OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

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MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: VALID I.R.C. § 338(h)(10) ELECTION

This Field Service Advice responds to your memorandum dated December 18, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Company X =

Old Target Company =

New Target Company =

Company B =

Company C =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Date 11 =

Date 12 =

Day B =

Day C =

Month 1 =

Month 2 =

Month 3 =

Month 4 =

BBB =

Schedule B =

b% =

c% =

d% =

#b =

#c =

#d =

Shareholder B =

Shareholder C =

Preparer G =

CCC =

State C =

State E =

State G =

State H =

City D =

$b =

$c =

$d =

$e =

$f =

$g =

$h =

$j =

$k =

$m =

$n =

$p =

$q	=
$r	=
$s	=
$t	=
$u	=
$v	=
$w	=
$x	=
$y	=
$z	=
$bb	=
$cc	=

ISSUE(S):

1. Whether Company X and the shareholders of Old Target Company made a valid joint election under I.R.C. § 338(h)(10)[1] and Treas. Reg. § 1.338(h)(10)-1(d)(2) regarding Company X's Year 2 stock acquisition of Old Target Company.

2. Whether the Old Target Company properly made a retroactive election under I.R.C. § 338(i) and Treas. Reg. § 1.338(i)-1 to apply the provisions of I.R.C. § 338(h)(10).

3. If Company X and Old Target Company's shareholders did not make a valid joint election under I.R.C. § 338(h)(10) and Old Target Company did not make a valid retroactive election to apply the provisions of I.R.C. § 338(h)(10) as required by I.R.C. § 338(i), whether they substantially complied with the provisions of Treas. Reg. §§ 1.338(h)(10)-1(d)(2) and 1.338(i)-1.

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[1]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

CONCLUSIONS:

1. Company X and the shareholders of Old Target Company did not make a valid joint election under I.R.C. § 338(h)(10) and Treas. Reg. § 1.338(h)(10)-1(d)(2) regarding Company X's Year 2 stock acquisition of Old Target Company.

2. The Old Target Company never made a retroactive election under I.R.C. § 338(i) and Treas. Reg. § 1.338(i)-1 to apply the provisions of I.R.C. § 338(h)(10).

3. Company X and Old Target Company's shareholders did not make a valid joint election under I.R.C. § 338(h)(10) nor substantially comply with the provisions of Treas. Reg. § 1.338(h)(10)-1(d)(2) and Old Target Company did not make a valid retroactive election under I.R.C. § 338(i) to apply the provisions of I.R.C. § 338(h)(10) nor substantially comply with the provisions of Treas. Reg. § 1.338(i)-1.

FACTS:

The Transactions

On Date 3[2], Company X, an BBB, acquired b% of the common stock of Old Target Company, an electing S corporation. Thereafter, on Date 11, Company X merged with Company B, a wholly owned subsidiary of Company C, with Company B surviving.

Summary

Company X, the purchasing corporation, contends that it entered into a valid joint election under section 338(h)(10) with the shareholders of a target S corporation (Old Target Company). If there was a valid joint election under section 338(h)(10), Old Target Company (the old target), would be required to recognize gain on the "deemed sale" of its assets. As Old Target Company was an S corporation, any gain or loss recognition would pass through to the shareholders. If a valid section

[2]Date 3 will be the date used for purposes of this field service advice. Several dates on or about Date 3 were referenced to as the date Company X acquired b% of the common stock of Old Target Company. #b Forms 8023-A, executed by the #b Old Target Company shareholders, indicate Date 4, a Day B, is the date of the acquisition. Other materials submitted to this office indicate the date could have been Date 2 or, as indicated in the incoming memorandum, Date 3.

338(h)(10) joint election was made, no gain or loss would be recognized from the sale of Old Target Company's stock. Company X, as the purchasing corporation, would have obtained a stepped up basis in New Target Company's assets.

In the facts before us, however, the amount realized from the deemed sale of Old Target Company's assets, as reported on its final return, has a $k difference when compared to the basis of these assets on the return for the purchasing corporation and New Target Company's return. Company X received a stepped up basis of $k without Old Target Company recognizing income (which would be passed on to the shareholders) from the deemed sale of assets as required under section 338(h)(10). This discrepancy resulted in a significant loss of revenue to the government. The tax years of Old Target Company and its shareholders, who should have recognized income on the deemed sale of the assets, are closed. The Service takes the position that the joint election was invalid.

Prior to January 12, 1994, an S corporation could not be a target in a section 338(h)(10) joint election. Final regulations, issued on January 12, 1994, provided that an S corporation could be a target in a section 338(h)(10) election. The final regulations also permitted a target S corporation to retroactively apply the provisions of section 338(h)(10) to transactions, such as the in the facts before us, after January 13, 1992 and before January 20, 1994, as long as it complied with the provisions of Treas. Reg. § 1.338(i)-1. Without complying with the retroactive provisions of Treas. Reg. § 1.338(i)-1, Old Target Company could not have retroactively made a valid section 338(h)(10) election.

