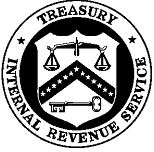

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR BENJAMIN A. DE LUNA
ASSOCIATE AREA COUNSEL CC:LM:RFP:JAX
Attn: Felicia L. Branch, Senior Attorney, LMSB

FROM: Gerald B. Fleming
Senior Technician Reviewer CC:CORP:2

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated May 7, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Purchaser =

Target =

X =

Partner1 =

Subsidiary1 =

Hybrid =

Exchange =

Date A =

Date B =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

ISSUES

1. Whether the adjusted grossed-up basis (AGUB) of the assets of Target was properly computed.

2. Whether the gain realized by Target upon an election pursuant to § 338 affects the earnings and profits of Target corporation.

3. Whether the reallocation of approximately $b among the Purchaser's affiliates is an unauthorized change in method of accounting.

4. Whether the 21-business day period used to determine the average trading price of the stock of Purchaser which ended 13-business days prior to the Annual Meeting was calculated correctly.

CONCLUSIONS

1. We do not agree with the Purchaser's calculation of AGUB. AGUB is determined by using a formula that is a function of the Purchaser's basis in recently purchased stock. Applying that formula to the facts in this case yields an AGUB of $c.

2. We agree that Old Target will recognize the gain or loss from the deemed sale of its assets to New Target and its tax year will end on Date A for U.S. federal income tax purposes. The resulting gain or loss on the deemed asset sale will increase or decrease Old Target's earnings and profits.

3. Having considered all the known facts, we agree that the reallocation of goodwill from Subsidiary1 to Hybrid is a change in method of accounting.

4. We have no opinion on this issue. Determination of the 21-business day period involves an interpretation of the contract between Target and Purchaser and, in light of our conclusion under Issue 1, does not directly affect the tax issues raised by your request.

FACTS

The information presented indicates that on Date A, Purchaser acquired a% of the outstanding stock of Target (a foreign corporation) and intellectual property.[1] Purchaser made an election on behalf of Target under § 338(g).[2] The consideration used for the acquisition was a combination of Purchaser's stock and cash. Purchaser's stock was exchanged with all Target shareholders except one

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[1]As part of the transaction Purchaser changed its name to X; references to Purchaser will also mean X where appropriate.

[2]All section references are to the Internal Revenue Code of 1986 (the Code) and Treasury Regulations as amended and in effect at the time of the transaction.

dissenting shareholder who received cash. Additional Purchaser's shares were exchanged for intellectual property. The contractually agreed upon purchase price for the Target stock was $c. The price agreed upon for the intellectual property was $i. It is unclear from the facts of the submission whether, prior to this transaction, Target conducted any U.S. business or had any U.S. investments or any direct or indirect U.S. shareholders.

Purchaser and Target agreed to an exchange ratio to determine the number of shares of Purchaser's stock to be issued in this transaction. The exchange was subject to a minimum and maximum exchange ratio. The average trading price (ATP) of Purchaser's stock was determined during a 21-business day period (average period). The average period ended 19-days before Date A. The exchange ratio calculation used the $c purchase price and the ATP to arrive at the number of shares to be issued to the selling shareholders and the party selling the intellectual property. During this period the ATP was $j per share.

Using $j per share resulted in the exchange ratio of k to 1. Purchaser valued the transaction for purposes of § 338 at $d, which is more than $c and includes the amount attributed to the intellectual property. The $d amount resulted from adding the cash outlay of $e (to the dissenting shareholder) to the value of Purchaser's stock exchanged in the transaction determined by using a share price of $f (the closing share price of Purchaser's stock on the Exchange on Date A). In calculating the value of stock it exchanged in the transaction, Purchaser included the shares exchanged for intellectual property.

On Date B, Target converted to a partnership (Hybrid)[3] for U.S. tax purposes while electing to remain a corporation for its foreign jurisdiction. In connection with the conversion, Partner1 acquired g% of Target, leaving Purchaser with h% of Target. After the conversion, Hybrid incurred losses in Year 2 and Year 3. In Year 4, Purchaser reallocated $b of Subsidiary1's goodwill to Hybrid.

