Office of Chief Counsel
Internal Revenue Service
memorandum

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

Legend

Parent =

Sub =

Target =

Year 1 =

Year 2 =

xx =

yy =

ISSUE

Whether a taxpayer, in the absence of final regulations under §336(e), can make an election under §336(e) of the Internal Revenue Code to disregard the intragroup distribution of a subsidiary and instead treat the transaction as a sale of the subsidiary's underlying assets.

CONCLUSION

No, absent the issuance of final regulations, a taxpayer may not make an election under §336(e).

FACTS

Parent was the common parent of an affiliated group of corporations, including Sub and Target, which filed a U.S. consolidated Federal income tax return. During Year 1, Sub, a wholly-owned subsidiary of Parent, distributed all of the stock of Target to Parent. Parent treated the stock distribution as a taxable stock distribution under §301 in which Sub recognized gain of approximately $xx under §311(b) that was deferred under §1.1502-13 of the Income Tax Regulations.

During Year 2 (a time approximately 4 years after Year 1) Parent sold all of its Sub stock to an unrelated purchaser and reported a capital loss from the sale on its consolidated return. Upon examination of Parent Group's consolidated income tax return, the examination team proposed increasing the §311(b) gain from $xx to $yy. In response, Parent filed an affirmative claim, alleging that the Year 1 distribution actually qualified as a tax-free spin-off under §355 rather than a taxable distribution of Target. The examination team has proposed to deny §355 treatment. Parent now proposes to file an amended tax return for Year 2 and make a §336(e) election with respect to the distribution of Target stock which occurred in Year 1.

LAW AND ANALYSIS

Section 336(e) was, enacted by the Tax Reform Act of 1986, P.L. 99-514, sec. 631(a), 100 Stat. 2085, 2270-71 (1986), and provides that

> Under regulations prescribed by the Secretary, if—
>
> (1) a corporation owns stock in another corporation meeting the requirements of section 1504(a)(2), and
>
> (2) such corporation sells, exchanges, or distributes all of such stock,

> an election may be made to treat such sale, exchange, or distribution as a disposition of all of the assets of such other corporation, and no gain or loss shall be recognized on the sale, exchange, or distribution of such stock.

The legislative history to §336(e) in part, states that,

> [U]nder regulations, principles similar to those of section 338(h)(10) may be applied to taxable sales or distributions of controlled corporation stock. The conferees intend that the regulations under this elective procedure will account for appropriate principles that underlie the liquidation-reincorporation doctrine. For example, to the extent that regulations make available an election to treat a stock transfer of controlled corporation stock to persons related to such corporation within the meaning of section 368(c)(2), it may be appropriate to provide special rules for such corporation's section 381(c) tax attributes so that net operating losses may not be used to offset liquidation gains, earnings and profits may not be manipulated, or accounting methods may not be changed.

See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., Vol. II at 204 (1986).

On August 22, 2008, the Internal Revenue Service and the Treasury Department issued proposed regulations under §336(e). The proposed regulations, and the preamble to the proposed regulations, make clear that the regulations are prospective in nature and §336(e) elections will only be permissible for stock dispositions occurring on or after the date final regulations are published. The proposed regulations use only a portion of the broad statutory grant of authority. See Proposed §§1.336-1(b)(4)(C), 1.336-1(b)(11), and 1.336-5. The preamble also states that the proposed regulations, when finalized, will provide the requirements and mechanics for, and consequences of, treating a stock sale, exchange, or distribution as a deemed asset disposition and that absent the issuance of further guidance, these regulations would provide the exclusive means of making elections under §336(e).

Where the Code grants the Service regulatory authority, and the Service has not issued regulations, the courts have frequently determined whether or not courts can apply rules which carry out the legislative intent. See e.g., *Occidental Petroleum Corp. v. Comm.*, 82 T.C. 819 (1984), and *Estate of Neumann v. Comm.*, 106 T.C. 216 (1996). In *Neumann*, Judge Tannenwald draws a distinction between a "how" regulation and a "whether" regulation. See *Neumann* at 219. A statute is self-executing if the regulation referred to in the statute is to deal with "how" to apply the statute. A regulation is self-executing when Congress states what a particular rule is to provide and articulates the overall purpose behind a given section in the legislative history, but leaves the mechanics or details affecting the application of the statute to the Secretary. In such instance, the promulgation of a regulation only constitutes a means of arriving at "how" that tax, otherwise imposed by statute, should be determined.

A regulation is not self-executing, however, if a “whether” regulation is required. That is, the promulgation of the regulation is a necessary condition to determining “whether” the statute applies in the first instance. For non self-executing statutes, the statute manifests the intent of Congress to require such regulations as a condition to the imposition of relevant statute.

