(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:*

Class	Asset	Original allocation	Final allocation
I	Cash	$200	$200
II	Portfolio of actively traded securities.	300	*268
III	Accounts receivable	600	536
IV	Inventory	300	268
V	Building	800	714
V	Land	200	178
V	Investment in T1	450	402
VII	Goodwill and going concern value.	150	134
	Total	3,000	2,700

* All numbers rounded for convenience.

[T.D. 8940, 66 FR 9929, Feb. 13, 2001; 66 FR 17363, Mar. 30, 2001]

§ 1.338–7 Allocation of redetermined ADSP and AGUB among target assets.

(a) *Scope.* ADSP and AGUB are 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 or AGUB. This section provides rules for allocating redetermined ADSP or AGUB.

(b) *Allocation of redetermined ADSP and AGUB.* When ADSP or AGUB is redetermined, a new allocation of ADSP or AGUB is made by allocating the redetermined ADSP or AGUB amount under the rules of § 1.338–6. If the allocation of the redetermined ADSP or AGUB amount under § 1.338–6 to a given asset is different from the original allocation to it, the difference is added to or subtracted from the original allocation to the asset, as appropriate. (See paragraph (d) of this section for new target's treatment of the amount so allocated.) Amounts allocable to an acquisition date asset (or with respect to a disposed-of acquisition date asset) are subject to all the asset allocation rules (for example, the fair market value limitation in § 1.338–6(c)(1)) as if the redetermined ADSP or AGUB were the ADSP or AGUB on the acquisition date.

(c) *Special rules for ADSP*—(1) *Increases or decreases in deemed sale tax consequences taxable notwithstanding old target ceases to exist.* To the extent general principles of tax law would require a seller in an actual asset sale to account for events relating to the sale that occur after the sale date, target must make such an accounting. Target is not precluded from realizing additional deemed sale tax consequences because the target is treated as a new corporation after the acquisition date.

(2) *Procedure for transactions in which section 338(h)(10) is not elected*—(i) *Deemed sale tax consequences included in new target's return.* If an election under section 338(h)(10) is not made, any additional deemed sale tax consequences of old target resulting from an increase or decrease in the ADSP are included in new target's income tax return for new target's taxable year in which the increase or decrease is taken into account. For example, if after the acquisition date there is an increase in the allocable ADSP of section 1245 property for which the recomputed basis (but not the adjusted basis) exceeds the portion of the ADSP allocable to that particular asset on the acquisition date, the additional gain is treated as ordinary income to the extent it does not exceed such excess amount. See paragraph (c)(2)(ii) of this section for the special treatment of old target's carryovers and carrybacks. Although included in new target's income tax return, the deemed sale tax consequences are separately accounted for as an item of old target and may not be offset by income, gain, deduction, loss, credit, or other amount of new target. The amount of tax on income of old target resulting from an increase or decrease in the ADSP is determined as if such deemed sale tax consequences had been recognized in old target's taxable year ending at the close of the acquisition

date. However, because the income resulting from the increase or decrease in ADSP is reportable in new target's taxable year of the increase or decrease, not in old target's taxable year ending at the close of the acquisition date, there is not a resulting underpayment of tax in that past taxable year of old target for purposes of calculation of interest due.

(ii) *Carryovers and carrybacks*—(A) *Loss carryovers to new target taxable years.* A net operating loss or net capital loss of old target may be carried forward to a taxable year of new target, under the principles of section 172 or 1212, as applicable, but is allowed as a deduction only to the extent of any recognized income of old target for such taxable year, as described in paragraph (c)(2)(i) of this section. For this purpose, however, taxable years of new target are not taken into account in applying the limitations in section 172(b)(1) or 1212(a)(1)(B) (or other similar limitations). In applying sections 172(b) and 1212(a)(1), only income, gain, loss, deduction, credit, and other amounts of old target are taken into account. Thus, if old target has an unexpired net operating loss at the close of its taxable year in which the deemed asset sale occurred that could be carried forward to a subsequent taxable year, such loss may be carried forward until it is absorbed by old target's income.

(B) *Loss carrybacks to taxable years of old target.* An ordinary loss or capital loss accounted for as a separate item of old target under paragraph (c)(2)(i) of this section may be carried back to a taxable year of old target under the principles of section 172 or 1212, as applicable. For this purpose, taxable years of new target are not taken into account in applying the limitations in section 172(b) or 1212(a) (or other similar limitations).

(C) *Credit carryovers and carrybacks.* The principles described in paragraphs (c)(2)(ii)(A) and (B) of this section apply to carryovers and carrybacks of amounts for purposes of determining the amount of a credit allowable under part IV, subchapter A, chapter 1 of the Internal Revenue Code. Thus, for example, credit carryovers of old target may offset only income tax attributable to items described in paragraph (c)(2)(i) of this section.

(3) *Procedure for transactions in which section 338(h)(10) is elected.* If an election under section 338(h)(10) is made, any changes in the deemed sale tax consequences caused by an increase or decrease in the ADSP are accounted for in determining the taxable income (or other amount) of the member of the selling consolidated group, the selling affiliate, or the S corporation shareholders to which such income, loss, or other amount is attributable for the taxable year in which such increase or decrease is taken into account.

(d) *Special rules for AGUB*—(1) *Effect of disposition or depreciation of acquisition date assets.* If an acquisition date asset has been disposed of, depreciated, amortized, or depleted by new target before an amount is added to the original allocation to the asset, the increased amount otherwise allocable to such asset is taken into account under general principles of tax law that apply when part of the cost of an asset not previously taken into account in basis is paid or incurred after the asset has been disposed of, depreciated, amortized, or depleted. A similar rule applies when an amount is subtracted from the original allocation to the asset. For purposes of the preceding sentence, an asset is considered to have been disposed of to the extent that its allocable portion of the decrease in AGUB would reduce its basis below zero.