If there was not a valid section 338(h)(10) election, the sale of the Old Target Company's stock was a stock sale. New Target Company (Company X and its subsidiaries, including New Target Company since Company X filed a consolidated return) would have received a carryover basis, rather than a stepped up basis, in all of the assets of New Target Company, resulting in a lower basis in the assets of New Target Company than claimed[3].

Therefore, Company X should not have received a step up in basis in the New Target Company's assets. As a result, the Service is seeking a $s adjustment as the potential tax deficiency against Company X and Company C resulting from this denial of basis to New Target Company.

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[3]The adjustment results from the disallowance of amortization associated with the section 338(h)(10) election to step up Company X's basis in New Target Company's assets.

Old Target Company's Date 3 Form 1120S (U.S. Income Tax Return for an S Corporation)

Old Target Company, a State E corporation headquartered in City D, filed its final return (Form 1120S) for the year ending Date 3. The return was signed and dated by Shareholder B on Date 3 and by the preparer, Preparer G, on Date 5. Old Target Company's return did not include a Form 8023 (Elections Under section 338 for Corporations Making Qualified Stock Purchases) nor did it reflect a deemed sale of assets resulting from the Date 3 acquisition by Company X[4].

After Old Target Company's Form 1120S return was filed, Company B (who was seeking to acquire Company X) approached Company X to negotiate whether a stepped up basis for Old Target Company's assets could be achieved through a retroactive joint election under section 338(h)(10). As Company B and Company X were seeking to merge, Company B sought after a stepped up basis in New Target Company's assets. As part of the merger agreement entered into between Company B and Company X in Month 3, Year 3, it was agreed upon that Company X and Old Target Company would enter into a joint section 338(h)(10) election. Company X paid $z to the former shareholders of Old Target Company to make the joint section 338(h)(10) election ($cc each to Shareholder B and Shareholder C)[5]. The election for application of section 338(h)(10) was executed on #b Forms 8023-A on Date 8. The Forms 8023-A were attached to Company X's return. Old Target Company did not do the following:

- Old Target Company never amended its Form 1120S for Date 3 to reflect the gain on the deemed sale of assets under section 338(h)(10);

- Old Target Company never amended its return to include the form 8023-A. There is no evidence that either Old Target Company or Company X issued Forms 1099 to Old Target Company's shareholders to reflect the deemed liquidation; and

- Old Target Company never attached a statement to its final return (or an amended return) indicating that, as an S corporation, it was retroactively applying the regulations pursuant to Treas. Reg. § 1.338(i)-1(b).

Company X's Day C, Year 2 Form 1120 (U.S. Corporation Income Tax Return)

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[4]According to the revenue agent the joint section 338(h)(10) election was made subsequent to the filing of Old Target Company's return.

[5]The Service has not ascertained whether the S corporation shareholders reported the $z.

Company X filed its consolidated Year 2 return (Form 1120) on Date 9. Attached to this return were #b Forms 8023-A (Corporate Qualified Stock Purchases- Revised as of May, 1994).

The Form 8023-A's were dated Date 8, and signed separately by Old Target Company's #b shareholders (Old Target Company's shareholders)[6] and by Company X's president. Each form included a statement setting forth the total consideration paid by Company X, Old Target Company's liabilities assumed by Company X, and the fair market value of Old Target Company's assets. The Forms 8023-A reflected a higher sales price for Old Target Company than what was reported in Old Target Company's Form 1120S. However, Old Target Company's Form 1120S was not amended to reflect the joint election made under section 338(h)(10), or disclose the higher value of Old Target Company's assets over what was reported on Old Target Company's return.

Election Form Never Filed With Service Center

The original Form 8023-A was never filed with the Internal Revenue Service Center where the Federal income tax return that includes the deemed sale gain is or will be filed (the Service Center where the target (and/ or shareholders) of the Old Target Company filed their income tax returns). The only Forms 8023-A filed were as attachments to Company X's return. The Form 8023-A filing requirements are discussed in more detail below.

The Old Target Company Audit

Old Target Company's Forms 1120S for Year 1 and Date 3 were examined by the State G District in Year 5. During the audit, the Examination Division made adjustments to both returns for issues unrelated to the section 338(h)(10) election and the deemed sale of assets. At that time, Old Target Company's representative (Preparer G) provided the examining agent with a copy of an amended Schedule K-1 for Shareholder C, reflecting his distributive share of the deemed sale of Old Target Company's assets.

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[6]Shareholder B and Shareholder C owned c% and d% percent, respectively, of Old Target Company's common stock on the acquisition date.

The signature line on Form 8023-A states the following: "Under penalties of perjury, I declare that I am authorized to make the section 338(h)(10) election on line 7 on behalf of the common parent or selling group, the selling affiliate or S corporation shareholder."