There are no magic words in a statute which differentiate between a “how” regulation and a “whether” regulation. While often a “how” regulation provides that “the Secretary shall prescribe regulations” or “under regulations prescribed by the Secretary” (see e.g., *International Multifoods Corp.* & *Cos. v. Comm.*, 108 T.C. 579 (1997), and *Occidental Petroleum*) and a “whether” regulation may provide “only to the extent provided in regulations” (see e.g., *Alexander v. Comm.*, 95 T.C. 467 (1990), affd. without published opinion sub nom *Stell v. Comm.*, 999 F.2d 544 (9th Cir 1993)), neither phrase is determinative as to whether a statute is self-executing or not. Analysis of the legislative history to the provision is the only way to determine whether a statute is self-executing.

As the proposed §336(e) regulations and the preamble to the regulations provide, §336(e) is not self-executing. Section 336(e) provides that under regulations prescribed by the Secretary, an election may be made in certain circumstances to treat the sale, exchange, or distribution of the stock of a corporation as a sale of that corporation’s underlying assets. This language is extremely broad. How far, if anywhere, did Congress intend these regulations to go? Any taxable transaction in which 80 percent of the stock of a corporation is disposed of? Only transactions in which 80 percent or more of the stock is sold or distributed to one person? What about transactions in which 50 percent of the stock is sold and 50 percent is distributed? What about transactions in which some of the stock of the target corporation is retained? And what about tax-free reorganizations? Should regulations be applicable to tax-free reorganizations, thus making §368 elective? As clearly demonstrated above, the number of issues to be considered is enormous. No specific guidelines on how to implement the election or the specific overall goals of the section are provided in the legislative history. The legislative history does instruct that if §336(e) regulations are promulgated, they may apply principles similar to those of §338(h)(10) and that special rules may be appropriate for stock transfers of controlled corporation stock to persons related to the transferring corporation. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., Vol. II at 204 (1986). But Congress recognized that the number of issues involved was huge. Congress authorized regulations if the Secretary determined that such regulations would help carry out the purposes of subchapter C, but in no way did Congress mandate them. Therefore, the promulgation of regulations under §336(e) is needed to carry out the election.

Taking a giant leap, let’s assume that Congress did intend that the Secretary issue regulations to address some transactions in which a corporation disposes of the stock of an 80 percent owned subsidiary, i.e., that in some instances §336(e) is self-executing. There is additional authority to conclude that distributions occurring between related

parties should not be permitted. As mentioned above, the legislative history to §336(e) specifically mentions that transfers to related parties, to the extent permitted to qualify for the election, pose special problems and should be subject to special rules. Furthermore, if the legislative history to §336(e) is followed and one looks to the principles involving a §338(h)(10) election, transactions between related parties (as defined in §338(h)(3)) are not purchases for purposes of §338, and therefore ineligible for the §338(h)(10) election. Again, although Congress did authorize the Secretary to issue regulations on transactions with related parties if the Secretary thought them appropriate, in no way did Congress mandate them.

Lastly, assuming arguendo, that §336(e) is self-executing, case law provides that in implementing a self-executing statute, courts must apply what they believe was Congressional intent. The courts must do "the best we can" with the statutory provisions. *Occidental* at 829; *International Multifoods* at 587 (quoting *Occidental*). See also *American Standard, Inc. v. U.S.*, 602 F.2d 256 (1979), in which the Court of Claims held a portion of §1.1502-25 to be invalid and allowed the taxpayer to use a different method which the court found to be a reasonable method. Effectively, after a portion of §1.1502-25 was found to be invalid, the tax law was left in the same position as with a self-executing statute.

In the instant case, Parent wants to make an election over five years after the date of the transaction. We believe that so doing cannot be within Congressional intent and cannot be considered reasonable.

The legislative history to §336(e) provides that any regulations that are promulgated under the provision may use principles similar to those in §338(h)(10). Elections under §338(h)(10) must be made no later than the 15th day of the ninth month after the month in which the subject transaction took place. Section 338(g)(1) and §1.338(h)(10)-1(c)(3). We see nothing to suggest that Congress intended that any election to be authorized by regulations under §336(e) be available years after the transaction took place.

To further illustrate why an election under §336(e), if one were available prior to the promulgation of regulations, cannot be made on an amended return years after the date of the transaction, one must look at other elections within the Code and regulations. The Code and regulations provide for a large number of elections, all or most of which must be filed with a timely filed return, all or most of which are irrevocable or are only revocable with the consent of the Commissioner, and all of which apply only for the current or future years, unless the Code or regulations specifically provide for retroactive application. The rationale for the above requirements is to prevent a taxpayer from using hindsight in making an election, unless Congress or the Secretary specifically authorizes such hindsight. "Once a taxpayer makes an election of one of two or more alternative methods of reporting income, he should not be permitted to convert, of his own volition, when it later becomes evident that he has not chosen the most advantageous method." *Mamula v. Comm.*, 346 F.2d 1016, 1018 (9th Cir. 1965).

