

elections under section 338. The text of the temporary regulations herein also serves as the text of REG-252665-96.

**EFFECTIVE DATE:** These regulations are effective February 14, 1997.

For dates of applicability, see §§ 1.338(b)-2T(c)(4) and 1.1060-1T(a)(2)(ii).

**FOR FURTHER INFORMATION CONTACT:** Brendan P. O'Hara, Office of Assistant Chief Counsel (Corporate), (202) 622-7530 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

#### *Background*

These regulations amend the current temporary regulations under sections 1060 (§ 1.1060-1T) and 338(b) (§§ 1.338(b)-2T and 1.338(b)-3T) (the current regulations) with respect to the treatment of acquired intangible assets. They also amend related examples in the final regulations under section 338. Section 1060 provides for the allocation of purchase price among the assets of a trade or business under regulations. Section 338(b) provides for a similar allocation, also under regulations, for a deemed purchase of assets under section 338. The current regulations employ a residual method of allocation. The legislative history of section 1060, adopted in 1986, noted with approval the use of the residual method under the section 338(b) regulations and required that the same method be used pursuant to regulations to be prescribed under section 1060. S. Rep. No. 99-313, 99th Cong., 2d Sess. 253, 254 (1986); 1986-3 C.B. Vol. 3, 253-54.

The current regulations place each acquired asset into one of four asset classes. The purchase price is allocated among the classes in priority order. No asset in any class except for the last class is allocated more than its fair market value. If the aggregate purchase price allocable to a particular class is less than the aggregate fair market value of the assets within the class, each asset is allocated an amount in proportion to its fair market value and nothing is allocated to any junior class.

The four classes under the current regulations are as follows:

**Class I**—Cash and cash equivalents;  
**Class II**—Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency;

**Class III**—All assets not in Class I, II, or IV; and

**Class IV**—Intangible assets in the nature of goodwill and going concern value.

Section 197 was enacted as part of the Omnibus Budget Reconciliation Act of 1993, Public Law 103-66, 107 Stat. 312 (1993) (the 1993 Act). Prior to the 1993 Act, acquired goodwill and going concern value were not amortizable, but other acquired intangible assets were amortizable if they could be separately identified and their useful lives determined with reasonable accuracy. Section 197 responded to policy and administrative concerns regarding the treatment of acquired intangibles by providing similar treatment for goodwill, going concern value, and certain other intangible assets acquired in a taxable acquisition and held in connection with a trade or business. The 1993 Act allows taxpayers to amortize certain acquired intangible assets (amortizable section 197 intangibles) over 15 years, subject to certain exceptions.

The report of the House Committee on Ways and Means accompanying the 1993 Act states that:

It is expected that the present [regulations under sections 338 and 1060] will be amended to reflect the fact that [section 197] allows an amortization deduction with respect to intangible assets in the nature of goodwill and going concern value. It is anticipated that the residual method specified in the regulations will be modified to treat all amortizable section 197 intangibles as Class IV assets and that this modification will apply to any acquisition of property to which [section 197] applies.

H.R. Rep. 111, 103d Cong., 1st Sess. 760, 776 (May 23, 1993), 1993-3 C.B. 336, 352.

The current regulations have not yet been amended in accordance with the legislative history of section 197. These new temporary regulations accomplish that change, with slight modifications, as discussed below.

#### *Explanation of Provisions*

The temporary and final regulations are amended to conform to the legislative history of the 1993 Act by placing all amortizable section 197 intangibles other than goodwill and going concern value in Class IV.

However, the new regulations also include nonamortizable section 197 intangibles in Class IV. Some section 197

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## **Section 338.—Certain Stock Purchases Treated as Asset Acquisitions**

*26 CFR 1.338(b)-2T: Allocation of adjusted grossed-up basis among target assets (temporary).*

**T.D. 8711**

**DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
26 CFR Part 1**

### **Intangibles Under Sections 1060 and 338**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final and temporary regulations.

**SUMMARY:** This document amends the temporary regulations under sections 1060 and 338(b) of the Internal Revenue Code (Code) relating to purchase price allocations in taxable asset acquisitions and deemed asset purchases. The amendments revise the treatment of intangible assets in such acquisitions to take into account the enactment of section 197 by the Omnibus Budget Reconciliation Act of 1993. This document also makes conforming amendments to the final regulations under section 338. The regulations provide guidance regarding taxable asset acquisitions and deemed asset purchases resulting from

intangibles are amortizable by the buyer though they were not amortizable by the seller. Other section 197 intangibles may not be amortizable because of the application of the anti-churning rules of section 197(f)(9). Although sections 338(b) and 1060 do not require conformity between the buyer and seller on purchase price allocations, they reflect strong policies encouraging conformity, including mandatory application of the rule of *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967), in cases where the parties have agreed to an allocation, and a reporting system designed to reveal situations where the parties' allocations are inconsistent. These policies favoring conformity are best served by requiring both parties to include the same assets in each class. Moreover, this rule is also more consistent with section 1060(b) as amended by the 1993 Act. Section 1060(b)(1) requires the parties to report, under regulations, "the amount of consideration received for the assets which is allocable to section 197 intangibles." The term *section 197 intangibles* is more inclusive than amortizable section 197 intangibles. The goals of consistency, simplification, and administrability will be better achieved with respect to allocations to section 197 intangibles if all such assets are removed from Class III and isolated in a junior class (or classes). Accordingly, these regulations classify all section 197 intangibles (other than goodwill and going concern value) as Class IV assets.