As discussed more fully below, Shareholder C included the $t gain reflected on this amended Schedule K-1 on his original Year 2 Form 1040, filed on Date 10. However, an amended Schedule K-1 was not offered for Shareholder B at that time, presumably because he had already filed his Year 2 return, which had not included any gain on a deemed sale of Old Target Company's assets. According to Preparer G, Shareholder B did not file an amended Year 2 return because the tax effect of reporting his distributive share of the gain on the deemed sale would approximate the gain realized on the actual sale of his Old Target Company stock. Preparer G also provided the examining agent with copies of Old Target Company's workpapers reflecting the deemed sale of assets and the shareholders' respective distributive shares of that gain.

The workpapers submitted to the examining agent who audited Old Target Company reflect a "deemed sale price" for the Old Target Company stock of $c, computed as follows:

Total proceeds	$h[7]
Assumed liabilities	$f
Total	$c

In its books, however, Company X inconsistently computed its Adjusted Grossed-Up Basis (AGUB) in Old Target Company's assets at $b, based on the following:

Cash paid	$ j
Preferred stock issued	$m
Liabilities assumed	$d
AGUB	$b

The difference between Company X's AGUB and the amount used by Old Target Company as the deemed sale price is attributable to different values placed by Old Target Company and Company X on (i) the Company X preferred stock received by Old Target Company's #b shareholders, and (ii) the amount of Old Target Company's liabilities assumed by Company X.

[7]This figure equals cash of $j and $x worth of Company X convertible preferred stock.

These differences are summarized below:

Preferred stock -		Difference
Per Company X's books	$m	
Per Old Target Company's books	- $x	$q
Liabilities assumed -		
Per Company X's books	$d	
Per Old Target Company's books	- $f	$w
Total Difference		**$k**

Shareholder B's Day C, Year 2 Form 1040

On his Year 2 Form 1040, filed on Date 7, Shareholder B reported a $u gain on the actual sale of his Old Target Company stock to Company X,[8] but did not report any portion of his distributive share of the gain on the deemed sale of Old Target Company's assets.[9] According to the examination team, the gain reported by Shareholder B was understated because the amount realized was based on the Shareholder B's share of the $c deemed sale price rather than the $b used by Company X. Shareholder B never filed an amended return to report the gain on the deemed sale, although his distribution was reflected in Old Target Company's workpapers submitted to the revenue agent during the audit of Old Target Company's returns. Shareholder B never filed an amended return despite the fact that the Form 8023-A Shareholder B completed on Date 8 and jointly signed by Company X and Old Target Company's shareholders disclosed a higher value of Old Target Company's assets than originally reported on Old Target Company's 1120S, and thus consequently on Shareholder B's individual tax return.

Shareholder C's Day C, Year 2 Form 1040

Conversely, Shareholder C reported a gain on the deemed sale of Old Target Company's assets of $t and a ($bb) loss on the sale of his Old Target Company stock.[10] As previously noted, the $t was reflected on an amended Schedule K-1 prepared before Shareholder C filed his original return. However, Shareholder C

[8]On his Year 2 Schedule D, Shareholder B reported an amount realized of $n and an adjusted basis of $v, resulting in a capital gain of $u.

[9]As noted below, the gain on the shareholders' sale of the their Old Target Company stock is ignored for federal income tax purposes.

[10]The loss is computed based on an amount realized and adjusted basis of $r and $p, respectively.

computed both the liquidating distribution and the capital loss based on the lesser deemed sale price, as opposed to the higher AGUB used by Company X.

Company X has never adequately explained the reason for the significant difference between the AGUB used by Company X and the deemed sale price in Old Target Company's workpapers.[11] In any event, the inconsistent treatment by Company X and Old Target Company resulted in a substantial tax loss to the government. As noted above, Company X computed its deductions using the higher AGUB, while the #b shareholders computed their gain and loss stemming from their sale of stock using the lower deemed sale price. The IRS is now unable to adjust the shareholders' Year 2 returns because the three-year statute of limitations under section 6501 has already expired for each individual for that year.

LAW AND ANALYSIS

1. Company X did not make a valid election under section 338(h)(10) relating to its Year 2 stock acquisition of Old Target Company.

Section 338(h)(10)

Section 338(a)[12] allows a corporation (the purchasing corporation) that acquires the stock of another corporation (the target corporation) in a "qualified stock purchase" to elect to have the target corporation's assets take a value based on the amount paid by the purchasing corporation for the target corporation's stock. A "qualified stock purchase" is any transaction or a series of transactions which takes place during a 12-month period in which the purchasing corporation acquires 80 percent of the stock of the target corporation.

Section 338(h)(10) provides that, under regulations prescribed by the Secretary, an election may be made under which the target corporation recognizes gain or loss on the sale of its stock as if it sold all of its assets in a single transaction. If a valid section 338(h)(10) election is made, no gain or loss will be recognized on stock sold or exchanged in the transaction by the target's shareholder. See Treas. Reg. §§ 1.338(h)(10)-1(a), (e)(2).

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[11]The shareholders' allocable share of these proceeds are summarized as follows:

Shareholder B	x	c%	$n
Shareholder C	x	d%	$r
			$h

[12]Section 338 was added to the Code by section 224(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 324, 485-90.

