§ 1.338−4  Aggregate deemed sale price; various aspects of taxation of the deemed asset sale.

(a) Scope. This section provides rules under section 338(a)(1) to determine the aggregate deemed sale price (ADSP) for target. ADSP is the amount for which old target is deemed to have sold all of its assets in the deemed asset sale. ADSP is allocated among target’s assets in accordance with §1.338−6 to determine the amount for which each asset is deemed to have been sold. When a subsequent increase or decrease is required under general principles of tax law with respect to an element of ADSP, the redetermined ADSP is allocated among target’s assets in accordance with §1.338−6 to determine the amount of liabilities of old target. General principles of tax law apply in determining the timing and amount of the elements of ADSP.

(ii) Redetermination of ADSP. ADSP is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, for the elements of ADSP. For example, ADSP is redetermined because of an increase or decrease in the amount realized for recently purchased stock or because liabilities not originally taken into account in determining ADSP are subsequently taken into account. Increases or decreases with respect to the elements of ADSP result in the reallocation of ADSP among target’s assets under §1.338−7.

(iii) Example. The following example illustrates this paragraph (b)(2):

Example. In Year 2, T, a manufacturer, purchases a customized delivery truck from X with purchase money indebtedness having a stated principal amount of $100,000. P acquires all of the stock of T in Year 3 for $700,000 and makes a section 338 election for T. Assume T has no liabilities other than its purchase money indebtedness to X. In Year 4, when T is neither insolvent nor in a title 11 case, T and X agree to reduce the amount of the purchase money indebtedness to $80,000. Assume further that the reduction would be a purchase price reduction under section 108(e)(5). T and X’s agreement to reduce the amount of the purchase money indebtedness to $80,000 would not, under general principles of tax law that would apply if the deemed asset sale had actually occurred, change the amount of liabilities of old target taken into account in determining its amount realized. Accordingly, ADSP is not redetermined at the time of the reduction. See §1.338−5(b)(2)(ii) Example 1 for the effect on AGUB.

(c) Grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation’s recently purchased target stock—(1) Determination of amount. The grossed-up amount realized on the sale to the purchasing corporation of the purchasing corporation’s recently purchased target stock is an amount equal to—

(i) The amount realized on the sale to the purchasing corporation of the purchasing corporation’s recently purchased target stock determined as if the selling shareholder(s) were required to use old target’s accounting methods...
and characteristics and the installment
method were not available and deter-
mained without regard to the selling
costs taken into account under para-
graph (c)(1)(iii) of this section;
(ii) Divided by the percentage of tar-
get stock (by value, determined on the
acquisition date) attributable to that
recently purchased target stock;
(iii) Less the selling costs incurred by
the selling shareholders in connection
with the sale to the purchasing cor-
poration of the purchasing corpo-
rations’s recently purchased target stock
that reduce their amount realized on
the sale of the stock (e.g., brokerage
commissions and any similar costs to
sell the stock).
(2) Example. The following example il-
lustrates this paragraph (c):
Example. T has two classes of stock out-
standing, voting common stock and pre-
ferred stock described in section 1504(a)(4).
On March 1 of Year 1, P purchases 40 percent
of the outstanding T stock from S1 for $500,
20 percent of the outstanding T stock from
S2 for $225, and 20 percent of the outstanding
T stock from S3 for $275. On that date, the
fair market value of all the T voting com-
mon stock is $1,250 and the preferred stock
$750. S1, S2, and S3 incur $40, $35, and $25 re-
spectively of selling costs. S1 continues to
own the remaining 20 percent of the out-
standing T stock. The grossed-up amount re-
alized on the sale to P of P’s recently pur-
chased T stock is calculated as follows: The
total amount realized (without regard to
selling costs) is $1,900 (1,000/.5 + 225 + 275).
The percentage of T stock by value on the acqui-
sition date attributable to the recently pur-
chased T stock is 50% (1,000/(1,250 + 750)). The
selling costs are $100 (40 + 35 + 25). The
grossed-up amount realized is $1,900 (1,000/.5
− 100).
(d) Liabilities of old target—(1) In gen-
eral. In general, the liabilities of old
target are measured as of the begin-
nning of the day after the acquisition
date. (But see § 1.338–1(d) (regarding
certain transactions on the acquisition
date).) In order to be taken into ac-
count in ADSP, a liability must be a li-
ability of target that is properly taken
into account in amount realized under
general principles of tax law that
would apply if old target had sold its
assets to an unrelated person for con-
sideration that included the discharge of
its liabilities. See §1.1001–2(a). Such
liabilities may include liabilities for
the tax consequences resulting from the
deeded sale.
(2) Time and amount of liabilities. The
time for taking into account liabilities
of old target in determining ADSP and
the amount of the liabilities taken into
account is determined as if old target
had sold its assets to an unrelated per-
son for consideration that included the
discharge of the liabilities by the unre-
lated person. For example, if no
amount of a target liability is properly
taken into account in amount realized
as of the beginning of the day after the
acquisition date, the liability is not
initially taken into account in deter-
mapping ADSP (although it may be
taken into account at some later date).
(e) Deemed sale tax consequences. Gain
or loss on each asset in the deemed sale
is computed by reference to the ADSP
allocated to that asset. ADSP is allo-
cated under the rules of § 1.338–6.
Though deemed sale tax consequences
may increase or decrease ADSP by cre-
ating or reducing a tax liability, the
amount of the tax liability itself may
be a function of the size of the deemed
sale tax consequences. Thus, these de-
terminations may require trial and
error computations.
(f) Other rules apply in determining
ADSP. ADSP may not be applied in
such a way as to contravene other ap-
licable rules. For example, a capital
loss cannot be applied to reduce ordi-
nary income in calculating the tax li-
ability on the deemed sale for purposes
determining ADSP.
(g) Examples. The following examples
illustrate this section. For purposes of
the examples in this paragraph (g), un-
less otherwise stated, T is a calendar
year taxpayer that files separate re-
turns and that has no loss, tax credit,
or other carryovers to Year 1. Depre-
ciation for Year 1 is not taken into ac-
count. T has no liabilities other than
the Federal income tax liability result-
ning from the deemed asset sale, and the
T shareholders have no selling costs.
Assume that T’s tax rate for any ordi-
nary income or net capital gain result-
ning from the deemed sale of assets is 34
percent and that any capital loss is off-
set by capital gain. On July 1 of Year 1,
P purchases all of the stock of T and
makes a section 338 election for T. The
examples are as follows:
Example 1. One class, (i) On July 1 of Year 1, T's only asset is an item of section 1245 property with an adjusted basis to T of $50,000, a recomputed basis of $80,000, and a fair market value of $100,000. P purchases all of the T stock for $75,000, which also equals the amount realized for the stock determined as if the selling shareholder(s) were required to use old target's accounting methods and characteristics.

