target stock by the purchasing corporation after the acquisition date from minority shareholders. See also §1.338–1(d) (regarding certain transactions on the acquisition date).

(g) Examples. The following examples illustrate this section. For purposes of the examples in this paragraph (g), T has no liabilities other than the tax liability for the deemed sale tax consequences, T shareholders incur no costs in selling the T stock, and P incurs no costs in acquiring the T stock. The examples are as follows:

Example 1. (i) Before July 1 of Year 1, P purchases 10 of the 100 shares of T stock for $5,000. On July 1 of Year 2, P purchases 80 shares of T stock for $60,000 and makes a section 338 election for T. As of July 1 of Year 2, T's only asset is raw land with an adjusted basis to T of $50,400 and a fair market value of $100,000. T has no loss or tax credit carryovers to Year 2. T's marginal tax rate on capital gains is 28 percent. On June 30 of Year 2, P sells the remaining 20 shares of T stock for $50,000. On June 15 of Year 2, P purchases 50 shares of T stock for $50,000. On June 15 of Year 2, P contributes a tract of land to the capital of T and receives 10 additional shares of T stock as a result of the contribution. Both the basis and fair market value of the land at that time are $10,800. On June 30 of Year 2, P purchases the remaining 40 shares of T stock for $40,000 and makes a section 338 election for T. The AGUB of T is $87,672.72. Thus, P recognizes a gain in Year 2 with respect to its nonrecently purchased T stock of $2,500 (i.e., $7,500 − $5,000).

Example 2. On January 1 of Year 1, P purchases one-third of the T stock. On March 1 of Year 1, T distributes a dividend of $2,500 to all of its shareholders. On April 15 of Year 1, P purchases the remaining T stock and makes a section 338 election for T. The AGUB of T is $108,800. The AGUB of T is $110,800.

Example 3. (i) T's sole asset is a building worth $100,000. At this time, T has 100 shares of stock outstanding. On August 1 of Year 1, P purchases 10 of the 100 shares of T stock for $8,000. On June 1 of Year 2, P purchases 50 shares of T stock for $50,000. On June 15 of Year 2, P contributes a tract of land to the capital of T and receives 10 additional shares of T stock as a result of the contribution. Both the basis and fair market value of the land at that time are $10,800. On June 30 of Year 2, P purchases the remaining 40 shares of T stock for $40,000 and makes a section 338 election for T. The AGUB of T is $87,672.72.

(vii) As a result of the gain recognition election, P's basis in its nonrecently purchased T stock is increased from $5,000 to $7,500 (i.e., $60,000 × [(1 − .1)/(1 − .1)])

(viii) The AGUB of new T's assets is $87,672.72, determined as follows (In the following formula below, GRP is the grossed-up basis in P's recently purchased T stock, BNP is P's basis in nonrecently purchased T stock, L is T's liabilities, and X is P's acquisition costs for the recently purchased T stock):

\[
\text{AGUB} = \text{GRP} + \text{BNP} + L + X
\]

\[
\text{AGUB} = 60,000 \times (1 - .1) \times (1 - .1) + 5,000 + 12,672.72 + 0
\]

\[
\text{AGUB} = 87,672.72
\]

(v) If P makes a gain recognition election, the AGUB of new T's assets is $87,672.72, determined as follows:

\[
\text{AGUB} = 60,000 \times (1 - .1) \times (1 - .1) + 5,000 \times (1 - .1) + 12,672.72
\]

\[
\text{AGUB} = 87,672.72
\]

(vi) The calculation of AGUB if P makes a gain recognition election may be simplified as follows:

\[
\text{AGUB} = 60,000 \times .8 + 12,672.72
\]

\[
\text{AGUB} = 87,672.72
\]
not less than the amount of such indebtedness. (For purposes of the preceding sentence, a liability that was incurred because of the acquisition of the property is disregarded to the extent that such liability was not taken into account in determining old target’s basis in such property.)