LAW AND ANALYSIS

Issue 1

Section 338(a) provides that a purchasing corporation may elect to treat a qualified stock purchase of a target corporation as an asset purchase from the target. To accomplish this, § 338(a)(1) provides that the target corporation (old target) is treated as having sold all its assets at the close of the acquisition date at fair market value in a single transaction. Section 338(a)(2) provides that the target

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[3]Target changed its form to Hybrid on Date B. Target is referred to as Hybrid for periods on or after Date B.

corporation is subsequently treated as a new corporation (new target) which purchased all of the assets from old target at the beginning of the day after the acquisition date. Section 338(d)(3) defines a "qualified stock purchase" as any transaction in which stock (meeting the requirements of § 1504(a)(2))[4] of one corporation is acquired by another corporation by purchase during the 12-month acquisition period.[5] Section 338(h)(3) defines a "purchase" generally as any acquisition of stock but excludes acquisitions of stock in exchanges to which §§ 351, 354, 355, or 356 apply.

Under § 338(b)(1), the assets of the target are treated as purchased for an amount equal to the sum of (A) the grossed-up basis of the purchasing corporation's recently purchased stock (GUBRPS),[6] and (B) the basis of the purchasing corporation's nonrecently purchased stock (BNPS).[7] "Grossed-up basis" is defined in § 338(b)(4) as an amount equal to the basis of the corporation's recently purchased stock, multiplied by a fraction -- (A) the numerator of which is 100 percent minus the percentage of stock (by value) in target attributable to the purchasing corporation's nonrecently purchased stock (%NPS), and (B) the denominator of which is the percentage of stock (by value) in the target attributable to the purchasing corporation's recently purchased stock (%RPS).

Section 1012 provides, in general, that the basis of property shall be its cost. Section 1012, however, qualifies this general rule with the language "except as otherwise provided in this subchapter and subchapter C (relating to corporate distributions and adjustments)." Although § 338 is included in subchapter C, it does not prescribe any special rules for determining basis. For § 338 purposes, the "basis" of recently purchased stock is the cost basis under § 1012.

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[4]To meet the requirements of § 1504(a)(2), the purchaser must acquire stock possessing at least 80% of the total vote and 80% of the total value of target.

[5]"Acquisition period" is defined in § 338(h)(1) as the 12-month period beginning with the date of the first acquisition by purchase of stock included in a qualified stock purchase.

[6]GUBRPS is the product of (i) the basis of the recently purchased stock (BRPS) at the beginning of the day after the acquisition date, multiplied by (ii) a fraction, the numerator of which is 100 percent minus %NPS, and the denominator of which is the %RPS. Temp. Treas. Reg. § 1.338(b)-1T(d)(1) (1986).

[7]Basis of nonrecently purchased stock is generally the historic basis in the stock. Temp. Treas. Reg. § 1.338(b)-1T(e) (1986).

"Adjusted grossed-up basis (AGUB)" is defined in § 1.338(b)-1T(c) as the sum of (i) the GUBRPS, (ii) the BNPS, (iii) the liabilities of the target (L), and (iv) other relevant items (RI). Under § 1.338(b)-1T(f), liabilities of the target include its liabilities as of the beginning of the day after the acquisition date. Under § 1.388(b)-1T(c)(2), AGUB is determined at the beginning of the day after the acquisition date of the target.

The information provided indicates that on Date A, Purchaser acquired a% of Target's stock. The consideration used in this transaction was a combination of Purchaser's stock and cash. The purchase price of the Target stock negotiated by Purchaser and Target was $c. Additionally, Purchaser acquired intellectual property for $i in stock.

Although Purchaser included the amount paid for the intellectual property in its AGUB determination, the acquisition of the intellectual property is treated separately from the acquisition of Target stock. A qualified stock purchase, as defined in § 338(d)(3), is the purchase of stock only. Thus, the acquisition of other types of assets (such as the intellectual property) does not come within the definition of a qualified stock purchase. Therefore, Purchaser's acquisition of intellectual property was not part of the § 338 transaction, and the purchase price of the intellectual property is not included as a component of AGUB.