(ii) ADSP is determined as follows (for purposes of this section (g)), G is the grossed-up amount realized on the sale to P of P's recently purchased T stock, L is T's liabilities other than T's tax liability for the deemed sale tax consequences, T is the applicable tax rate, and B is the adjusted basis of the asset deemed sold:

\[ ADSP = G + L + T \times (ADSP - B) \]

\[ ADSP = ($75,000/1) + 0 + .34 \times (ADSP - $50,000) \]

\[ ADSP = $75,000 + .34ADSP - $17,136.66ADSP = $57,864 \]

\[ ADSP = $75,000 + .34ADSP - $17,136.66ADSP = $57,864 \]

Example 2. More than one class. (i) P purchases all of the T stock for $140,000, which also equals the amount realized for the stock determined as if the selling shareholder(s) were required to use old target’s accounting methods and characteristics. On July 1 of Year 1, T has liabilities (not including the tax liability for the deemed sale tax consequences) of $50,000, cash (a Class I asset) of $100,000, actively traded securities (a Class II asset) with a basis of $4,000 and a fair market value of $10,000, goodwill (a Class VII asset) with a basis of $3,000, and the following Class V assets:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>FMV</th>
<th>Ratio of asset FMV to total Class V FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$5,000</td>
<td>$35,000</td>
<td>14</td>
</tr>
<tr>
<td>Building</td>
<td>10,000</td>
<td>50,000</td>
<td>20</td>
</tr>
<tr>
<td>Equipment A (Recomputed basis $80,000)</td>
<td>5,000</td>
<td>90,000</td>
<td>36</td>
</tr>
<tr>
<td>Equipment B (Recomputed basis $20,000)</td>
<td>10,000</td>
<td>75,000</td>
<td>30</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$30,000</strong></td>
<td><strong>$250,000</strong></td>
<td>1.00</td>
</tr>
</tbody>
</table>

(ii) ADSP exceeds $20,000. Thus, $10,000 of ADSP is allocated to the cash and $10,000 to the actively traded securities. The amount allocated to an asset (other than a Class VII asset) cannot exceed its fair market value (however, the fair market value of any property subject to nonrecourse indebtedness is treated as being not less than the amount of such indebtedness; see §1.1338-6(c)(2)). See §1.1338-6(c)(1) (relating to fair market value limitation).