(ii) Transaction costs. Transaction costs are not taken into account in allocating ADSP or AGUB to assets in the deemed sale (except indirectly through their effect on the total ADSP or AGUB to be allocated).

(iii) Internal Revenue Service authority. In connection with the examination of a return, the Internal Revenue Service may challenge the taxpayer’s determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties.

(b) General rule for allocating ADSP and AGUB—(1) Reduction in the amount of consideration for Class I assets. Both ADSP and AGUB, in the respective allocation of each, are first reduced by the amount of Class I assets. Class I assets are cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions. If the amount of Class I assets exceeds AGUB, new target will immediately realize ordinary income in an amount equal to such excess. The amount of ADSP or AGUB remaining after the reduction is to be allocated to the remaining acquisition date assets.

(2) Other assets—(i) In general. Subject to the limitations and other rules of paragraph (c) of this section, ADSP and AGUB (as reduced by the amount of Class I assets) are allocated among Class II acquisition date assets of target in proportion to the fair market values of such Class II assets at such time, then among Class III assets so held in such proportion, then among Class IV assets so held in such proportion, then among Class V assets so held in such proportion, and finally to Class VII assets. If an asset is described below as includible in more than one class, then it is included in such class with the lower or lowest class number (for instance, Class III has a lower class number than Class IV).

(ii) Class II assets. Class II assets are actively traded personal property within the meaning of section 1092(d)(1) and §1.1092(d)–1 (determined without regard to section 1092(d)(3)). In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Class II assets do not include stock of target affiliates, whether or not of a class that is actively traded, other than actively traded stock described in section 1504(a)(4). Examples of Class II assets include U.S. government securities and publicly traded stock.

(iii) Class III assets. Class III assets are assets that the taxpayer marks to market at least annually for Federal income tax purposes and debt instruments (including accounts receivable). However, Class III assets do not include—

(A) Debt instruments issued by persons related at the beginning of the day following the acquisition date to the target under section 267(b) or 707;

(B) Contingent debt instruments subject to §1.1275–4, §1.483–4, or section 988, unless the instrument is subject to the non-contingent bond method of §1.1275–4(b) or is described in §1.988–2(b)(1)(B)(2); and

(C) Debt instruments convertible into the stock of the issuer or other property.

(iv) Class IV assets. Class IV assets are stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

(v) Class V assets. Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets.

(vi) Class VI assets. Class VI assets are all section 197 intangibles, as defined in section 197, except goodwill and going concern value.

(vii) Class VII assets. Class VII assets are goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).
(3) Other items designated by the Internal Revenue Service. Similar items may be added to any class described in this paragraph (b) by designation in the Internal Revenue Bulletin by the Internal Revenue Service (see §601.601(d)(2) of this chapter).

(c) Certain limitations and other rules for allocation to an asset—(1) Allocation not to exceed fair market value. The amount of ADSP or AGUB allocated to an asset (other than Class VII assets) cannot exceed the fair market value of that asset at the beginning of the day after the acquisition date.

(2) Allocation subject to other rules. The amount of ADSP or AGUB allocated to an asset is subject to other provisions of the Internal Revenue Code or general principles of tax law in the same manner as if such asset were transferred to or acquired from an unrelated person in a sale or exchange. For example, if the deemed asset sale is a transaction described in section 1056(a) (relating to basis limitation for player contracts transferred in connection with the sale of a franchise), the amount of AGUB allocated to a contract for the services of an athlete cannot exceed the limitation imposed by that section. As another example, section 197(f)(5) applies in determining the amount of AGUB allocated to an amortizable section 197 intangible resulting from an assumption-reinsurance transaction.

(3) Special rule for allocating AGUB when purchasing corporation has nonrecently purchased stock—(i) Scope. This paragraph (c)(3) applies if at the beginning of the day after the acquisition date—

(A) The purchasing corporation holds nonrecently purchased stock for which a gain recognition election under section 338(b)(3) and §1.338–5(d) is not made; and

(B) The hypothetical purchase price determined under paragraph (c)(3)(ii) of this section exceeds the AGUB determined under §1.338–5(b).