A purchaser of a target's stock in a qualified stock purchase benefits from a stepped up basis in a section 338(h)(10) election. A section 338(h)(10) election results in a single level of tax imposed on the deemed asset sale. It is the target S corporation's shareholders who must incur the tax liability as a result of the section 338(h)(10) election. See Treas. Reg. § 1.338(h)(10)-1(e).

Section 338(h)(10)(C) requires in connection with a section 338(h)(10) election that the purchasing corporation and common parent of a target corporation furnish to the Secretary, as provided for by the regulations, the following information:

(i) the amount of the purchase price allocated under subsection (b)(5) to goodwill or going concern value; and

(ii) any modification of the amount described in clause (i); and

(iii) any other information as the Secretary deems necessary to carry out the provisions of this paragraph.

Application of Section 338(h)(10) for an S Corporation

Under the authority granted by section 338(i), the Secretary issued proposed regulations under section 338(h)(10) on January 14, 1992. See 1992-1 C.B. 1000. Final regulations were adopted on January 12, 1994. T.D. 8515, 1994-1 C.B. 89. The stock acquisition in this case occurred on Date 3.

The proposed regulations did not allow for a section 338(h)(10) election for a target S corporation. The final regulations provide that a section 338(h)(10) election can be made if a target corporation is an S corporation immediately before the acquisition date. See Treas. Reg. § 1.338(h)(10)-1(a).

The preamble to Treasury Decision 8515 states that:

> "The final regulations also provide that a section 338(h)(10) election may be made if T [target] is an S corporation immediately before the acquisition date. The deemed sale gain is reported on T's final S corporation return and therefore is taken into account under section 1366 and 1367 in determining a T shareholder's basis in the T stock and resulting gain or loss on the deemed liquidation of T. The section 338(h)(10) election must be made jointly by P and the T shareholders. The instructions to the revised Form 8023 will provide more guidance on making the election."

Joint Election

Treas. Reg. § 1.338(h)(10)-1(d)(2) requires a section 338(h)(10) election be made by both the purchasing corporation and the selling consolidated group (or the selling affiliate or the S corporation shareholders) on Form 8023 in accordance with the instructions to the form. Also, the election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. Once a section 338(h)(10) election is made, it is irrevocable. Treas. Reg. § 1.338(h)(10)-1(d)(3).

Form 8023 (Elections Under Section 338 for Corporations Making Qualified Stock Purchases) and Form 8023-A (Corporate Qualified Stock Purchases)

During the years in question, including the period during which Old Target Company and its shareholders could have filed amended returns, there were several versions of the Form 8023:

Form 8023 (Revised as of November, 1992);

Form 8023-A (Revised as of May, 1994); and

Form 8023 (Revised as of September, 1997).

Form 8023 (Revised as of November, 1992) and Form 8023-A (Revised as of May, 1994) coexisted for a period of time[13]. Form 8023 (Revised as of September, 1997) replaced Form 8023-A (Revised as of May, 1994). See Announcement 97-114 November 17, 1997.

Form 8023 (Revised as of November, 1992)

The Instructions to Form 8023 (Revised as of November, 1992) state that the purchasing corporation (and the selling group, if a joint election is made under section 338(h)(10)) files Form 8023 to make this election or other elections (including subelections) under section 338 and the related regulations.

According to the instructions, the Form 8023 must be filed by the fifteenth day of the ninth month after the month in which the acquisition date occurred. The Form 8023 should be filed with the District Director (Attention: Chief of Examination) for

[13]Announcement 95-39 May 15, 1995 clarified that Form 8023, (Corporate Qualified Stock Purchase Elections), was replaced by Form 8023-A, (Corporate Qualified Stock Purchases). The announcement stated that, generally, Form 8023 applied to acquisitions of control of another corporation occurring before January 20, 1994, and Form 8023-A should be used to report such acquisitions occurring after January 19, 1994.

the Internal Revenue district where the principal place of business in which the purchasing corporation is located.

Form 8023-A (Revised as of May, 1994)[14]

The instructions to the Form 8023-A provide as follows:

If a section 338(h)(10) is made for a target, Form 8023-A must be filed jointly by the purchasing corporation and the S corporation shareholders. The instructions further provide that to make a section 338(h)(10) election for the target corporation, file Form 8023-A with the Internal Revenue Service Center where the Federal income tax return that includes the deemed sale gain is or will be filed. (i.e., in the instant case this would appear to be the Service Center where the target/#b shareholders of the Old Target Company filed their income tax returns).

Also, the instructions state that the Form 8023-A must be attached to the final income tax return for the old target and the first return of the new target. Whether or not a section 338(h)(10) election is made for the target, the purchasing corporation must attach Form 8023-A to its Federal income tax return for the tax year that includes the acquisition date.

According to page 2 of the Form 8023-A Instructions (Revised as of May, 1994), if a section 338(h)(10) joint election is made for the target corporation, a schedule **must** [emphasis added] be attached listing the amount of a) the consideration paid for the target stock in the qualified stock purchase, and b) the liabilities of the target corporation on the acquisition date. The instructions also state that in addition, the schedule should describe any other relevant items and list the aggregate fair market value by class of the Class II and Class III assets of the target corporation on the acquisition date. The instructions also require disclosure of each intangible amortizable Class III asset, specifying its fair market value and useful life.