In order to determine the appropriate number of shares to be issued in the exchange, the parties agreed to use an exchange ratio. The exchange ratio was determined by (i) dividing the purchase price of $c by $i, the ATP of Purchaser's stock during the average period, and (ii) then dividing that amount by the total number of Target shares outstanding. Purchaser multiplied the number of shares issued in the transaction by the closing share price of $f on Date A, the date of the exchange, to value the transaction for § 338 purposes. The revenue agent assigned to this audit proposes to value the transaction using a value below $l per share. The revenue agent justifies this valuation because of certain restrictions imposed on the disposition of the stock that Purchaser exchanged for Target stock in this transaction.

We believe that Purchaser acquired the Target stock for the amount equal to the ATP times the number of outstanding shares of Target times the exchange ratio. That amount is $c, the purchase price that the parties agreed to. Subject to the minimum and maximum exchange ratios, if Purchaser's stock had risen after the ATP was established, it would not have affected the number of Purchaser's shares that the Target shareholders would receive. Likewise, if Purchaser's stock had declined in value, the Target shareholders would still have received the same number of Purchaser's shares, subject to the minimum and maximum exchange ratios. Accordingly, we believe that Purchaser's cost basis for the Target stock is $c.

In this case the AGUB is $c. This value excludes the amount paid for the intellectual property. Neither the amount using the $f per share price proposed by the Purchaser nor the amount using the less than $l per share price proposed by the revenue agent complies with the provisions of §§ 338 and 1012 and the regulations in effect at the time of this transaction. Under § 1.338(b)-1T(c), AGUB is the sum of several factors which results in the following equations:

$$\begin{aligned} GUBRPS &= BRPS((100\% - \%NPS) \div \%RPS) \\ &= \underline{c}\ ((100 - 0) \div \underline{a}) \\ &= \underline{c}\ (1) \\ &= \underline{c} \end{aligned}$$

$$\begin{aligned} AGUB &= (GUBRPS + BNPS + L + RI) \\ &= (\underline{c} + 0 + 0 + 0) \\ &= \underline{c} \end{aligned}$$

AGUB is determined at the beginning of the day after the acquisition of Target stock through the application of the formula described in § 1.338(b)-1T(c)(2), as demonstrated above. Section 1012 defines basis as the cost of the property. AGUB is a value that uses the basis in recently purchased and nonrecently purchased stock as a component of its total value. The values advocated by the revenue agent and Purchaser are not based on the agreed cost of the property and consequently do not represent the correct amount to be used in calculating AGUB.

Generally under § 1.338(b)-2T(b), AGUB is allocated among Target's assets. First, AGUB is allocated to Class I assets, which are cash, demand deposits, accounts in banks, and other similar assets. Next, AGUB is allocated to Class II assets, which are generally readily marketable stocks or securities. Then allocations are made to Class III assets, which are assets that are not Class I, II, or IV assets. Finally, the residual is allocated to Class IV assets, which are intangible assets such as goodwill and going concern value. Section 1.338(b)-2T(c) provides that the amount of AGUB allocated to each asset shall not exceed its fair market value.

We are concerned that Purchaser may not have correctly allocated the AGUB to the assets of Target. The information provided indicates that in Year 1 a portion of Target's goodwill was allocated to Subsidiary1 as well as other subsidiaries. Target's total amount of goodwill $m exceeds the AGUB value of $c. Assuming Target has subsidiaries with ownership meeting the requirements of § 1504(a)(2), then an express election for Target is a deemed election for Target's subsidiaries under § 338(f)(1). The AGUB must be allocated to the stock of the Target's subsidiaries in the manner described above. (The stock of Target's subsidiaries is a Class III asset for purposes of the allocation.) The fair market value of the stock of a Target subsidiary should include any goodwill and going

concern value attributable to that subsidiary. The regulations do not provide for a separate allocation of Target's goodwill to each of its subsidiaries. Although further examination may demonstrate that the amount allocated to goodwill for each subsidiary was appropriate, Purchaser's methodology appears to depart from the regulations.

Issue 2:

Section 338(a) provides that if a corporation makes a qualified stock purchase and makes an election under that section, then the target corporation (i) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value and (ii) shall be treated as a new corporation which purchased all of its assets as of the beginning of the day after the acquisition date. Section 338(d)(3) defines a qualified stock purchase as any transaction or series of transactions in which stock (meeting the requirements of § 1504(a)(2)) of one corporation is acquired by another corporation by purchase during a 12-month acquisition period.