(ii) Determination of hypothetical purchase price. Hypothetical purchase price is the AGUB that would result if a gain recognition election were made.

(iii) Allocation of AGUB. Subject to the limitations in paragraphs (c)(1) and (2) of this section, the portion of AGUB (after reduction by the amount of Class I assets) to be allocated to each Class II, III, IV, V, VI, and VII asset of target held at the beginning of the day after the acquisition date is determined by multiplying—

(A) The amount that would be allocated to such asset under the general rules of this section were AGUB equal to the hypothetical purchase price; by

(B) A fraction, the numerator of which is actual AGUB (after reduction by the amount of Class I assets) and the denominator of which is the hypothetical purchase price (after reduction by the amount of Class I assets).

(4) Liabilities taken into account in determining amount realized on subsequent disposition. In determining the amount realized on a subsequent sale or other disposition of property deemed purchased by new target, §1.1001–2(a)(3) shall not apply to any liability that was taken into account in AGUB.

(5) Allocation to certain nuclear decommissioning funds—(i) General rule. For purposes of allocating ADSP or AGUB among the acquisition date assets of a target (and for no other purpose), a taxpayer may elect to treat a nonqualified nuclear decommissioning fund (as defined in paragraph (c)(5)(ii) of this section) of the target as if—

(A) Such fund were an entity classified as a corporation;

(B) The stock of the corporation were among the acquisition date assets of the target and a Class V asset;

(C) The corporation owned the assets of the fund;

(D) The corporation bore the responsibility for decommissioning one or more nuclear power plants to the extent assets of the fund are expected to be used for that purpose; and

(E) A section 338(h)(10) election were made for the corporation (regardless of whether the requirements for a section 338(h)(10) election are otherwise satisfied).

(ii) Definition of nonqualified nuclear decommissioning fund. A nonqualified nuclear decommissioning fund means a trust, escrow account, Government fund or other type of agreement—

(A) That is established in writing by the owner or licensee of a nuclear generating unit for the exclusive purpose...
of funding the decommissioning of one or more nuclear power plants;
(B) That is described to the Nuclear Regulatory Commission in a report described in 10 CFR 50.75(b) as providing assurance that funds will be available for decommissioning;
(C) That is not a Nuclear Decommissioning Reserve Fund, as described in section 468A;
(D) That is maintained at all times in the United States; and
(E) The assets of which are to be used only as permitted by 10 CFR 50.82(a)(8).

(iii) Availability of election. P may make the election described in this paragraph (c)(5) regardless of whether the selling consolidated group (or the selling affiliate or the S corporation shareholders) also makes the election. In addition, the selling consolidated group (or the selling affiliate or the S corporation shareholders) may make the election regardless of whether P also makes the election. If T is an S corporation, all of the S corporation shareholders, including those that do not sell their stock, must consent to the election for the election to be effective as to any S corporation shareholder.

(iv) Time and manner of making election. The election described in this paragraph (c)(5) is made by taking a position on an original or amended tax return for the taxable year of the qualified stock purchase that is consistent with having made the election. Such tax return must be filed no later than the later of 30 days after the date on which the section 338 election is due or the day the original tax return for the taxable year of the qualified stock purchase is due (with extensions).

(v) Irrevocability of election. An election made pursuant to this paragraph (c)(5) is irrevocable.

(vi) Effective/applicability date. This paragraph (c)(5) applies to qualified stock purchases occurring on or after September 11, 2007. For qualified stock purchases occurring before September 11, 2007 and on or after September 15, 2004, see §1.338–6T as contained in 26 CFR part 1 in effect on April 1, 2007. For qualified stock purchases occurring before September 15, 2004, see §1.338–6 as contained in 26 CFR part 1 in effect on April 1, 2004.