Form 8023 (Revised as of September, 1997)

Form 8023 (Revised as of September, 1997) replaced Form 8023-A (Revised as of May, 1994). There are minor technical differences between Form 8023 (Revised as of September, 1997) and Form 8023-A (Revised as of May, 1994).

A valid section 338(h)(10) election was not made in this case as Company X, Old Target Company and Old Target Company's shareholders did not comply with the simultaneous joint election requirements provided in the regulations and instructions to Form 8023-A. Treas. Reg. § 1.338(h)(10)-1(d)(2) requires that a

[14]The joint section 338(h)(10) election was made on the Form 8023-A in Month 3 of Year 3 and such election was not contemplated before that date.

section 338(h)(10) election be made in accordance with the instructions to Form 8023[15].

- Company X never filed the original Form 8023-A (Revised as of May, 1994), as required by the instructions and Treas. Reg. §1.338(h)(10)-1(d)(2). According to the Form 8023-A (Revised as of May, 1994) instructions, the form had to file Form 8023-A with the Internal Revenue Service Center where the Federal income tax return that includes the deemed sale gain is or will be filed. Company X merely attached the Forms 8023-A (Revised as of May, 1994) to its return for its Day C, Year 2 year end return, as filed on Date 9.

  The completed Form 8023-A, a #d page document including the schedules, should have been sent as a "stand alone" document to the Service Center where the federal tax return that includes the deemed sale gain is or will be filed (the final 1120S return for Old Target's Company and/or its shareholders). Company X, the purchasing corporation, only met the requirement of attaching a copy of the Form 8023-A to its own return. Merely attaching the original Form 8023-A as part of the voluminous purchasing corporation's return, instead of sending it as a "stand alone" document to the correct Service Center, will not suffice to place the government on notice that an election was made.

- Old Target Company did not amend its return to reflect the consequences of a joint deemed sale election under section 338(h)(10). Treas. Reg. §§ 1.338(h)(10)-1(e)(1), 1(e)(2)(ii).

- Old Target Company return never included a deemed sale election Form 8023-A, or any similar statement with any return. Treas. Reg. § 1.338(h)(10)-1(d)(2).

Company X claims it has an additional $k stepped up basis in the assets of New Target Company, based on an excess amount of sales price which Old Target Company's S corporation shareholders never included as taxable gain. Neither Old Target Company, nor Shareholder B amended their returns even when they were aware of the $k sales price discrepancy utilized by Old Target Company and Company X in calculating the New Target Company's assets. Both S corporation shareholders were aware of the discrepancies as early as Date 8 (and maybe

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[15]Treas. Reg. § 1.338(h)(10)-1(d)(2) states that "a section 338(h)(10) election is made jointly by P and the selling consolidated group (or the selling affiliate or the S corporation shareholders) on Form 8023 in accordance with the instructions to the form. The section 338(h)(10) election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs."

sooner) when they signed the Forms 8023-A that were attached to Company X's return filed #c days later.

More specifically, Old Target Company's work papers (and consequently, Old Target Company's Form 1120S filed in Month 1 of Year 3[16], and Shareholder B's Form 1040 filed in Month 2 of Year 3) reflect that the consideration paid by Company X for Old Target Company was $h. Also, Old Target Company's work papers disclose $f of Old Target Company liabilities as assumed by Company X. However, the mandatory schedule attached to the Form 8023-A for electing section 338(h)(10), as completed by Shareholder B on Date 8, disclosed that Company X paid Old Target Company consideration worth $g. Therefore, Shareholder B had knowledge that the consideration paid, as reported on the Form 8023-A, differed by $q ($g less $h), when compared with Old Target Company's Form 1120S. Also, Old Target Company's liabilities assumed by Company X on the acquisition date are disclosed as $e on the Form 8023-A. Shareholder B, therefore, had knowledge that the liabilities as reported on the Form 8023-A differed by $y ($e less $f) when compared with Old Target Company's Form 1120S[17]. Shareholder B never amended the Form 1120S nor attached the Form 8023-A to reflect any differences[18]. Without the attached Form 8023-A to an amended Form 1120S, the Service would likely have had difficulty in knowing that a joint section 338(h)(10) election was made when it audited Old Target Company's return.

No action was ever taken to make certain the original Form 8023-A was filed with the Internal Revenue Service Center where the federal income tax return that includes the deemed sale gain is or will be filed. Had these requirements been met, the Service would have been placed on notice of the section 338(h)(10) election.

Also, Old Target Company's representative was aware of the joint deemed sale election but never bothered to amend Old Target Company's return or make certain an amended K-1 was issued to Shareholder B to accurately reflect the joint deemed election.

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[16]Shareholder B signed Old Target Company's Form 1120S

[17]Company X's financial statements indicated that it assumed $d of Old Target Company's liabilities, which when compared with Old Target Company's work papers for the transaction disclose $f of assumed liabilities. Shareholder B knew of a discrepancy in the amount of the assumed liabilities as disclosed on Old Target Company's 1120S and the Form 8023-A when he signed the Form 8023-A.

