b), the assets of target corporation shall be treated as purchased for an amount equal to the sum of the grossed up basis of the purchasing corporation's recently purchased stock and the basis of the purchasing corporation's nonrecently purchased stock. In essence all the assets of the target corporation would have a stepped up basis. The net effect of a section 338 election is that the purchasing corporation obtains a basis in target assets that generally reflects the price it paid for the stock. In addition, if the purchasing corporation wants I.R.C. § 338 treatment for the target and each of its affiliates, the purchasing corporation must make a separate election for the target and each of its affiliates. Treas. Reg. 1.338-4T(h)(8) example 1.

When CorpH purchased all of the CorpB stock, it made a qualified purchase of that stock under I.R.C. § 338(d). CorpH made an I.R.C. § 338 election for CorpB and for its wholly owned subsidiary CorpC. CorpB and CorpC as targets, each would be treated as selling their respective assets to themselves under I.R.C. § 338(a). Therefore, the assets of CorpC and CorpB would have a stepped up basis.

CorpB's pre acquisition basis in its assets was approximately #c. Following the section 338 election, CorpH reported a stepped up basis of #d for CorpB assets. (consideration paid plus liabilities assumed less cash) That amount was allocated entirely to class III assets and consisted of #e for the value of the CorpC stock and #f for a tax refund receivable.

<u>PartE's acquisition of CorpC.</u>

As planned on Date 4, #g days after the acquisition of CorpB, CorpB sold all of the stock of CorpC to PartE, for #h. As a result of the section 338 election, PartE acquired CorpC stock with a stepped up basis of #e million. On that same day, CorpB made two loans from the sales proceeds of CorpC; a #i #j demand loan to CorpH, (which was used by CorpH to repay its loan from PartE) and a #i #k loan payable Date 6, to CorpI, a subsidiary of CorpD. The CorpH loan was mostly eliminated in Month1 of Year 1 when CorpB made a deemed distribution of #l to CorpH, which was then deemed paid back to CorpB as a payment of the loan. The distribution was treated by CorpH as a return of capital. To pay off the balance of the loan and the accrued interest, CorpH borrowed #m from CorpD at #p on Date 5.

CorpH was not liquidated after the sale of CorpC. It was still in existence in Year 3. Following the sale of CorpC to PartE, CorpH's only asset was the stock of CorpB. It had no employees and conducted no business. Its total expenses for each of the years Year 1, Year 2, and Year 3 was under #n. Its address was the address of CorpD. The Forms 5471 filed for CorpH lists its principal business activity as "business 1." Except for a minor amount of cash, however, the only investment CorpH owned was the stock of CorpB.

<u>Law and Analysis-Issue(1) I.R.C. § 338</u>

<u>Law</u>

I.R.C. § 338 election provides that, if a corporation ("target") is acquired by another corporation ("Purchasing corporation") in a qualified stock purchase, the purchasing corporation may elect (or may be deemed to elect under certain consistency rules) to have the target treated as if it (1) sold all its assets (as "old target") at fair market value at the close of the day on which the qualified stock purchase occurred ("acquisition date") and (2) purchased those assets as a new corporation ("new target") at the beginning of the following day, for an amount generally equal to the price paid by the purchasing corporation for target stock plus liabilities of target and other relevant items. I.R.C. § 338(a) and (b). The net effect of a section 338 election is that the purchasing corporation obtains a basis in target assets that generally reflects the price it paid for target stock. If the purchasing corporation wants I.R.C. § 338 treatment for the target and each of its affiliates, the purchasing corporation must make a separate election for the target and each of its affiliates. Treas. Reg. 1.338-4T(h)(8) example 1. In this situation, the target and each of its affiliates will be deemed to sell their assets to themselves, so that the purchasing corporation will obtain a basis in the target and affiliate assets equal to the price paid for the target stock.