(d) Examples. The following examples illustrate §§1.338–4, 1.338–5, and this section:

Example 1. (i) T owns 90 percent of the outstanding T1 stock. P purchases 100 percent of the outstanding T stock for $2,000. There are no acquisition costs. P makes a section 338 election for T and, as a result, T1 is considered acquired in a qualified stock purchase. A section 338 election is made for T1. The grossed-up basis of the T stock is $2,000 (i.e., $2,000 + $1).

(ii) The liabilities of T as of the beginning of the day after the acquisition date (including the tax liability for the deemed sale tax consequences) that would, under general principles of tax law, properly be taken into account at that time, are as follows:

Liabilities (nonrecourse mortgage plus unsecured liabilities) ...................................................... $700
Taxes Payable .................................................................................................................. 300
Total ............................................................................................................................... 1,000

(iii) The AGUB of T is determined as follows:

Grossed-up basis ........................................................................................................... $2,000
Total liabilities .............................................................................................................. 1,000
AGUB .......................................................................................................................... 3,000

(iv) Assume that ADSFP is also $3,000.

(v) Assume that, at the beginning of the day after the acquisition date, T’s cash and the fair market values of T’s Class II, III, IV, and V assets are as follows:

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Asset</th>
<th>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>I ............</td>
<td>Cash</td>
<td>$200</td>
</tr>
<tr>
<td>II ...........</td>
<td>Portfolio of actively traded securities</td>
<td>$300</td>
</tr>
<tr>
<td>III ..........</td>
<td>Accounts receivable</td>
<td>$600</td>
</tr>
<tr>
<td>IV ...........</td>
<td>Inventory</td>
<td>$300</td>
</tr>
<tr>
<td>V ............</td>
<td>Building</td>
<td>$800</td>
</tr>
<tr>
<td>V ............</td>
<td>Land</td>
<td>$200</td>
</tr>
<tr>
<td>V ............</td>
<td>Investment in T1</td>
<td>$450</td>
</tr>
<tr>
<td>Total ..........</td>
<td>2,850</td>
<td></td>
</tr>
</tbody>
</table>

*Amount.

(vi) Under paragraph (b)(1) of this section, the amount of ADSFP and AGUB allocable to T’s Class II, III, IV, and V assets is reduced by the amount of cash to $2,800, i.e., $3,000 — $200. $300 of ADSFP and of AGUB is then allocated to actively traded securities. $600 of ADSFP and of AGUB is then allocated to accounts receivable. $300 of ADSFP and of AGUB is then allocated to the inventory. Since the remaining amount of ADSFP and of AGUB is $1,600 (i.e., $3,000 — ($200 + $300 + $800 + $300)), an amount which exceeds the sum of the fair market values of T’s Class V assets, the amount of ADSFP and of AGUB allocated to each Class V asset is its fair market value:

Building ........................................................................... $800
Land .................................................................................. 200
§ 1.338–6

26 CFR Ch. I (4–1–11 Edition)

Investment in T1 ........................................ 450

Total .................................................. 1,450

(vii) T has no Class VI assets. The amount of ADSP and of AGUB allocated to T’s Class VII assets (goodwill and going concern value) is $150, i.e., $1,600–$1,450.

(viii) The grossed-up basis of the T1 stock is $500, i.e., $500 × 1.9.

(ix) The liabilities of T1 as of the beginning of the day after the acquisition date (including the tax liability for the deemed sale tax consequences) that would, under general principles of tax law, properly be taken into account at that time, as follows:

| General Liabilities | $100 |
| Tax Payable | 20 |
| Total | 120 |

(x) The AGUB of T1 is determined as follows:

| Grossed-up basis of T1 Stock | $500 |
| Liabilities | 120 |
| Total | 1,600 |

(xi) Assume that ADSP is also $500.

(xii) Assume that at the beginning of the day after the acquisition date, T1’s cash and the fair market values of its Class IV and VI assets are as follows:

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Asset</th>
<th>Fair market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Cash</td>
<td>*$50</td>
</tr>
<tr>
<td>IV</td>
<td>Inventory</td>
<td>200</td>
</tr>
<tr>
<td>VI</td>
<td>Patent</td>
<td>350</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>600</td>
</tr>
</tbody>
</table>

* Amount.