To reconcile the original intention of Congress in requiring the residual method of allocation for goodwill and going concern value with the legislative history of the 1993 Act, these regulations provide that goodwill and going concern value will be assigned to a true residual class, Class V. This method is consistent with the policies of section 197 (which regards many intangible assets as the functional equivalent of goodwill and going concern value and thus treats them uniformly) as well as the original intention of the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085 (1986) (that goodwill and going concern value not be valued separately for purchase price allocation purposes). Allocating goodwill and going concern value to Class V avoids the need for determining the value of goodwill and going concern value through a non-residual method. Although this approach places some section 197 intangibles in Class V instead of Class IV, it

carries out the expectation set forth in the legislative history of the 1993 Act by making section 197 intangibles junior to all other assets in the allocation scheme. The practical significance of placing goodwill and going concern value in Class V is generally limited to circumstances in which fewer than all of the amortizable section 197 intangibles acquired in a single transaction are subsequently disposed of at a gain. Those situations, in any case, require some method of allocation among the intangibles.

#### *Effective Date*

These regulations are effective for applicable asset acquisitions, as defined in section 1060(c), completed on or after February 14, 1997, and for acquisition dates, as defined in section 338(h)(2), on or after February 14, 1997.

As described above, the current regulations have been in conflict with the 1993 Act legislative history concerning the classification of amortizable section 197 intangibles other than goodwill and going concern value since August 10, 1993, generally (the date of enactment of section 197), and, in some cases, since 1991.

The legislative history to the 1993 Act clearly contemplates that changes to the classification system would be made by amended regulations. In the absence of such amendments, the only system available under regulations was the four-class system established before the enactment of section 197. Further, the IRS revised Form 8594, Asset Acquisition Statement under Section 1060, in January of 1996 in a manner consistent with the legislative history, i.e., by placing all amortizable section 197 intangibles in Class IV. For acquisition dates before February 14, 1997, if section 197 applies to any asset acquired or deemed acquired, the taxpayer (and all related parties) may consistently (in all transactions in which AGUB, ADSP, MADSP, or consideration must be allocated under section 338 or 1060)—

- (i) apply these new rules in full as written;
- (ii) apply the current temporary regulations as written; or
- (iii) apply the current temporary regulations as written, but treat all amortizable section 197 intangibles as Class IV assets.

#### *Special Analyses*

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

#### *Drafting Information*

The principal author of these regulations is Brendan P. O'Hara, Office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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#### *Adoption of Amendments to the Regulations*

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. In § 1.338-0, entries for § 1.338(b)-2T(b)(2)(v) and § 1.338(b)-2T(c)(4) are added to read as follows:

#### *§ 1.338-0 Outline of topics.*

\* \* \* \* \*

#### *§ 1.338(b)-2T Allocation of adjusted grossed-up basis among target assets (temporary).*

\* \* \* \* \*

- (b) \* \* \*
- (2) \* \* \*
- (v) Class V assets.
- (c) \* \* \*
- (4) Effective dates.

\* \* \* \* \*

Par. 3. Section 1.338-3 is amended by:

- 1. Revising paragraph (b)(4).
- 2. Revising paragraph (d)(8)(ii) *Example 1*, paragraph (e); *Example 2*, paragraphs (a), (b), and (d); *Example 3*,

paragraph (d); and *Example 4*, paragraphs (d) and (f). The revisions read as follows:

§ 1.338-3 *Deemed sale and aggregate deemed sale price.*

\* \* \* \* \*

(b) \* \* \*

(4) *Classes of assets.* The classes of assets are defined in § 1.338(b)-2T(b).

\* \* \* \* \*

(d) \* \* \*

(8) \* \* \*

(ii) \* \* \*

*Example 1.* \* \* \*

(e) The facts are the same as in paragraph (a) of this *Example 1*, except that T also has goodwill (a Class V asset) with an appraised value of \$10,000. The results are the same as in paragraphs (b) and (c) of this *Example 1*. Because the ADSP does not exceed the fair market value of the Class III asset, no amount is allocated to the Class V assets (assets in the nature of goodwill and going concern value).

*Example 2.* \* \* \*

(a) P purchases all of the T stock for \$140,000. On July 1 of Year 1, T has liabilities (not including the tax liability for deemed sale gain of its assets) of \$50,000, cash (a Class I asset) of \$10,000, readily marketable securities (a Class II asset) with a basis of \$4,000 and a fair market value of \$10,000, goodwill (a Class V asset) with a basis of \$3,000, and the following Class III assets:

Asset	Basis	FMV	Ratio
1. Land . . . . .	\$ 5,000	\$ 35,000	.14
Inventory . . . . .	10,000	50,000	.20
Equipment A (recomputed basis \$80,000) . . . . .	5,000	90,000	.36
4. Equipment B (recomputed basis \$20,000) . . . . .	10,000	75,000	.30
Totals . . . . .	\$30,000	\$250,000	1.00

(b) The ADSP exceeds \$20,000. Thus, \$10,000 of the ADSP is allocated to the cash and \$10,000 to the marketable securities. Except as provided in section 7701(g), the amount allocated to an asset (other than a Class V asset) cannot exceed its fair market value. See § 1.338(b)-2T(c)(1) (relating to fair market value limitation).