(iii) The portion of ADSP allocable to the Class V assets is preliminarily determined as follows (in the formula, the amount allocated to the Class I assets is referred to as I and the amount allocated to the Class II assets as II):

\[ ADSP_{V} = (G - (I + II)) + L + T \times [(II - B_{II}) + (ADSP_{V} - B_{V})] \]

(iv) The facts are the same as in paragraph (i) of this Example 1, except that on July 1 of Year 1, P purchases only 80 of the 100 shares of T stock for $60,000. The grossed-up amount realized on the sale to P of P’s recently purchased T stock (G) is $75,000 ($60,000). Consequently, ADSP and the deemed sale tax consequences are the same as in paragraphs (i) and (ii) of this Example 1.
Example 3. More than one class. (i) The facts are the same as in Example 2, except that P purchases the T stock for $150,000, rather than $140,000. The amount realized for the stock determined as if the selling shareholder(s) were required to use old target’s accounting methods and characteristics is also $150,000.

(ii) As in Example 2, ADSP exceeds $20,000. Thus, $10,000 of ADSP is allocated to the cash and $10,000 to the actively traded securities.

(iii) The portion of ADSP allocable to the Class V assets as preliminarily determined under the formula set forth in paragraph (iii) of Example 2 is $260,363.64. The amount allocated to the Class V assets cannot exceed their aggregate fair market value ($250,000). Thus, preliminarily, the ADSP amount allocated to Class V assets is $250,000.

(iv) Based on the preliminary allocation, the ADSP is determined as follows (in the formula, the amount allocated to the Class I assets is referred to as I, the amount allocated to the Class II assets as II, and the amount allocated to the Class V assets as V):

\[
\text{ADSP} = G + L + T_1 + (I - B_1) + (V - B_V) + (\text{ADSP} - (I + II + V + B_V))
\]

\[
\text{ADSP} = 150,000 + 50,000 + .34 \times |(10,000 - 10,000) + (\text{ADSP} - 30,000)|
\]

\[
\text{ADSP} = 234,020
\]

(v) Because ADSP as determined exceeds the aggregate fair market value of the Class I, II, III, IV, V, and VI assets, the $250,000 amount preliminarily allocated to the Class V assets is appropriate. Thus, the amount of ADSP allocated to Class V assets equals their aggregate fair market value ($250,000), and the allocated ADSP amount for each Class V asset is its fair market value. Further, because there are no Class VI assets, the allocable ADSP amount for the Class VII asset (goodwill) is $8,818.18 (the excess of ADSP over the aggregate ADSP amounts for the Class I, II, III, IV, V and VI assets).

Example 4. Amount allocated to T1 stock. (i) The facts are the same as in Example 2, except that T owns all of the T1 stock (instead of the building), and T1’s only asset is the building. The T1 stock and the building each have a fair market value of $50,000, and the building has a basis of $10,000. A section 338 election is made for T1 (as well as T), and T1 has no liabilities other than the tax liability for the deemed sale tax consequences. T is the common parent of a consolidated group filing a final consolidated return described in §1.338-10(a)(1).

(ii) ADSP exceeds $20,000. Thus, $10,000 of ADSP is allocated to the cash and $10,000 to the actively traded securities.

(iii) Because T does not recognize any gain on the deemed sale of the T1 stock under paragraph (h)(2) of this section, appropriate adjustments must be made to reflect accurately the fair market value of the T and T1 assets in determining the allocation of ADSP among T’s Class V assets (including the T1 stock). In preliminarily calculating ADSP, in this case, the T1 stock can be disregarded, and, because T owns all of the T1 stock, the T1 asset can be treated as a T asset. Under this assumption, ADSP, is $223,666.67. See paragraph (iv) of Example 2.

(iv) Because the portion of the preliminary ADSP allocable to Class V assets ($223,666.67) does not exceed their fair market value ($250,000), no amount is allocated to Class VII assets for T. Further, this amount ($223,666.67) is allocated among T’s Class V assets in proportion to their fair market values. See paragraph (v) of Example 2. Tentatively, $84,733.34 of this amount is allocated to the T1 stock.

(v) The amount tentatively allocated to the T1 stock, however, reflects the tax incurred on the deemed sale of the T1 asset equal to $13,169.34 (.34×$84,733.34−$10,000). Thus, the ADSP allocable to the Class V assets of T, and the ADSP allocable to the T1 stock, as preliminarily calculated, each must be reduced by $13,169.34. Consequently, these amounts, respectively, are $20,000.33 and $35,861.00. In determining ADSP for T1,
§ 1.338–4

26 CFR Ch. I (4–1–10 Edition)

(4) Deemed sale producing effectively connected income. A foreign target recognizes gain or loss on the deemed sale of stock of a foreign target affiliate to the extent that such gain or loss is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States.

