

v. Commissioner, 80 T.C. 895 (1983) (individual purchased target stock and then target merged into another corporation controlled by the individual); *Estate of McWhorter v. Commissioner*, 69 T.C. 650 (1978), *aff'd*, 590 F.2d 340 (8th Cir. 1978) (corporation purchased target stock and then target merged into purchaser); and *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974) (corporation purchased target stock and then target merged into purchaser).

The *Yoc Heating* court's analysis of the transaction as, in substance, a taxable asset acquisition by the subsidiary is consistent with generally applied federal income tax principles. For example, in *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951), an acquiring corporation's purchase of a target corporation's stock followed by the liquidation of the target was treated for federal income tax purposes as, in substance, a direct purchase of the target's assets by the acquiring corporation. The Tax Court's characterization in *Kimbell-Diamond* was based on a finding that the acquiring corporation intended to obtain the target's assets rather than its stock. As a result, the acquiring corporation's basis in the target's assets was determined by reference to the purchase price of the target's stock.

In 1954, Congress codified principles derived from *Kimbell-Diamond* by enacting former section 334(b)(2) of the Internal Revenue Code of 1954, which created an objective test that permitted a stock purchase followed by liquidation of the target to be treated as an asset acquisition. S. Rep. No. 1622, 83d Cong., 2d Sess. 257 (1954).

In 1982, Congress repealed section 334(b)(2) and replaced it with section 338, which provides that, if a corporation makes a qualified stock purchase (QSP) of the stock of a target, the purchasing corporation may elect to have the target treated as having sold all of its assets at the close of the acquisition date in a single transaction and as a new corporation that purchased all such assets at the beginning of the following day. Section 338 was "intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine." H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 467, 536 (1982), 1982-2 C.B. 600, 632.

Under section 338(i), the IRS and Treasury are authorized to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 338. The IRS and Treasury

believe that the result in *Yoc Heating* is inconsistent with the legislative intent behind section 338. As a result of the enactment of section 338, an intragroup merger or similar transaction following a QSP generally should not be treated as part of an overall asset acquisition. The qualified stock purchase must be accorded its intended effect. *Cf. Rev. Rul. 90-95*, 1990-2 C.B. 67 (applying sections 332 and 334 to a merger of the target into the purchasing corporation following a QSP). If a section 338 election is not made, in a subsequent intragroup merger or similar transaction, the target assets generally should preserve their historic basis maintained in the qualified stock purchase. The IRS and Treasury believe that applying the reorganization rules to the target and purchasing group in mergers and similar transactions following a QSP is the simplest and most effective means of achieving the congressional intent in repealing the *Kimbell-Diamond* doctrine.

Explanation of Provisions

Proposed § 1.338-2(c)(3) applies to the transfer of target assets to the purchasing corporation or another member of the same affiliated group as the purchasing corporation (the transferee) following a QSP of target stock, if the purchasing corporation does not make a section 338 election for the target.

As noted above, for the transfer of target assets to be pursuant to a reorganization within the meaning of section 368, there must be a continuity of interest in the target's business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization. See § 1.368-1(b). The proposed regulations generally provide that, by virtue of the application of section 338, the purchasing corporation's target stock acquired in the QSP represents an interest on the part of a person who was an owner of the target's business enterprise prior to the transfer that can be continued in a reorganization for the purpose of determining whether the continuity of interest requirement is satisfied. A corollary provision enables the transfer to satisfy the requirements for an acquisitive reorganization under section 368(a)(1)(D).

Notwithstanding the general rule above, the proposed regulations provide that sections 354, 355, 356 and 358 do not apply to any person other than the purchasing corporation or another member of the same affiliated group as the purchasing corporation unless the transfer of target assets is pursuant to a

reorganization under generally applicable rules without regard to the provisions of the proposed regulations. The legislative history of section 338 does not indicate any intent to eliminate the continuity of interest requirement generally and allow reorganization treatment to shareholders receiving stock in acquisitions where the overall consideration does not preserve continuity of interest. The rules provided in the proposed regulations reconcile Congress' concerns in enacting section 338 with general reorganization principles.

The IRS and Treasury request comments on the proposed rules, including, particularly, comments regarding the collateral consequences of treating the transaction as a reorganization to the target and to the purchasing corporation and its affiliates, but not to persons unaffiliated with the purchasing corporation. The IRS and Treasury also solicit comments as to whether guidance is needed as to the proper treatment of post-QSP mergers and similar transactions if a section 338 election is made for the target.

Proposed Effective Date

Section 1.338-2(c)(3) is proposed to be effective for transfers of target assets occurring on or after the date final regulations are filed with the Office of the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before this proposed regulation is adopted as a final regulation, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for June 7, 1995, at 10 a.m. in room