\* \* \* \* \*

(d) Because, under the preliminary calculations of the ADSP, the amount to be allocated to the Class I, II, III, and IV assets does not exceed their aggregate fair market value, no ADSP amount is allocated to goodwill. Accordingly, the deemed sale of the goodwill results in a capital loss of \$3,000. The portion of the ADSP allocable to the Class III assets is finally determined by taking into account this loss as follows:

$$ADSP_{III} = (G - (I + II)) + L + T_R \times [(II - B_{II}) + (ADSP_{III} - B_{III}) + (ADSP_V - B_V)]$$

$$ADSP_{III} = (\$140,000 - (\$10,000 + \$10,000)) + \$50,000 + .34 \times [(\$10,000 - \$4,000) + (ADSP_{III} - \$30,000) + (\$0 - \$3,000)]$$

$$ADSP_{III} = \$160,820 + .34ADSP_{III}$$

$$.66ADSP_{III} = \$160,820$$

$$ADSP_{III} = \$243,666.67$$

\* \* \* \* \*

*Example 3.* \* \* \*

(d)(1) 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 III assets as *III*.)

$$ADSP = G + L + T_R \times [(II - B_{II}) + (III - B_{III}) + (ADSP - (I + II + III + B_V))]$$

$$ADSP = \$150,000 + \$50,000 + .34 \times [(\$10,000 - \$4,000) + (\$250,000 - \$30,000) + (ADSP - (\$10,000 + \$10,000 + \$250,000 + \$3,000))]$$

$$ADSP = \$200,000 + .34ADSP - \$15,980$$

$$.66ADSP = \$184,020$$

$$ADSP = \$278,818.18$$

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

*Example 4.* \* \* \*

(d) Because the portion of the preliminary ADSP allocable to Class III assets (\$243,666.67) does not exceed their fair market value (\$250,000), no amount is allocated to Class V assets for T. Further, this amount (\$243,666.67) is allocated among T's Class III assets in proportion to their fair market values. See paragraph (e) of *Example 2*. Tentatively, \$48,733.34 of this amount is allocated to the T1 stock.

\* \* \* \* \*

(f) The facts are the same as in paragraph (a) of this *Example 4*, except that the T1 inventory has a \$12,500 basis and a \$62,500 value, the T1 stock has a \$62,500 value, and T owns 80% of the T1 stock. In preliminarily calculating ADSP<sub>III</sub>, the T1 stock can be disregarded but, because T owns only 80% of the T1 stock, only 80% of T1 asset basis and value should be taken into account in calculating T's ADSP. By taking into account 80% of these amounts, the remaining calculations and results are the same as in paragraphs (b), (c), (d), and (e) of this *Example 4*, except that the grossed-up basis in T's recently purchased T1 stock is \$44,455.00 (\$35,564.00/0.8).

Par. 4. Section 1.338(b)-2T is amended by:

1. Revising paragraphs (b)(2), (c)(1), and (c)(3)(iii).
2. Adding paragraph (c)(4).
3. Revising paragraph (d) *Example 1*, paragraphs (vi) and (x) through (xiii).
4. Revising paragraph (d) *Example 2*, paragraphs (vi) through (viii).

The revisions and addition read as follows:

§ 1.338(b)-2T *Allocation of adjusted grossed-up basis among target assets (temporary).*

\* \* \* \* \*

(b) \* \* \*

(2) *Other assets*—(i) *In general.* Subject to the limitations and other

special rules of paragraph (c) of this section, adjusted grossed-up basis (as reduced by Class I assets) is allocated among Class II assets of target held at the beginning of the day after the acquisition date in proportion to their fair market values at such time, then among Class III assets so held in such proportion, then among Class IV assets so held in such proportion, and finally to Class V assets.

(ii) *Class II assets.* Class II assets are certificates of deposit, U.S. Government securities, readily marketable stock or securities (within the meaning of § 1.351-1(c)(3)), foreign currency, and other items designated in the Internal Revenue Bulletin by the Internal Revenue Service.

(iii) *Class III assets.* Class III assets are all assets of target other than Class I, II, IV, and V assets.

(iv) *Class IV assets.* Class IV assets are all section 197 intangibles, as defined in section 197, except those in the nature of goodwill and going concern value.

(v) *Class V assets.* Class V assets are section 197 intangibles in the nature of goodwill and going concern value.

(c) \* \* \*

(1) *Basis not to exceed fair market value.* The amount of adjusted grossed-up basis allocated to an asset (other than Class V assets) shall not exceed the fair market value of that asset at the beginning of the day after the acquisition date. For modification of this fair market value limitation with respect to certain contingent income assets, see § 1.338(b)-3T(g).

\* \* \* \* \*

(3) \* \* \*

(iii) *Allocation of adjusted grossed-up basis.* Subject to the limitations in paragraphs (c)(1) and (2) of this section, adjusted grossed-up basis (after reduction by the amount of Class I assets) is allocated among Class II, III, IV, and V assets of target held at the beginning of the day after the acquisition date in proportion to their fair market values at such time. For this purpose, the fair market value of Class V assets is deemed to be the excess, if any, of the hypothetical purchase price over the sum of the amount of the Class I assets and the fair market values of the Class II, III, and IV assets.

(4) *Effective dates.* This section applies for acquisition dates on or after February 14, 1997. For acquisition dates before February 14, 1997, if section 197 does not apply to any asset deemed

acquired, the provisions of the regulations in effect before February 14, 1997, apply (see § 1.338(b)-2T as contained in 26 CFR part 1 revised April 1, 1996). For acquisition dates before February 14, 1997, if section 197 applies to any asset deemed acquired, the taxpayer (and all related parties) may consistently (in all transactions in which AGUB, ADSP, MADSP, or consideration must be allocated under section 338 or 1060)—

(i) Apply the provisions of this section;

(ii) Apply the provisions of this section as in effect before February 14, 1997 (see § 1.338(b)-2T as contained in 26 CFR part 1 revised April 1, 1996); or

(iii) Apply the provisions of this section as in effect before February 14, 1997 (see § 1.338(b)-2T as contained in 26 CFR part 1 revised April 1, 1996), but treat all amortizable section 197 intangibles as Class IV assets.

(d) \* \* \*

*Example 1.* \* \* \*

(vi) T has no Class IV assets. The amount allocated to T's Class V assets (assets in the nature of goodwill and going concern value) is \$150, i.e., \$2,500 - \$2,350.

\* \* \* \* \*

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

Asset Class	Asset	Fair Market Value
I	Cash.....	\$ 50*
III	Equipment.....	200
IV	Patent.....	350
	Total.....	\$ 600

\* Amount

(xi) The amount of AGUB allocable to T1's Class III and IV assets is first reduced by the \$50 of cash.