(xiii) The amount of ADSP and of AGUB allocable to T1’s Class IV and VI assets is first reduced by the $50 of cash.

(xiv) Because the remaining amount of ADSP and of AGUB ($570) is an amount which exceeds the fair market value of T1’s only Class IV asset, the inventory, the amount allocated to the inventory is its fair market value ($300). After that, the remaining amount of ADSP and of AGUB ($270) exceeds the fair market value of T1’s only Class VI asset, the patent. Thus, the amount of ADSP and of AGUB allocated to the patent is its fair market value ($350).

(xv) The amount of ADSP and of AGUB allocated to T1’s Class VII assets (goodwill and going concern value) is $30, i.e., $570–$550.

Example 2. (i) Assume that the facts are the same as in Example 1 except that P has, for five years, owned 20 percent of T’s stock, which has a basis in P’s hands at the beginning of the day after the acquisition date of $100, and P purchases the remaining 80 percent of T’s stock for $1,600. P does not make a gain recognition election under section 338(b)(3).

(ii) Under § 1.338–5(o), the grossed-up basis of recently purchased T stock is $1,600, i.e., $1,600 × (1–0.2)/0.8.

(iii) The AGUB of T is determined as follows:

| Grossed-up basis of recently purchased stock as determined under § 1.338–5(o) ($1,600 × (1–0.2)/0.8) | $1,600 |
| Basis of nonrecently purchased stock | 100 |
| Liabilities | 1,000 |
| Total | 3,000 |

(iv) Since P holds nonrecently purchased stock, the hypothetical purchase price of the T stock must be computed and is determined as follows:

| Grossed-up basis of recently purchased stock as determined under § 1.338–5(o) ($1,600 × (1–0.2)/0.8) | $1,600 |
| Basis of nonrecently purchased stock as if the gain recognition election under § 1.338–5(o) had been made ($1,600 × 2(1–0.2)) | 400 |
| Liabilities | 1,000 |
| Total | 3,000 |

(v) Since the hypothetical purchase price ($3,000) exceeds the AGUB ($2,700) and no gain recognition election is made under section 338(b)(3), AGUB is allocated under paragraph (c)(3) of this section.

(vi) First, an AGUB amount equal to the hypothetical purchase price ($3,000) is allocated among the assets under the general rules of this section. The allocation is set forth in the column below entitled Original Allocation. Next, the allocation to each asset in Class II through Class VII is multiplied by a fraction having a numerator equal to the actual AGUB reduced by the amount of Class I assets ($2,700–$200 = $2,500) and a denominator equal to the hypothetical purchase price reduced by the amount of Class I assets ($3,000–$200 = $2,800), or 2,500/2,800. This produces the Final Allocation:

<table>
<thead>
<tr>
<th>Class</th>
<th>Asset</th>
<th>Original allocation</th>
<th>Final allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Cash</td>
<td>$200</td>
<td>$200</td>
</tr>
<tr>
<td></td>
<td>Portfolio of actively traded securities</td>
<td>300 *668</td>
<td></td>
</tr>
<tr>
<td>III</td>
<td>Accounts receivable</td>
<td>600 536</td>
<td></td>
</tr>
<tr>
<td>IV</td>
<td>Inventory</td>
<td>300 268</td>
<td></td>
</tr>
<tr>
<td>V</td>
<td>Building</td>
<td>800 714</td>
<td></td>
</tr>
<tr>
<td>VI</td>
<td>Land</td>
<td>200 178</td>
<td></td>
</tr>
<tr>
<td>VII</td>
<td>Investment in T1</td>
<td>450 402</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Goodwill and going concern value</td>
<td>150 134</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>3,000 2,700</td>
<td></td>
</tr>
</tbody>
</table>

* All numbers rounded for convenience.


124