[18]Shareholder C also completed a separate Form 8023-A on Date 8, although unnecessary, which was attached to Company X's return.

The reason the joint election rules under section 338(h)(10) and section 338(i) are required is to prevent exactly what has transpired in this case. The Service should not be positioned where it cannot identify whether a retroactive joint election has been made. The joint election on Form 8023-A, as required under section 338(h)(10) (and amended return, if necessary) enables the Service to identify whether the parties reported and utilized the same sales price in determining the proper amount of deemed gain recognized by Old Target Company (and thus its shareholders) and in determining the purchase price basis ("AGUB") used by the New Target Company to calculate the basis of the assets acquired. Here, a significant loss of tax revenues has occurred because of Company X's and Old Target Company's shareholders failure to correctly execute a joint election.

2. The Old Target Company never made a retroactive election under section 338(i) and Treas. Reg. § 1.338(i)-1 to apply the provisions of section 338(h)(10).

The Date 3 transaction occurred after January 13, 1992 and before January 12, 1994. Prior to January 12, 1994, an S corporation could not be a target in a section 338(h)(10) joint election. Final regulations, issued on January 12, 1994, provided that an S corporation could be a target in a section 338(h)(10) election. The final regulations also permitted a target S corporation to retroactively apply the provisions of section 338(h)(10) to transactions, such as the in the facts before us, after January 13, 1992 and before January 20, 1994[19]. Without complying with the provisions of Treas. Reg. § 1.338(i)-1, Old Target Company could not have a section 338(h)(10) election.

On Date 5, the Old Target Company filed its final return and did not elect to retroactively apply section 338(h)(10). Company B and Company X later sought to obtain a stepped up basis in Old Target Company's assets with a section 338(h)(10) election. Company X, after Old Target Company's return was filed, approached the Old Target Company's shareholders and offered to pay them $z for making this election. Despite receiving $z, Old Target Company's return was never amended to reflect a section 338(h)(10) election nor was a statement attached, as required in Treas. Reg. § 1.338(i)-1(b), to indicate they were retroactively applying the relevant provisions under section 338 for the transaction in question because the Date 3 transaction occurred between January 13, 1992 and January 20, 1994.

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[19]According to Treas. Reg. § 1.338(i)-1(b), a target with an acquisition date on or after January 14, 1992 and before January 20, 1994 may apply Treas. Reg. §§ 1.338-1 through 1.338-5, 1.338-4T(h), 1.338(b)-1, and 1.338(h)(10)-1 by including a statement with its return (including an amended return) for the period that includes the acquisition date to the effect that it is applying all of these sections pursuant to Treas. Reg. § 1.338(i)-1(b).

The Old Target Company was required to amend its return and include a statement indicating it was retroactively applying the provisions of section 338(h)(10) by Treas. Reg. § 1.338(i)-1(b). Old Target Company's final return did not include a retroactive statement required under Treas. Reg. § 1.338(i)-1(b), to apply the section 338(h)(10) joint election. The Old Target Company's return has no remarks, inclusions, notes or attachments indicating it was retroactively applying the provisions of section 338(h)(10)- the return only reflects that there was only a deemed stock sale (and not a deemed asset sale). Old Target Company had the opportunity to amend its return and attach the retroactive statement, as required under Treas. Reg. § 1.338(i)-1(b), to its return. The opportunity for Old Target Company to amend its return and include the statement implementing the retroactive statement under Treas. Reg. § 1.338(i)-1(b) closed when the period for amending its return for its final year closed. Old Target Company chose not to do so. Failure to comply with the provisions of Treas. Reg. § 1.338(i)-1(b) prevents the Old Target Company from retroactively implementing section 338(h)(10).

3. Company X and Old Target Company's shareholders did not make a valid joint election under section 338(h)(10) nor substantially comply with the provisions of Treas. Reg. § 1.338(h)(10)-1(d)(2) and Old Target Company did not make a valid retroactive election under section 338(i) to apply the provisions of section 338(h)(10) nor substantially comply with the provisions of Treas. Reg. § 1.338(i)-1.

Courts apply the doctrine of substantial compliance where taxpayers fail to properly adhere to the requirements of making an election. The critical question is whether the requirements for making an election relate to the substance or the essence of the statute. If the requirements of the election relate to the substance or essence of the statute, strict adherence to all of the statutory and regulatory requirements is a precondition to an effective election.

If the requirements of an election are procedural or directory in that they are not of the essence of the thing to be done, they may be fulfilled by substantial, if not strict, compliance. See Columbia Iron & Metal v. Commissioner, 61 T.C. 5, 8 (1973), acq. 1979-2 C.B. 1. (Taxpayer failed to attach corporate minutes to the tax return). Therefore, the substantial compliance doctrine can be used only to correct minor procedural errors. See Tipps v. Commissioner, 74 T.C. 458, 474 (1980), acq. 1981-2 C.B. 2 (taxpayer filed required form, but failed to include certain information).