(xii) Since the remaining amount of AGUB (\$570) is an amount which exceeds the fair market value of T1's only Class III asset, the equipment, the amount allocated to the equipment is its fair market value (\$200). After that, the remaining amount of AGUB (\$370) exceeds the fair market value of T1's only Class IV asset, the patent. Thus, the amount allocated to the patent is its fair market value (\$350).

(xiii) The amount allocated to T1's Class V assets (assets in the nature of goodwill and going concern value) is \$20, i.e., \$570 - \$550.

*Example 2.* \* \* \*

(vi) The amount of AGUB (\$2,700) available to allocate to T's assets is reduced by the amount of cash to \$2,500, i.e., \$2,700 - \$200. This \$2,500 balance is then allocated among the Class II, III, IV, and V assets in proportion to, and not in excess of, their fair market values (as determined under § 1.338(b)-2T(c)(iii)).

(vii) Under paragraph (c)(3) of this section, the fair market value of the Class V assets is deemed to be \$150, i.e., the \$3,000 hypothetical purchase price minus \$2,850 (the sum of T's cash, \$200,

and the fair market value of its Class II, III, and IV assets, \$2,650). The allocation is as follows:

Portfolio of marketable securities.....	\$ 268*
Inventory.....	268
Accounts receivable.....	536
Building.....	714
Land.....	178
Investment in T1.....	402
Goodwill and going concern value.....	134
Total.....	\$2,500

\* All numbers rounded for convenience.

(viii) If the AGUB of T is increased (or decreased) as a result of a subsequent adjustment, the hypothetical purchase price and the deemed fair market value of the Class V assets shall be redetermined and the increase (or decrease) in AGUB shall be allocated among T's acquisition date assets pursuant to § 1.338(b)-3T(f). The increase (or decrease) in AGUB is allocated pursuant to § 1.338(b)-3T(f) even if the hypothetical purchase price, as redetermined, no longer exceeds AGUB, as redetermined.

Par. 5. Section 1.338(b)-3T is amended by:

1. Revising paragraphs (e)(1), (f)(1), and (f)(2).

2. In paragraph (j), redesignating *Example (1)* through *Example (8)* as *Example 1* through *Example 8*.

3. Revising the following newly designated examples in paragraph (j): *Example 1*; *Example 2*; *Example 3*, paragraph (i) and paragraphs (v) through (vii); and *Example 6* through *Example 8*.

The revisions read as follows:

*§ 1.338(b)-3T Subsequent adjustments to adjusted grossed-up basis (temporary).*

\* \* \* \* \*

(e) \* \* \*

(1) *In general.* If adjusted grossed-up basis was allocated in accordance with the rules of § 1.338(b)-2T(b)(2), a decrease in adjusted gross-up basis (as determined under paragraph (c)(3) of this section) is allocated in the following order: first, as a reduction in the bases of target's Class V acquisition date assets, second, as a reduction of the bases of target's Class IV acquisition date assets in proportion to their fair market values at the beginning of the day after the acquisition date, third, as a reduction of the bases of target's Class III acquisition date assets in proportion to their fair market values at the beginning of the day after the acquisition date, and finally, as a reduction of the bases of target's Class II acquisition date assets in proportion to their fair market values at the beginning of the day after the acquisition date. The decrease in adjusted grossed-up basis allocated to an asset shall not exceed the adjusted grossed-up basis of target previously allocated to that asset. If ad-

justed grossed-up basis was allocated among target's assets pursuant to § 1.338(b)-2T(c)(3), a decrease in adjusted grossed-up basis (as determined under paragraph (c)(3) of this section) is accounted for in accordance with the rules of paragraph (f) of this section.

\* \* \* \* \*

(f) \* \* \*

(1) *Scope.* This paragraph (f) applies if adjusted grossed-up basis was allocated among new target's Class II, III, IV, and V assets in accordance with § 1.338(b)-2T(c)(3) and an adjustment event occurs after the close of the new target's first taxable year.

(2) *Allocation of increases (decreases) in adjusted grossed-up basis.* If an adjustment event after the close of new target's first taxable year increases (or decreases) adjusted grossed-up basis, the following items shall be redetermined, taking into account such adjustment event: the hypothetical purchase price, the deemed fair market value of Class V assets, and the adjusted grossed-up basis allocable to each acquisition date asset under § 1.338(b)-2T(c)(3) (the redetermined (c)(3) amount). (The redetermination of the deemed fair market value of Class V assets under this paragraph (f)(2) is made by taking into account the target's Class I assets and the fair market values of its Class II, III, and IV assets at the beginning of the day after the acquisition date.) If the redetermined (c)(3) amount for an acquisition date asset exceeds the amount of adjusted grossed-up basis previously allocated to such asset (taking into account prior adjustments under this paragraph (f)), an amount of adjusted grossed-up basis equal to such excess shall be allocated to such asset. If the amount of the adjusted grossed-up basis previously allocated to an acquisition date asset (taking into account prior adjustments under this paragraph (f)) exceeds the redetermined (c)(3) amount for that asset, an amount equal to such excess shall be allocated as a reduction in the basis of such asset. The rules of paragraph (d)(2) of this section (or paragraph (e)(2) of this section) apply for the treatment of amounts allocable under this paragraph (f) to an acquisition date asset that has been disposed of, depreciated, amortized, or depleted.

\* \* \* \* \*

(j) \* \* \*

*Example 1.* (i)(A) T's assets other than goodwill and going concern value, and their fair market

values at the beginning of the day after the acquisition date, are as follows:

Asset Class	Asset	Fair Market Value
III	Building	\$100
III	Stock of X (not a target)	200
	Total	\$300

(B) T has no liabilities other than a contingent obligation and T does not use the elective formula under section 338(h)(11).