(5) Deemed sale of insurance company target affiliate electing under section 953(d). A domestic target recognizes gain (but not loss) on the deemed sale of stock of a target affiliate that has in effect an election under section 953(d) in an amount equal to the lesser of the gain realized on the sale of the recently purchased T1 stock or the earnings and profits described in section 953(d)(4)(B).

(6) Deemed sale of DISC target affiliate. A foreign or domestic target recognizes gain (but not loss) on the deemed sale of stock of a target affiliate that is a DISC or a former DISC (as defined in section 992(a)) in an amount equal to the lesser of the gain realized on the amount of accumulated DISC income determined with respect to such stock under section 995(c). Such gain is included in gross income as a dividend as provided in sections 996(c) and 996(g).

(7) Anti-stuffing rule. If an asset the adjusted basis of which exceeds its fair market value is contributed or transferred to a target affiliate as transferred basis property (within the meaning of section 7701(a)(43)) and a purpose of such transaction is to reduce the gain (or increase the loss) recognized on the deemed sale of such target affiliate’s stock, the gain or loss recognized by target on the deemed sale of stock of the target affiliate is determined as if such asset had not been contributed or transferred.

(8) Examples. The following examples illustrate this paragraph (h):

Example 1. (i) P makes a qualified stock purchase of T and makes a section 338 election for T. T’s sole asset, all of the T1 stock, has a basis of $50 and a fair market value of $150. T’s deemed purchase of the T1 stock results in a qualified stock purchase of T1 and a section 338 election is made for T1. T1’s assets have a basis of $50 and a fair market value of $150.

(ii) T realizes $100 of gain on the deemed sale of the T1 stock, but the gain is not recognized because T directly owns stock in T1 satisfying the requirements of section 1504(a)(2) and a section 338 election is made for T1.
§ 1.338–5

Internal Revenue Service, Treasury

(iii) T1 recognizes gain of $100 on the deemed sale of its assets.

Example 3. (i) P makes a qualified stock purchase of T and makes a section 338 election for T. T owns all of the stock of FT1 and FT2. T's deemed purchase of the T1 and T2 stock results in a qualified stock purchase of T1 and T2 and section 338 elections are made for T1 and T2. T1 and T2 each own 50 percent of the vote and value of T3 stock. The deemed purchases by T1 and T2 of the T3 stock result in a qualified stock purchase of T3 and a section 338 election is made for T3.

(ii) Because T, T1, T2, and T3 are members of a consolidated group and all of the deemed asset sales are reported on the T group's final consolidated return. See §1.338–10(a)(1).

(iii) The liabilities of new target.

Example 4. (i) T's sole asset, all of the FT1 stock, has a basis of $25 and a fair market value of $150. FT1's sole asset, all of the FT2 stock, has a basis of $75 and a fair market value of $150. FT1 and FT2 each have $50 of accumulated earnings and profits for purposes of section 1248(c) and (d). FT2's assets have a basis of $25 and a fair market value of $150, and their sale would not generate income effectively connected with the conduct of a trade or business within the United States. FT1 does not have an election in effect under section 953(d) and neither FT1 nor FT2 is a passive foreign investment company.

(ii) P makes a qualified stock purchase of T and makes a section 338 election for T. T's deemed purchase of the FT1 stock results in a qualified stock purchase of FT1 and a section 338 election is made for FT1. Similarly, FT1's deemed purchase of the FT2 stock results in a qualified stock purchase of FT2 and a section 338 election is made for FT2.

(iii) T recognizes $125 of gain on the deemed sale of the FT1 stock under paragraph (h)(3) of this section. FT1 does not recognize $75 of gain on the deemed sale of the FT2 stock under paragraph (h)(2) of this section. FT2 recognizes $25 of gain on the deemed sale of its assets. The $125 gain T recognizes on the deemed sale of the FT1 stock is included in T's income as a dividend under section 1248, because FT1 and FT2 have sufficient earnings and profits for full recharacterization. $50 of accumulated earnings and profits in FT1, $50 of accumulated earnings and profits in FT2, and $25 of deemed sale earnings and profits in FT2.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.

Example 2. The facts are the same as in Example 1, except that P does not make a section 338 election for T1. Because a section 338 election is not made for T1, the $100 gain realized by T on the deemed sale of the T1 stock is recognized.