An I.R.C. § 338 election is only available with respect to a transaction where the acquiring entity is a corporation. I.R.C. § 338(d). Even if a corporation is used for the acquisition, it will not be considered for tax purposes to have purchased the target stock if such corporation is not the purchaser. Treas. Reg. § 1.338-3T(b) provides:

> *Rules Relating to qualified stock purchases-(1) Purchasing corporation requirement.* An individual cannot make a qualified stock purchase of target. I.R.C. § 338(d)(3) requires, as a condition of a qualified stock purchase, that a corporation purchase the stock of target. If an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include, new P's merging downstream into target, liquidating or otherwise disposing of the target stock following the purported stock purchase.

Analysis- Issue-1- I.R.C. § 338

Area Associate Counsel has made the argument that CorpH was not the real purchaser of the CorpB stock. Area Associate Counsel argues that PartE (a partnership) was the real purchaser of the CorpB stock, and that the existence of CorpH, as a purchaser of CorpB stock, should be ignored. Therefore, because PartE was a partnership, it could not make a valid I.R.C. § 338 election. Therefore, the assets of CorpB, which include the CorpC stock, should not be given a stepped up basis at the time PartE is deemed to have purchased the CorpB stock. (When the CorpC stock is later sold by CorpB to PartE, CorpB will thus recognize a larger gain on the sale of that stock to PartE.) Area Associate Counsel has proposed various arguments that would treat PartE as the real purchaser of the CorpB stock, and ignore CorpH as the purchaser of the CorpB stock. We will now comment on these arguments.

A. Moline properties

You argue that CorpH was a sham entity and should be disregarded for tax purposes, and based thereon, contend that PartE, rather than CorpH was the true purchaser of CorpB.

Courts sometimes will ignore the existence of a corporation calling it a "straw," "dummy." A court will not disregard a corporation as a sham if it has a business purpose or any business activity. Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 438-439 (1943). In Moline, the Court explained, that if the purpose of incorporating is to gain an advantage under the law of the state of incorporation or to avoid or comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. Only minimal business activities are needed in order to comply with Moline. However, if the corporation owns no assets and does not in fact carry on any business, it can be ignored under Moline.

In your memo, you contend that since CorpH had very few assets and conducted almost no business activities, therefore, it was a sham corporation and should be disregarded as an entity. However, CorpH held and continued to hold the stock of CorpB. The fact that CorpH is a holding company, should satisfy the Moline business activity requirement. (Holding companies must perform various business administrative duties.) Further, the requirement of a business activity under Moline is minimal. In addition, all that is required under Moline is the holding of a minimal amount of assets by the corporate entity. CorpH had a minimal amount of assets. Therefore, it appears that under Moline, the existence of CorpH should be respected as well as CorpH's I.R.C. § 338 purchase of CorpB stock.

B. Treas. Reg. § 1.338-3T(b)

In your memo you assert that Treas. Reg. § 1.338-3T(b) can be applied to disregard CorpH's qualified stock purchase of CorpB, and treat PartE as purchasing the stock of CorpB.

Treas. Reg. § 1.338-3T(b) provides that if an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include, new P's merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase. In the instant case, CorpH, did not merge downstream into CorpB, the target, nor did CorpH liquidate into PartE. In addition, CorpH still holds the CorpB stock. Thus, CorpH was not a transitory corporation. Therefore, Treas. Reg. 1.338-3T(b) will not apply to disregard CorpH's qualified stock purchase of CorpB.

C. Step transaction doctrine

You argue that by application of the step transaction doctrine PartE purchased the CorpB stock.

The step transaction doctrine is employed to ascertain whether the separate identity of several transactions will be respected, or whether several transactions will be considered as elements of a single transaction. The step transaction doctrine may be applicable whenever 2 or more purported transactions, independent in form, are deemed to be so dependent upon each other in substance, that they are viewed as elements of one transaction.

The Courts have articulated certain tests to determine whether to apply the step transaction doctrine. One of these tests is the end result test. Under this test, ostensibly separate transactions are amalgamated when it appears they were really component steps of a single transaction, and that each of the steps was intended to be taken for the purpose of reaching a specific end result. Culligan Water Conditioning of Tri-Cities. v. U.S., 567 F.2d 867 (9th Cir. 1978)

The courts are seldom rigid in applying the end result test. Although there is no single set of factors that determine whether the step transaction doctrine should be applied, the courts generally look to the intent of the parties and the time interval between the transfers.