There are no reported cases addressing substantial compliance for section 338 elections. In Knight-Ridder Newspapers, Inc. V. U.S., 743 F.2d 781 (CA-11), the Eleventh Circuit held that where a taxpayer failed to file Form 5006 (Guideline Class Life System) to its tax return pursuant to the regulations and failed to check the appropriate box on schedule G of its corporate tax return to substantiate the election, it was precluded from using the method of depreciation claimed by the

taxpayer. The Court held that an essential purpose of the election is furthered by a clear manifestation to the government of the taxpayer's election.

Unequivocal Election

Without an unequivocal joint section 338(h)(10) election by the parties involved (including, among other provisions, requirements that mandate the Form 8023-A be attached to the returns impacted by such elections), taxpayers have the opportunity to back in and out of elections to the government's detriment. It is impossible to determine from Old Target Company's return that a joint section 338(h)(10) election was made.

As a result of: Old Target Company's failure to: 1) amend its return; 2) attach a Form 8023-A to its final (amended) return; and 3) attach a statement to the return indicating it was retroactively applying the section 338(h)(10) election pursuant to Treas. Reg. § 1.338(i)-1(b), as well as Company X's failure to make the appropriate "stand alone" election by sending it to the Service Center where the federal tax return where the deemed sale is filed (as opposed to merely attaching it to its voluminous return), the government was placed at a significant disadvantage. Specifically, the Service had no way of knowing that there was an election under section 338(h)(10) and Treas. Reg. § 1.338(i)-1(b) or that it should examine the returns of the #b shareholders or that of the purchasing corporation, which would have disclosed the inconsistency between the deemed sale price and AGUB used by Old Target Company and New Target Company, respectively. Consequently, Company X was able to step-up its basis in New Target Company's assets by an additional $k, while both Shareholder B and Shareholder C computed gain using the lesser "deemed sale price" reflected in Old Target Company's workpapers.

Consequences of Failing to Make a Joint Election

A factor in ascertaining whether an election provision must be literally complied with is the consequence of noncompliance. See Hewlett-Packard Co. v. Commissioner, 67 T.C. 736, 749 (1977), acq. In result, 1979-2 C.B. 2.

Without the prerequisite filing requirements for a joint election under the regulations and the instructions to Form 8023-A, the Service is hindered in its ability to identify corporations and shareholders engaged in section 338(h)(10) joint elections and Treas. Reg. § 1.338(i)-1(b) retroactive elections.

The prerequisites for a section 338(h)(10) election must be strictly complied with, especially: 1) the required filing of the original Form 8023-A with the Internal Revenue Service Center where the federal income tax return that includes the deemed sale gain is or will be filed; 2) requiring Form 8023-A to be attached to the old target's (amended) return.

The prerequisites of Treas. Reg. § 1.338(i)-1(b) requiring the old target to attach a statement to its (amended) return indicating retroactive application of the Treasury Regulations under the section 338(h)(10) must be strictly complied with.

In this case, no action was ever taken to do any of the three above listed requirements. The reason why these rules are in place can be demonstrated by what has occurred in this case. Not even an audit of the old target's return for the year in question will uncover that a section 338(h)(10) joint election or a retroactive election under Treas. Reg. § 1.338(i)-1(b) was made.

Company X's failure to file the "stand alone" Form 8023-A election and Old Target Company's failure to attach a copy of it to the Old Target Company's final return together, much less failure to meet other requirements, constitute a failure to substantially comply with the requirements of making the instant election. The instructions to the Form 8023-A require that a disclosure be made as to the consideration paid for the target stock and the liabilities of the target stock on the acquisition date. The Form 8023-A, which was signed by both buyer (Company X) and seller (shareholders of Old Target Company), was attached to Company X' s return and included this information. Providing such information is a material requirement for securing the election since it should serve to preclude the buyer and seller from asserting differing purchase prices with regard to the gain realized from the deemed sale of the assets and with regard to the cost basis for the assets deemed acquired. The failure to file the Form 8023-A with the Service Center for the tax returns that were to include the deemed sale gain (the final 1120S return for Old Target Company and/or its shareholders) along with the failure to attach the form 8023-A to Old Target Company's final S Corporation return served to limit the Service's ability to discover this purchase price discrepancy. The Form 8023-A attached to Company X's return is presumably insufficient to focus the Service on the seller's returns.