(ii)(A) On September 1, 1997, P purchases all of the outstanding stock of T for \$270 and makes an express election for T. The grossed-up basis of the T stock and T's adjusted grossed-up basis (AGUB) are both \$270. The AGUB is ratably allocated among T's Class III assets in proportion to their fair market values as follows:

Asset	Basis
Building (\$270 x 100/300)	\$ 90
Stock (\$270 x 200/300)	180
Total	\$270

(B) No amount is allocated to the Class V assets. New T is a calendar year taxpayer. Assume that the X stock is a capital asset in the hands of new T.

(iii) On January 1, 1998, new T sells the X stock and uses the proceeds to purchase inventory.

(iv) On June 30, 1999, the contingent liability of old T becomes fixed and determinable. The amount of the liability is \$60.

(v) T's AGUB increases by \$60 from \$270 to \$330. This \$60 increase in AGUB is first allocated among T's acquisition date assets in accordance with the provisions of § 1.338(b)-2T. Since the redetermined AGUB for T (\$330) exceeds the sum of the fair market values at the beginning of the day after the acquisition date of the Class III acquisition date assets (\$300), AGUB allocated to those assets is limited to those fair market values under § 1.338(b)-2T(c)(1). As there are no Class IV assets, the remaining AGUB of \$30 is allocated to goodwill and going concern value (Class V assets). The amount of increase in AGUB allocated to each acquisition date asset is determined as follows:

Asset	Original AGUB	Redetermined AGUB	Increase in AGUB
Building	\$ 90	\$100	\$10
X Stock	180	200	20
Goodwill and going concern value	0	30	30
Total	\$270	\$330	\$60

(vi) Since the X stock was disposed of before the contingent liability became fixed and determinable, no amount of the increase in AGUB attributable to such stock may be allocated to any T asset. Rather, such amount, \$20, is allowed as a capital loss to T for the taxable year 1999 under the principles of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). In addition, the \$10 increase in AGUB allocated to the building and the \$30 increase in AGUB allocated to the goodwill and going concern value are treated as basis redeterminations in 1999. See paragraph (d)(2) of this section.

**Example 2.** (i) On January 1, 1998, P purchases all of the outstanding stock of T and makes an express election for T. T does not use the elective formula under section 338(h)(11). Assume that the AGUB of T is \$500 and is allocated among T's acquisition date assets as follows:

Asset Class	Asset	Basis
III	Machinery	\$150
III	Land	250
V	Goodwill and going concern value	100
	Total	\$500

(ii) On September 30, 1998, P filed a claim against the selling shareholders of T in a court of appropriate jurisdiction alleging fraud in the sale of the T stock.

(iii) On January 1, 2007, the former shareholders refund part of the purchase price to P in a settlement of the lawsuit. This refund results in a decrease of T's AGUB of \$140.

(iv) Under paragraph (e)(1) of this section, the decrease in AGUB is allocated among T's acquisition date assets. First, because \$100 was originally allocated to the Class V assets, \$100 of the decrease is allocated to those assets. As there were no Class IV assets acquired, the remaining decrease in AGUB (\$40) is allocated to the Class III assets in proportion to their fair market values at the beginning of the day after the acquisition date. Thus, \$15 is allocated to the machinery (\$40 x 150/\$400) and \$25 to the land (\$40 x 250/\$400).

(v) Assume that, as a result of deductions under section 168, the adjusted basis of the machinery immediately before the decrease in AGUB is zero. The machinery is treated as if it were disposed of before the decrease is taken into account. In 2007, T recognizes income of \$15, the character of which is determined under the principles of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), and the tax benefit rule. No adjustment to the basis of T's assets is made for any tax paid on this amount. Assume also that, as a result of amortization deductions, the adjusted basis of the goodwill and going concern value immediately before the decrease in AGUB is \$40. A similar adjustment to income is made in 2007 with respect to the \$60 of previously amortized goodwill and going concern value.

(vi) In summary, the basis of T's acquisition date assets, as of January 1, 2007, is as follows:

Asset	Basis
Machinery	\$ 0
Land	225
Goodwill and going concern value	0

**Example 3.** (i) Assume that the facts are the same as *Example 2* of § 1.338(b)-2T(d) except that the recently purchased stock is acquired for \$1,600 plus additional payments that are contingent upon T's future earnings. Thus, T's AGUB, determined as of the beginning of the day after the acquisition date (after reduction by T's cash of \$200), is \$2,500 and is allocable among T's Class II, III, IV, and V acquisition date assets pursuant to § 1.338(b)-2T(c)(3)(iii) as follows:

Portfolio of marketable securities	\$ 268*
Inventory	268
Accounts receivable	536
Building	714
Land	178
Investment in T1	402
Goodwill and going concern value	134
Total	\$2,500

\* All numbers rounded for convenience.

(v) Under § 1.338(b)-2T(c)(3) the redetermined fair market value of Class V assets is deemed to be \$400, i.e., the hypothetical purchase price, as redetermined, of \$3,250 minus \$2,850 (the sum of T's cash, \$200, and the fair market values of its Class II, III, and IV assets, \$2,650).

(vi) The amount of AGUB available to allocate to T's Class II, III, IV, and V acquisition date assets is \$2,700 (i.e., redetermined AGUB reduced by cash). AGUB allocable to each of T's acquisition date assets (i.e., the redetermined (c)(3) amount) is redetermined using the deemed fair market value of the Class V assets from paragraph (v) of this Example as follows:

Portfolio of marketable securities	\$ 266*
Inventory	266
Accounts receivable	531
Building	708
Land	177
Investment in T1	398
Goodwill and going concern value	354
Total	\$2,700

\* All numbers rounded for convenience.