Even, if it is found that a transaction is part of an overall plan, the step transaction doctrine will usually not create additional steps that never occurred. For example, in Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988). Mobil Oil Corporation ("Mobil") acquired, pursuant to a public tender offer, over 50 percent of the shares of Esmark, Inc. ("Esmark") so that Esmark would redeem Mobil's Esmark shares using the stock of Vickers, a holding company owning the stock of certain petroleum corporations that Mobil wanted. The court, in rejecting the I.R.S.' argument that the transaction should be recharacterized as a sale of Vickers by Esmark and a redemption of Esmark stock from its shareholders, held that the step transaction doctrine does not apply, since the I.R.S. did not simply combine steps, but rather, created new ones.

In your memo, you state that the purchase of CorpB stock by CorpH should not be respected. In your memo, you indicate that the substance of the transaction was the purchase of CorpB stock by PartE, a partnership, and that furthermore, CorpH was injected into the transaction, solely for the purpose of acquiring CorpB and CorpC in a I.R.C. § 338 transaction.

In the instant case, if the purchase by CorpH of CorpB stock followed by the sale by CorpB of CorpC stock to PartE were to be recharacterized, any recharacterization of this transaction, would have to account for all steps taken in form. The purchase by CorpH of CorpB stock, and the sale by CorpB of CorpC stock to PartE would be recharacterized as a purchase of CorpB stock by PartE, followed by the sale of CorpC stock by CorpB to PartE, followed by a drop down of the CorpB stock from PartE to CorpH.

Even though the purchase of CorpB stock by CorpH, was part of an overall plan to allow PartE indirectly to acquire the CorpB stock, the Service should not apply the end result test of the step transaction doctrine to this transaction. The Service should not recharacterize a transaction if its recharacterization will require more steps than what took place under the form of the transaction. Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988).

In the instant case, the form of the transaction requires two steps. The recast of this transaction requires three steps. Therefore, the form of this transaction should be respected, and CorpH should be treated as the purchaser of the CorpB stock in a qualified stock purchase for purposes of I.R.C. § 338.

(D) Revenue Ruling 90-95

In your memo, you state that Revenue Ruling 90-95 is analogous to the instant case. You assert the reasoning of Revenue Ruling 90-95 (where the step transaction doctrine was applied to disregard the existence of a merging corporation for federal income tax purposes) can be applied to disregard CorpH, and therefore disregard its qualified stock purchase of CorpB.

In Revenue Ruling 90-95, 1990-2 CB 67, P a domestic corporation, formed a wholly owned domestic subsidiary corporation, S, for the sole purpose of acquiring all of the stock of an unrelated domestic target corporation, T, by means of a reverse subsidiary cash merger. Prior to the merger, S conducted no activities other than those required for the merger. Pursuant to the plan of merger, S merged into T with T surviving, and the shareholders of T exchanged all of their T stock for cash from S. P then liquidated T. Part of the cash used to carry out the acquisition was received by S from P; the remaining cash was borrowed by S. Following the merger, P owned all of the outstanding T stock. An issue in the ruling was whether P is treated on the occurrence of the merger, as having acquired the stock of T in a qualified stock purchase under I.R.C. § 338, even though P liquidated T immediately after S merged into T. The ruling holds that the step-transaction doctrine applies to disregard the existence of S for federal income tax purposes. S it noted, was formed solely to enable P to acquire the T stock, and it did not conduct any activities that were not related to that acquisition. Accordingly, the ruling found that the transaction is treated as a qualified stock purchase by P of T stock.

In Revenue Ruling 90-95, the step transaction was applied to disregard the existence of a merging corporation for federal income tax purposes. In the instant case you wish to apply the step transaction doctrine to disregard the existence of a purchasing corporation, and therefore disregard its qualified purchase of a target.