As a result of Purchaser's acquisition of a% of Target stock and the § 338(g) election for Target, Old Target will recognize the gain or loss from the deemed sale of its assets to New Target and its tax year will end on Date A for U.S. federal income tax purposes. The resulting gain or loss on the deemed asset sale will increase or decrease Old Target's earnings and profits. However, New Target is treated as a new corporation (see § 338(a)(2)) and does not inherit Old Target's earnings and profits.

Section 1.338-5T(f) provides that if, for its tax year that includes its acquisition date and for any other relevant tax year, a foreign target for which a § 338 election is made has no items of income for which it is taxable under chapter 1 of the Code (including any item of income resulting from a § 338 election[8]), then, in general, the § 338 election results in potential U.S. tax consequences only for domestic shareholders of that foreign target. Thus, for example, the adjustment to the foreign target's earnings and profits that results from the § 338 election may affect the amount of a distribution that is treated as a dividend for the domestic shareholders. Similarly, if the foreign target corporation is a controlled foreign corporation, § 338 may affect the amount included in the gross income of certain

[8]For instance, Old Target may be subject to U.S. tax under Chapter 1 of the Code if the deemed sale of its assets under § 338 resulted in income effectively connected with a U.S. trade or business.

domestic shareholders under § 951 or § 1248.[9] Temp. Treas. Reg. § 1.338-5T(f). Additionally, special rules apply with respect to the foreign tax credit when a § 338 election is made. Section 338(h)(16) provides that, except as provided in regulations, § 338 does not apply for purposes of determining the source or character of any item for purposes of §§ 901-908 (relating to the foreign tax credit). However, the preceding sentence does not apply to any gain to the extent the gain is includible in gross income as a dividend under § 1248 (determined without regard to any deemed sale under § 338 by a foreign corporation). Consequently, § 338(h)(16) ignores a deemed asset sale for purposes of determining the source of an item and the § 904(d) separate category to which an item belongs.

An issue not addressed in your May 7, 2002 memorandum is Hybrid's status as a dual resident corporation. As of Date B, when Target became Hybrid, a partnership for U.S. purposes, it became a hybrid entity separate unit under § 1.1503-2(c)(4), an entity that is not taxable as an association for U.S. tax purposes but is taxed as a corporation for foreign tax purposes. A hybrid entity separate unit is a dual resident corporation under § 1.1503-2(c)(2). Unless agreements under § 1.1503-2(g)(2)(i) were filed for the losses incurred in Year 2 and Year 3 tax years, in which Purchaser agreed not to use the losses against the income of another person under foreign law or, if so, to recapture the losses, plus interest, for U.S. purposes, the losses incurred by Hybrid during Year 2 and Year 3 could not be used against the income of Purchaser in any year, or a consolidated group of which it was a member. However, the losses could be used against Hybrid's income in other years.

Issue 3:

The Office of the Associate Chief Counsel (Income Tax and Accounting) reviewed this issue. Their review agreed with the analysis and conclusion of the issue as submitted. Accordingly, the Year 4 reallocation of goodwill from Subsidiary1 to Hybrid is a change in method of accounting.

Issue 4:

Purchaser and Target agreed to use an ATP during an average period to determine the number of shares to be issued by Purchaser to Target in this transaction. The revenue agent has raised a question whether the parties used the correct beginning and ending dates for the average period. We express no opinion on this issue. Any dispute among the affected parties (i.e., Purchaser and Target

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[9]There may be additional U.S. federal income tax consequences if the foreign target was a foreign personal holding company or a passive foreign investment company.

shareholders) concerning the average period would be one for them to resolve under the terms of their contract and the application of general contract principles. In any event, a change in the average period would affect only the ATP and the exchange ratio used to determine the number of Purchaser's shares to be exchanged in the transaction. In light of our discussion and conclusion under Issue 1, however, a change in the average period would not alter the determination that AGUB is $c in this case.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call (202) 622-7770 if you have any further questions.

Sincerely,
William D. Alexander
Acting Associate Chief Counsel (Corporate)

By: Gerald B. Fleming
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