(vii) As illustrated by this example, the application of paragraph (f) of this section results in a basis increase for some assets and a basis decrease for other assets. The amount of increase (or decrease) in AGUB allocated to each acquisition date asset is determined as follows:

Asset	Original AGUB	Redetermined (c)(3) Amount	Increase (or Decrease) in AGUB
Portfolio of marketable securities	\$ 268	\$ 266	\$(2)
Inventory	268	266	(2)
Accounts receivable	536	531	(5)
Building	714	708	(6)
Land	178	177	(1)
Investment in T1	402	398	(4)
Goodwill and going concern value	134	354	220
Total	\$2,500	\$2,700	\$200

\* \* \* \* \*

**Example 6.** (i)(A) T has three assets (other than goodwill and going concern value) whose fair market values as of the beginning of the day after the acquisition date are as follows:

Asset Class	Asset	Fair Market Value
III	Building	\$100
III	Equipment	50
IV	Secret process	50
	Total	\$200

(B) The secret process is a section 197 intangible. T has no liabilities. Assume that no election under section 338(h)(10) or (h)(11) is in effect.

(ii) On January 1, 1998, P purchases all of the outstanding T stock for \$225 plus 50 percent of the net profits generated by the secret process for each of the next three years, determinable and payable on January 1 of each following year. P and T are calendar year taxpayers.

(iii) As of the beginning of January 2, 1998, T's AGUB is \$225, allocated as follows:

Asset Class	Asset	Basis
III	Building	\$100
III	Equipment	50
IV	Secret process	50
V	Goodwill and going concern value	25
	Total	\$225

(iv) On January 1, 1999, \$5 is paid by P for the T stock by reason of the net profits from the secret process. The payments are not attributable

in any respect to any of T's other acquisition date assets. As a result, T's AGUB on January 1, 1999 is increased by \$5.

(v) Assume that on January 1, 1999, the fair market value of the secret process is redetermined to be \$52. (For purposes of this redetermination, only those circumstances that resulted in the increase to AGUB are taken into account.)

(vi) On January 1, 1999, only \$2 of the \$5 increase in AGUB is allocated to the secret process because the increase in AGUB so allocated cannot increase the basis of the secret process above its redetermined fair market value (\$52). The balance of the increase is allocated to goodwill and going concern value because the fair market value limitation of § 1.338(b)-2T(c)(1) precludes allocating additional AGUB to the Class III and IV assets.

(vii) The price for which old target is deemed to have sold the secret process is increased to reflect the \$2 increase allocated to its basis to new target. See § 1.338-3(d) and paragraph (h)(1) of this section.

(viii) If the fair market value of the secret process as of January 1, 1999, is unchanged from the fair market value as of the beginning of the day after the acquisition date, then the \$5 increase in AGUB is allocated to T's goodwill and going concern value.

*Example 7.* (i) The facts are the same as in *Example 6* except that—

(A) The secret process is valued at \$75 as of the beginning of the day after the acquisition date; and

(B) P pays \$250 for the T stock and the former T shareholders agree to refund a portion of the purchase price to P for each of the three years that the net income from the secret process is less than \$15 per year, determinable and payable on January 1 of the next year.

(ii) Assume that the secret process in the hands of new T is an amortizable section 197 intangible and, therefore, on January 1, 1999, new T's adjusted basis in the secret process is \$70 (i.e., \$75-\$5 of allowable amortization).

(iii) Assume the net income from the process is less than \$15 for 1998, and on January 1, 1999, P receives a refund that reduces the stock purchase price by \$3.

(iv) Assume that as of January 1, 1999, the fair market value of the secret process is redetermined to be \$65. (For purposes of this redetermination, only those circumstances that resulted in the decrease to AGUB are taken into account.)

(v) As of January 1, 1999, the AGUB of T is decreased by \$3. This decrease is allocated to the secret process, the basis of which becomes \$67 (i.e., \$70-\$3) and is amortizable over the remaining 14 years.

(vi) The price for which old target is deemed to have sold the secret process is decreased to reflect the \$3 decrease allocated to its basis to new target. See § 1.338-3(d) and paragraph (h)(1) of this section.

*Example 8.* The facts are the same as in *Example 6* except that the intangible Class IV asset is a patent instead of a secret process. The redetermination of the fair market value of the patent on January 1, 1999, is made without regard to the decrease in the remaining life of the patent because that is not a circumstance that resulted in the increase in AGUB.

Par. 6. Section 1.1060-1T is amended by:

1. Designating the text of paragraph (a)(2) following the heading as paragraph (a)(2)(i), adding a heading to

newly designated paragraph (a)(2)(i), and adding paragraph (a)(2)(ii).

2. In paragraph (a)(3), revising the outline of topics entries for (a)(2), (b)(2) and (h)(3).

3. Revising the seventh sentence of paragraph (b)(4).

4. Revising paragraphs (d)(2), (e)(1), and (f)(3)(i).

5. Revising the following examples in paragraph (g): *Example 1*; *Example 2*; *Example 3*, paragraphs (i), (viii), and (xi); and *Example 4*.

5. Revising paragraph (h)(3).

The additions and revisions read as follows:

§ 1.1060-1T *Special allocation rules for certain asset acquisitions (temporary).*

(a) \* \* \*

(2) *Effective date*—(i) *In general.* \* \* \*

(ii) *Allocation of consideration.* Paragraphs (d) and (h)(3) of this section and conforming amendments to other provisions of this section apply to applicable asset acquisitions completed on or after February 14, 1997. For applicable asset acquisitions completed before February 14, 1997, if section 197 does not apply to any of the acquired assets, the provisions of the regulations in effect before February 14, 1997 apply (see § 1.1060-1T as contained in 26 CFR part 1 revised April 1, 1996). For applicable asset acquisitions completed before February 14, 1997, if section 197 applies to any of the acquired assets, the taxpayer (and related parties) may consistently (in all transactions in which AGUB (as defined in § 1.338(b)-1), ADSP (as defined in § 1.338-3), MADSP (as defined in § 1.338(h)(10)-1), or consideration must be allocated under section 338 or 1060)—

(A) Apply the provisions of this section;

(B) Apply the provisions of this section as in effect before February 14, 1997 (see § 1.1060-1T as contained in 26 CFR part 1 revised April 1, 1996); or

(C) Apply the provisions of this section as in effect before February 14, 1997 (see § 1.1060-1T as contained in 26 CFR part 1 revised April 1, 1996), but treat all amortizable section 197 intangibles as Class IV assets.