However, In Revenue Ruling 90-95, S, the company that was disregarded for tax purposes, did not make a qualified stock purchase, rather S merged out of existence. In the instant case, CorpH, the company you wish to disregard, made a purported qualified stock purchase. In addition, in Revenue Ruling 90-95, there is no question that S, the company that was disregarded, went out of existence. S merged out of existence per the facts. In the instant case, per the form of the transaction, CorpH did not go out of existence. Therefore the threshold issue in the instant case is whether or not CorpH can be disregarded as a purchaser, even though in form, it remains in existence.

In the instant case, the facts indicate that PartE did form CorpH for the purpose of allowing CorpH to acquire CorpB, and to make an I.R.C. § 338 stock purchase. However, Revenue Ruling 90-95, 1990-2 CB 67, based its conclusion on the fact that S was a transitory corporation, which conducted no activities other than those required for its merger into T. S was in existence for only a short period of time, before it merged out of existence into T. S was a “borne to die” corporation. Yet, CorpH remains in existence, and is a viable corporation holding CorpB stock. Based on these differences, Revenue Ruling 90-95, 1990-2 CB 67, cannot be applied to disregard CorpH. Thus, CorpH's purchase of CorpB should be respected.

Summary

Area Associate Counsel has proposed various arguments, which are mentioned above, which would treat PartE as the real purchaser of the CorpB stock, and ignore CorpH as the purchaser of the CorpB stock. As mentioned above, these arguments should be rejected. We thus conclude that CorpH should be respected as the purchaser of the CorpB stock.

Law and Analysis-Issue-2- Foreign base company income

We have determined that CorpH’s purchase of CorpB stock was a qualified purchase, and therefore, CorpH made a valid I.R.C. § 338(g) election with regard to the purchase of CorpB and CorpC.

Because CorpH's I.R.C. § 338 election is valid, CorpB will have a stepped up basis in the stock of CorpC, and CorpC will have a stepped up basis in its assets under I.R.C.§ 338(g). Consequently CorpB will have little if any recognized gain on the subsequent sale of the CorpC stock. To the extent CorpB recognizes gain on the upstream stock sale of CorpC stock to PartE, such gain would be personal holding company income under I.R.C.§ 954(c), which is foreign base company income under I.R.C. § 954(a).

Law and Analysis-Issue-3-Subpart F income

Because we conclude that CorpH's I.R.C. § 338 election is valid, CorpB will have a stepped up basis in the stock of CorpC, and CorpC will have a stepped up basis in its assets. Consequently, CorpB will have little, if any, recognized gain on the sale of the CorpC stock. To the extent CorpB recognizes gain on the upstream stock sale of CorpC stock to PartE, such gain would be personal holding company income under I.R.C.§ 954(c), which is foreign base company income under I.R.C.   § 954(a), which in turn is subpart F income under section I.R.C. § 952. Consequently, CorpF as a U.S. shareholder of CorpB, within the meaning of I.R.C. § 951, would have a subpart F inclusion.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Moline Properties

There is an argument that CorpH was a dummy corporation, and its existence should be ignored, because it conducted almost no business activities, had no employees and had very few assets. The only assets of CorpH consisted of stock of CorpB and cash received from a capital contribution from PartE. CorpH borrowed money from PartE to purchase the CorpB stock. When CorpB sold the CorpC stock to PartE, it loaned out part of the proceeds received from this sale to CorpH. CorpH used these loan proceeds to pay off its loan owed to PartE. CorpH appears to have had no ability to pay off its debt owed to CorpB. Therefore, the Service could argue that the existence of CorpH should be ignored as the purchaser of the CorpB stock. However, the taxpayer would argue that CorpH was a holding company for CorpB, and that its duties as a holding company constituted adequate business activity under Moline. In addition, CorpH has incurred minimal expenses as a holding company each year and has a small amount of assets. Taxpayer will argue, all that is required to satisfy Moline is a minimal amount of business activity and a minimal amount of assets, and that therefore, CorpH's corporate existence should be respected.

Hence, even though CorpH performed few business activities and had very few assets, its status as a corporation should be respected. Its business activities were that of a holding company. Holding companies perform various administrative functions, and therefore, CorpH's existence should be respected under Moline. CorpH should be respected as the purchaser of the CorpB stock.