Elections are intended to allow taxpayers to determine which course of action to take based on their current situation or their projected situation. If a taxpayer was allowed to make an election after the due date of its return, or to unilaterally revoke an election, this would allow taxpayers the use of hindsight to retroactively reduce their tax liability, to the prejudice of the government. *Cf.* §301.9100-3, under which, upon the showing of good cause, the Commissioner may grant time beyond the regulatorily provided due date for an election, provided, among other requirements, the taxpayer demonstrates that it is not using hindsight in requesting relief.

Parent cites the case of *Grynberg v. Comm.*, 83 T.C. 255 (1984), as authority for making an election on an amended return. However, we find that *Grynberg* provides no support for Parent's argument, but, to the contrary, provides authority for why an election should not be permitted on an amended return. *Grynberg* cites *Goldstone v. Comm.*, 65 T.C. 113, 116 (1975), which provides three fact patterns in which elections are allowed in amended returns. Those fact patterns are (a) the amended return was filed prior to the due date of the original return, (b) the taxpayer's treatment of the item on the amended return is not inconsistent with treatment of the item on the original return, and (c) the taxpayer's original return with respect to the item was improper. None of those three situations exist here. First, the amended return will be filed well beyond the due date of the original return. Second, the election would provide for a sale of the assets of Target, not a stock distribution, which is entirely inconsistent with the treatment of the transaction on Parent's original return. Third, treating the stock distribution as such on its original return (whether it is a §355 distribution or a §301 distribution) rather than disregarding the distribution and treating the transaction as an asset sale by Target is not improper. In fact, since we believe there is no such thing as a §336(e) election prior to the promulgation of regulations authorizing such election, treating the stock distribution on its original return as such was and is the only proper treatment.

Additional authority against Parent being able to make an election on an amended return is the Supreme Court case *Pacific National Co. v. Welch*, 304 U.S. 191 (1938). In that case, the taxpayer reported the sales of lots on its 1928 tax return under one of two permissible methods of reporting, the "deferred payment method", rather than under the other permissible method, the "installment method." In 1931, the taxpayer filed a claim for refund, attempting to have its profit from the sales of lots reported under the installment method. The District Court held that the taxpayer reported income under a permissible method "and thereby made an election which became binding on the expiration of the time allowed for filing the return" and did not allow the taxpayer to switch its method, finding for the Government. The Court of Appeals affirmed, *Pacific Nat. Co. v. Welch*, 91 F.2d 590 (9th Cir. 1937). Because of a conflict between the 9th Circuit's opinion and that of the Court of Claims in *United States v. Kaplan*, 8 F. Supp. 965 (Ct. Cl. 1937), the Supreme Court granted certiorari. 302 U.S. 679.

On certiorari, the Supreme Court affirmed the 9th Circuit in *Pacific National Co.* and reversed the Court of Claims in *Kaplan*. The Court held that by reporting income on its 1928 return according to the deferred payment method, the taxpayer made an election which was binding upon it and the Commissioner. The Court also stated "Change from one method to the other, as petitioner seeks, would require recomputation and readjustment of tax liability for subsequent years and impose burdensome uncertainties upon the administration of the revenue laws. It would operate to enlarge the statutory period for filing returns….There is nothing to suggest that Congress intended to permit a taxpayer, after expiration of the time within which return is to be made, to have his tax liability computed and settled according to the other method." *Pacific Nat. Co.* at 194.

The rationale of *Pacific National* is on all fours with the facts of this case. Assuming that a §336(e) election is available absent the issuance of regulations, such election most likely would have been due no later than the due date of the Parent Group's income tax return, with extensions, or perhaps even earlier. However, by reporting its transaction as a stock distribution on its income tax return, taxpayer made a binding election not to treat the transaction as an asset sale. Allowing recomputation and readjustment of Parent Group's tax liability years after the original election would impose burdensome uncertainties on the administration of the revenue laws.

In conclusion, we believe that no §336(e) election is available prior to the issuance of regulations allowing such election, because §336(e) is not self executing. Further, even if §336(e) was self-executing in part, it would not be self-executing with respect to an intragroup distribution of stock. Lastly, even if §336(e) was self-executing with respect to an intragroup distribution of stock, allowing an election years after the date of the subject transaction would be a clear invitation to the use of hindsight, without clear Congressional intent to allow the use of hindsight, would not be a reasonable application of the statute, and would impose burdensome uncertainties on the administration of the revenue laws and therefore would not be a valid election.

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If you have any further questions please contact Mark Weiss at (202) 622-7750 or Ken Cohen at (202) 622-7790.

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