(3) \* \* \*

(a) \* \* \*

(2) *Effective date.*

(i) *In general.*

(ii) *Allocation of consideration.*

\* \* \* \* \*

(d) \* \* \*

(2) *Assets other than Class I assets.*

(i) *In general.*

(ii) *Class II assets.*

(iii) *Class III assets.*

(iv) *Class IV assets.*

(v) *Class V assets.*

\* \* \* \* \*

(h) \* \* \*

(3) *Interim procedures for Form 8594.*

(b) \* \* \*

(4) \* \* \* The money and other property that are treated as transferred in exchange for the like-kind property (and which are excluded from the assets to which section 1060 applies) are considered to come from the following assets in the following order: first from Class I assets, then from Class II assets, then from Class III assets, then from Class IV assets, and then from Class V assets. \* \* \*

\* \* \* \* \*

(d) \* \* \*

(2) *Assets other than Class I assets*—

(i) *In general.* Subject to the limitations and other special rules of paragraph (e) of this section, consideration (as reduced by the amount of Class I assets) is allocated among Class II assets transferred by the seller in proportion to the fair market values of such Class II assets on the purchase date, then among Class III assets transferred by the seller in proportion to the fair market values of such Class III assets on that date, then among Class IV assets transferred by the seller in proportion to the fair market values of such Class IV assets on that date, and finally to Class V assets.

(ii) *Class II assets.* Class II assets are certificates of deposit, U.S. government securities, readily marketable stock or securities (within the meaning of § 1.351-1(c)(3)), foreign currency, and other items designated in the Internal Revenue Bulletin by the Internal Revenue Service.

(iii) *Class III assets.* Class III assets are all assets other than Class I, II, IV, and V assets.

(iv) *Class IV assets.* Class IV assets are all section 197 intangibles, as defined in section 197, except those in the nature of goodwill and going concern value.

(v) *Class V assets.* Class V assets are section 197 intangibles in the nature of goodwill and going concern value.

(e) \* \* \*

(1) Allocation not to exceed fair market value. The amount of consideration allocated to an asset (other than Class V assets) shall not exceed the fair market value of that asset on the purchase date.

\* \* \* \* \*

(f) \* \* \*

(3) \* \* \*

(i) In general. A decrease in consideration is allocated in the following order: first, as a reduction in the amount previously allocated to Class V assets, second, as a reduction in the amount previously allocated to Class IV assets in proportion to their fair market values, third, as a reduction in the amount previously allocated to Class III assets in proportion to their fair market values, and finally, as a reduction in the amount previously allocated to Class II assets in proportion to their fair market values. Decreases in consideration allocated to an asset shall not exceed the amount of consideration previously allocated to that asset. Except as provided in paragraph (f)(4)(ii) of this section (relating to patents and similar property), the fair market value is the fair market value on the purchase date.

\* \* \* \* \*

(g) \* \* \*

Example 1. (i) On January 1, 1998, S, a sole proprietor, sells to P, a corporation, a group of assets which constitute a trade or business under paragraph (b)(2) of this section. P pays S \$2,000 in cash and assumes \$1,000 in liabilities. Thus, the total consideration is \$3,000.

(ii) Assume that P acquires no Class I assets and that on the purchase date, the fair market values of the Class II, Class III, and Class IV assets S sold to P are as follows:

Asset Class	Asset	Fair Market Value
II	Portfolio of marketable securities . . . . .	\$ 400
	Total Class II . . . . .	\$ 400
III	Furniture and fixtures . . . . .	\$ 800
	Building . . . . .	800
	Land . . . . .	200
	Equipment . . . . .	400
	Accounts receivable . . . . .	100
	Total Class III . . . . .	\$2,300
IV	Covenant not to compete . . . . .	\$ 100
	Total Class IV . . . . .	\$ 100

(iii) Under paragraphs (d)(1) and (2) of this section, the amount of consideration allocable to the Class II, III, IV, and V assets is the total consideration reduced by the amount of any Class I assets. Since P acquired no Class I assets, the total consideration of \$3,000 is next allocated first to Class II, then to Class III, and then to Class IV assets. Since the fair market value of the Class II assets is \$400, \$400 of consideration is allocated to the Class II assets. Since the remaining amount of consideration is \$2,600 (\$3,000 - \$400), an amount which exceeds the sum of the fair market values of the Class III assets (\$2,300), the amount allocated to each Class III asset is its fair market

value. Since, after the allocation to Class III assets, the remaining amount of consideration is \$300 (\$3,000 - (\$400 + \$2,300)), an amount which exceeds the fair market value of the Class IV asset (\$100), the amount allocated to the Class IV asset is its fair market value. Thus, the total amount allocated to the Class II assets is \$400, the total amount allocated to the Class III assets is \$2,300, and the total amount allocated to the Class IV asset is \$100.

(iv) The amount allocated to the Class V assets (assets in the nature of goodwill and going concern value) is \$200 (i.e., \$3,000 - (\$400 + \$2,300 + \$100)).

Example 2. (i) Assume the same facts as in Example 1. Assume further that P and S each use the calendar year as the taxable year and that, on September 30, 1998, P files a claim against S alleging fraud in the sale of all of the assets.