Conduit theory

Treas. Reg. § 1.338-3T(b) provides that if an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered for tax purposes to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include, new P’s merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase. In the instant case CorpH did not merge down stream into CorpB nor did CorpH liquidate, nor did CorpH dispose of CorpB’s stock. However, other factors can be considered in determining whether a purchaser is considered for tax purposes to purchase the target stock. Other factors may include, what party negotiated the purchase of the target stock, which party’s funds were used to purchase the target stock. In the instant case, originally, PartE was going to purchase the CorpB stock. However, PartE was informed that they could not make a valid I.R.C. § 338(g) election because it was a partnership. CorpH was then created for the sole purpose of purchasing CorpB stock. PartE formed CorpH with its cash. Most of this cash was then used by CorpH to purchase CorpB. The issue arises as to whether CorpH was nothing more than a conduit for the purchase of CorpB stock by PartE. Even though in form, PartE did not purchase the CorpB stock, it appears to have originally negotiated for the purchase of CorpB stock. CorpH was formed, and shortly thereafter purchased the CorpB stock. CorpH never participated in the negotiations for the purchase of the CorpB stock, and never used any of its own money to purchase the CorpB stock. Therefore, it could be argued that CorpH, was nothing more than a conduit for the purchase of CorpB stock by PartE, and that PartE was the real purchaser of CorpB stock.

However, it is hard to argue that CorpH is a conduit, for the purchase of CorpB stock by PartE, when it ended up holding the CorpB stock and thereafter continued holding CorpB stock. The CorpB stock represents assets of CorpB of at least #o in cash calculated as follows: On Date 4, #g days after the acquisition of CorpB, CorpB sold all of the stock of CorpC to PartE, for #h. On that same day, CorpB made two loans from the sales proceeds of CorpC; a #i #j demand loan to CorpH, (which was used by CorpH to repay its loan from PartE) and a #i #k loan to CorpI, a subsidiary of CorpD., payable Date 6. This loan was paid off in full with cash. The CorpH loan was mostly eliminated in Month1 of Year 1 when CorpB made a deemed distribution of #l to CorpH, which was then deemed paid back to CorpB as a payment of the loan. The distribution was treated by CorpH as a return of capital. To pay off the balance of the loan and the accrued interest, CorpH borrowed #m from CorpD at #p on Date 5. Therefore, CorpB will hold #o in cash as of Date 6. This is a substantial amount of assets. Therefore, CorpH is still holding a company with a substantial amount of assets. This makes it difficult to argue that CorpH acted as a conduit.

In addition, if CorpH, is to be viewed as nothing more than a conduit for the purchase of CorpB stock by PartE, and PartE was the real purchaser of CorpB stock, then the form of the transaction will have to be recharacterized. The form of the transaction is a purchase of CorpB stock by CorpH, followed by the sale of CorpC stock by CorpB to PartE. The recast would be a purchase of CorpB stock by PartE, followed by the sale of CorpC stock by CorpB to PartE, followed by a drop down of the CorpB stock from PartE to CorpH. The recast would require three steps and the form of the transaction required only two steps. The taxpayer would argue that the Esmark holding precludes a recharacterization of the instant transaction, in that if the recharacterization requires as many steps or more steps as the form of the transaction, the form of the transaction should be respected. [redacted]

Policy

CorpH should be allowed to make the I.R.C. § 338 election with respect to its purchase of the CorpB stock. This transaction has been structured so as to abide by the rules of I.R.C. § 338: that the purchaser be a corporation. Treas. Reg. § 1.338-3T(b) contemplates that an individual or partnership can form a corporation to acquire target stock, and do so merely to satisfy the “purchasing corporation requirement” of section 338. By inserting CorpH into the transaction, the requirements of I.R.C § 338 will be met, that the purchaser of stock be a corporation, not an individual or partnership. In addition, CorpH still holds the CorpB stock it purchased from the shareholders of CorpB. After CorpH purchased the CorpB stock, there was no attempt by CorpH to liquidate or otherwise merge out of existence, nor did it attempt to sell CorpB stock.

Please call if you have any further questions.

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