It appears that the only requirements performed correctly was that Company X attached Form 8023-A to its return and one of the individuals reported a deemed sale of assets (although that individual shareholder understated the gain). Almost no other requirement was met. Therefore, the parties' actions did not rise to the level of "substantial compliance". This is not a situation where the Service can, as it frequently does, overlook some minor procedural error and thus validate actions where there was substantial compliance. What happened here was almost a

complete disregard of complying with the joint election and retroactive election requirements.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

1. [redacted]

A. A Court may sympathize with Company X's argument that it substantially complied with the requirements for making the election and, therefore, a valid retroactive election was made. As discussed above, the Forms 8023-A were completed and signed by both the purchasing corporation as well as Old Target Company's shareholders. It was irrevocable at that time and Company X could, arguably, be estopped from denying there was a valid section 338(h)(10) joint election. Company X can argue that the Service was given an unequivocal election by receiving a jointly executed Form 8023-A as an attachment to purchaser's tax return. Depending on the facts and circumstances for various taxpayers, the Service will take the position that by attaching a copy of the election to the purchaser's tax return and sending it to the IRS, irrespective of the failure to complete the various other requirements imposed by the regulations and Form instructions, a taxpayer made a valid irrevocable section 338(h)(10) joint election. The Service frequently takes the position asserting that taxpayers are bound by filing a joint election, in the absence of revocation, where other minor procedural aspects of making a valid election are omitted. Situations where the Service wanted to hold taxpayers to its decision to make a valid election despite minor procedural errors can be readily distinguished from the instant case. Yet, taxpayers may be successful in arguing to a court that despite not meeting many of the required procedural elements of an election, a valid election was made.

B. A court may believe that a Form 8023-A attached to the buyer's return should be sufficient for the Service to discover the lower purchase price used by Old Target Company on its return and on the individual tax returns filed by Old Target Company's shareholders. A court may well conclude this given that such Form 8023-A discloses the name and address of the target corporation (Old Target Company) and the name and address of the shareholders (the selling shareholder) signing on behalf of the Old Target Company.

A court may also not be impressed with an argument that the Form 8023-A, which did reach a Service Center, went to the wrong Service Center.

C. A Court might be sympathetic to Company X's argument that it is not responsible for the reporting requirements of Old Target Company. Company X paid an extra $z to have this election made in an arm's length transaction to make certain a valid joint section 338(h)(10) election was properly consummated. Company X also initiated, assisted in completing, obtained the S corporation shareholder's signatures and attached the Form 8023-A to Company X's Form 1120 return. Also, Company X was unaware that Shareholder B used figures on the Form 8023-A that differed from those used on his Form 1040 or on Old Target Company's final Form 1120S.

D. [redacted]

The Service can counter that no "stand alone" election was ever filed and was never properly sent to the appropriate Service Center. According to the Form 8023-A instructions, the "stand alone" election should not have been attached to the Company X Form 1120 and sent to the Company X Service Center. Instead Form 8023-A should have been sent to where the Federal income tax return that includes the deemed sale gain is or will be filed (i.e., where the target, and / or, the S corporation shareholders file their returns), or, depending on whether the Form 8023 instructions were followed, to the District Director (Attention: Chief of Examination) where Company X filed its Form 1120. Neither of which were done.

E. Also, Company X can assail our position that in order to make an unequivocal joint section 338(h)(10) election a copy of the Form 8023-A has to be attached to the old target. The Form 8023 Instructions (Revised as of September, 1997) state that:

> "A copy of Form 8023 must be attached to the final income tax return of the old target, to the first income tax return of the new target, and to the income tax return of the purchasing corporation for its tax year that includes the acquisition date; but failure to do so will not invalidate a section 338 election."

This provision in the instructions precludes a taxpayer from arguing that it had an invalid election merely because the Form 8023 was not attached to the old target's return. Hence, taxpayers can argue that this provision demonstrates that attaching copies of the election to all required corporate filings is not necessarily a prerequisite to an unequivocal election where the joint election was timely filed. Therefore, the instructions to Form 8023 (Revised as of September 1997) arguably counters the Service position that including copies of Form 8023 to all of the returns for the targets and the purchasing corporation is crucial for a valid unequivocal election.

The simple rebuttal is that this provision assumes that the stand alone joint election was filed and thus the provision only concludes that a failure to attach the election to any of the returns will not serve to invalidate a section 338(h)(10) election.

Further, in rebuttal to the taxpayer's potential position, it appears that the Form 8023 (Revised as of September, 1997) only states that a section 338(g) election is not necessarily invalidated by merely not attaching a Form 8023 to the target's return. The instructions do not state that this rule is necessarily applicable for a section 338(h)(10) election, which, unlike a section 338(g) election, requires a joint election. There is significantly less risk of consequential harm to the Service where the Form 8023-A is not attached to the old target's return in a section 338(g) election. In a section 338(g) election the purchasing corporation, alone, makes the election and bears the impact of any consequences of the election. In comparison, failure to attach the Form 8023 to the old target in a section 338(h)(10) election seriously impedes the government's ability to recognize when a valid section 338(h)(10) joint election has been made, such as in this case.

More important, the "stand alone" election was never made since Form 8023-A as a stand alone document, or as an attachment, was never sent to the Service Center where the Federal income tax return that includes the deemed sale gain was filed (i.e., where the target and/or S corporation shareholders file their returns). Under the facts as we know them, the election Form 8023-A was merely attached to the Company X return. The Company X return, according to the Revenue Agent, is a voluminous document. A small #d page attachment to a voluminous filing is much more difficult to discover than a direct filing at the correct Service Center.

2. [redacted]

If you have any further questions, please call (202) 622-7930.

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