(ii) On January 1, 2007, S refunds \$400 of the purchase price to P in a settlement of the lawsuit.

(iii) Under paragraph (f)(3)(i) of this section, both S and P take into account the \$400 decrease in consideration and allocate it among the assets. First, since \$200 of consideration previously was allocated to the assets in the nature of goodwill and going concern value (Class V assets), \$200 of the decrease in consideration is allocated to those assets. Then, since \$100 of consideration previously was allocated to the only Class IV asset, the covenant not to compete, the next \$100 of the remaining decrease in consideration (\$200) is allocated to that asset. The remaining decrease in consideration (\$100) is then allocated to the Class III assets in proportion to their fair market values on the purchase date as follows:

Asset	Fair market value	Allocation fraction	Decrease in consideration (\$100 x Col. (2))
Furniture and fixtures . . . . .	\$ 800	800/2,300	\$ 34.78
Building . . . . .	800	800/2,300	34.78
Land . . . . .	200	200/2,300	8.70
Equipment . . . . .	400	400/2,300	17.39
Accounts receivable . . . . .	100	100/2,300	4.35
Total . . . . .	\$2,300		\$100.00

(iv) In summary, the redetermined consideration that S received for the group of assets is \$2,600 after taking into account the decrease in consideration. After allocating the decrease, P's and S's redetermined consideration is as follows:

Asset	Original consideration	Decrease in consideration	Redetermined consideration
Portfolio of marketable securities . . . . .	\$ 400.00	\$ 0.00	\$ 400.00
Furniture and fixtures . . . . .	800.00	34.78	765.22
Building . . . . .	800.00	34.78	765.22
Land . . . . .	200.00	8.70	191.30
Equipment . . . . .	400.00	17.39	382.61
Accounts receivable . . . . .	100.00	4.35	95.65
Covenant not to compete . . . . .	100.00	100.00	0.00
Goodwill and going concern value . . . . .	200.00	200.00	0.00
Total . . . . .	\$3,000.00	\$400.00	\$2,600.00

(v) Assume that, as a result of deductions under section 168, P's adjusted basis in the equipment immediately before the decrease in consideration is zero. P, therefore, treats the equipment as if it were disposed of before the decrease is taken into account. In 2007, P recognizes income of \$17.39, the character of which is determined under the principles of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), and the tax benefit rule. No adjustment to the basis of P's assets is made for any tax paid on this amount. Assume also that, as a result of amortization deductions, the adjusted basis of the covenant not to compete and the goodwill and going concern value immediately before the decrease in consideration is \$120. A similar adjustment to income is made in 2007 with respect to the \$180 of previously amortized covenant not to compete and goodwill and going concern value.

Example 3. (i) On January 1, 1998, A transfers assets X, Y, and Z worth \$1,000 to B in exchange for assets D, E, and F, worth \$100, plus \$1,000 cash.

(viii) A, as transferor of assets X, Y, and Z, received \$100 that must be allocated under section 1060 and paragraph (d) of this section. Since A transferred no Class I, II, III, or IV assets to which section 1060 applies, the \$100 is allocated to Class V assets (assets in the nature of goodwill and going concern value).

(xi) B, as transferee of assets X, Y, and Z, gave A \$100 that must be allocated under section 1060 and paragraph (d) of this section. Since B received from A no Class I, II, III, or IV assets to which section 1060 applies, the \$100 consideration is allocated by B to Class V assets (assets in the nature of goodwill and going concern value).

Example 4. (i) On January 1, 1998, S, a sole proprietor, sells to P, a corporation, a group of assets which constitutes a trade or business under paragraph (b)(2) of this section. S, who plans to retire immediately, also executes a covenant not to compete in P's favor. P pays S \$3,000 in cash and assumes \$1,000 in liabilities. Thus, the total consideration is \$4,000.

(ii) On the purchase date, P and S also execute a separate agreement that states that the fair market values of the Class II, Class III, and Class IV assets S sold to P are as follows:

Asset Class	Asset	Fair Market Value
II	Portfolio of marketable securities . . . . .	\$ 500
	Total Class II . . . . .	\$ 500
III	Furniture and fixtures . . . . .	\$ 800
	Building . . . . .	800
	Land . . . . .	200
	Equipment . . . . .	400
	Accounts receivable . . . . .	200
	Total Class III . . . . .	\$2,400
IV	Covenant not to compete . . . . .	\$ 900
	Total Class IV . . . . .	\$ 900

(iii) P and S each allocate the consideration in the transaction among the assets transferred under paragraph (d) of this section in accordance with the agreed upon fair market values of the assets, so that \$500 is allocated to Class II assets, \$2,400 is allocated to Class III assets, \$900 is allocated to Class IV assets, and \$200 (\$4,000 total consideration less \$3,800 allocated to asset classes II, III, and IV) is allocated to the Class V assets (assets in the nature of goodwill and going concern value).

(iv) In connection with the examination of P's return, the District Director, in determining the fair market values of the assets transferred, may disregard the parties' agreement. Assume that the District Director correctly determines that the fair market value of the covenant not to compete was \$100. Since the allocation of consideration among Class II, III, and IV assets results in allocation up to the fair market value limitation, the \$800 of unallocated consideration resulting from the District Director's redetermination of the value of the covenant not to compete is allocated to Class V assets (assets in the nature of goodwill and going concern value).

(h) \* \* \*

(3) *Interim procedures for Form 8594.* Until such time, if any, as Form 8594 is revised to require otherwise, the sum of the amounts allocated to Classes IV and V should be reported on Form 8594 as Class IV assets.

Margaret Milner Richardson,  
*Commissioner of Internal Revenue.*

Approved December 20, 1996.

Donald C. Lubick,  
*Acting Assistant Secretary  
of the Treasury.*