(2) *Section 38 property.* Section 1.47–2(c) applies to a reduction in basis of section 38 property under this section.

(e) *Examples.* The following examples illustrate this section. Any amount described in the following examples is exclusive of interest. For rules characterizing deferred contingent payments as principal or interest, see §§ 1.483–4, 1.1274–2(g), and 1.1275–4(c). The examples are as follows:

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
V	Building	$ 100

Asset class	Asset	Fair market value
V	Stock of X (not a target)	200
	Total	300

(B) T has no liabilities other than a contingent liability that would not be taken into account under general principles of tax law in an asset sale between unrelated parties when the buyer assumed the liability or took property subject to it.

(ii)(A) On September 1, 2000, P purchases all of the outstanding stock of T for $270 and makes a section 338 election for T. The grossed-up basis of the T stock and T's AGUB are both $270. The AGUB is ratably allocated among T's Class V assets in proportion to their fair market values as follows:

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

(B) No amount is allocated to the Class VII 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, 2001, new T sells the X stock and uses the proceeds to purchase inventory.

(iv) Pursuant to events on June 30, 2002, the contingent liability of old T is at that time properly taken into account under general principles of tax law. 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 § 1.338–6. Because 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 V acquisition date assets ($300), AGUB allocated to those assets is limited to those fair market values under § 1.338–6(c)(1). As there are no Class VI assets, the remaining AGUB of $30 is allocated to goodwill and going concern value (Class VII assets). The amount of increase in AGUB allocated to each acquisition date asset is determined as follows:

Asset	Original AGUB	Redetermined AGUB	Increase
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 was properly taken into account for tax purposes, 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 2002 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 2002. See paragraph (d)(1) of this section.

Example 2. (i) On January 1, 2002, P purchases all of the outstanding stock of T and makes a section 338 election for T. Assume that ADSP and AGUB of T are both $500 and are allocated among T's acquisition date assets as follows:

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

(ii) On September 30, 2004, 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 $140 of the purchase price to P in a settlement of the lawsuit. Assume that, under general principles of tax law, both the seller and the buyer properly take into account such refund when paid. Assume also that the refund has no effect on the tax liability for the deemed sale tax consequences. This refund results in a decrease of T's ADSP and AGUB of $140, from $500 to $360.

(iv) The redetermined ADSP and AGUB of $360 is allocated among T's acquisition date assets. Because ADSP and AGUB do not exceed the fair market value of the Class V assets, the ADSP and AGUB amounts are allocated to the Class V assets in proportion to their fair market values at the beginning of the day after the acquisition date. Thus, $135 ($150 × ($360/($150 + $250))) is allocated to the machinery and $225 ($250 × ($360/($150 + $250))) is allocated to the land. Accordingly, the basis of the machinery is reduced by $15 ($150 original allocation—$135 redetermined allocation) and the basis of the land is reduced by $25 ($250 original allocation—$225 redetermined allocation). No amount is allocated to the Class VII assets. Accordingly, the basis of the goodwill and going concern value is reduced by $100 ($100 original allocation—$0 redetermined allocation).

(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* 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 §1.338–6(d) *Example 2* except that the recently purchased stock is acquired for $1,600 plus additional payments that are contingent upon T's future earnings. Assume that, under general principles of tax law, such later payments are properly taken into account when paid. 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 allocated among T's acquisition date assets under §1.338–6(c)(3)(iii) as follows:

Class	Asset	Final allocation
I	Cash	$200
II	Portfolio of actively traded securities.	*268
III	Accounts receivable	536
IV	Inventory	268
V	Building	714
V	Land	178
V	Investment in T1	402
VII	Goodwill and going concern value	134
	Total	2,700

* All numbers rounded for convenience.

(ii) At a later point in time, P pays an additional $200 for its recently purchased T stock. Assume that the additional consideration paid would not increase T's tax liability for the deemed sale tax consequences.

(iii) T's AGUB increases by $200, from $2,700 to $2,900. This $200 increase in AGUB is accounted for in accordance with the provisions of §1.338–6(c)(3)(iii).

(iv) The hypothetical purchase price of the T stock is redetermined as follows:

Grossed-up basis of recently purchased stock as determined under §1.338–5(c) ($1,800 × (1 − .2)/.8)	$ 1,800
Basis of nonrecently purchased stock as if the gain recognition election under §1.338–5(d)(2) had been made ($1,800 × .2/(1 − .2))	450
Liabilities	1,000
Total	3,250

(v) Since the redetermined hypothetical purchase price ($3,250) exceeds the redetermined AGUB ($2,900) and no gain recognition election was made under section 338(b)(3), the rules of §1.338–6(c)(3)(iii) are reapplied using the redetermined hypothetical purchase price and the redetermined AGUB.

(vi) First, an AGUB amount equal to the redetermined hypothetical purchase price ($3,250) is allocated among the assets under the general rules of §1.338–6. The allocation is set forth in the column below entitled *Hypothetical Allocation*. Next, the allocation to each asset in Class II through Class VII is multiplied by a fraction with a numerator equal to the actual redetermined AGUB reduced by the amount of Class I assets ($2,900 − $200 = $2,700) and a denominator equal to the redetermined hypothetical purchase price reduced by the amount of Class I assets ($3,250 − $200 = $3,050), or 2,700/3,050. This produces the *Final Allocation:*

Class	Asset	Hypothetical allocation	Final allocation
I	Cash	$200	$200
II	Portfolio of actively traded securities.	300	*266
III	Accounts receivable	600	531
IV	Inventory	300	266
V	Building	800	708
V	Land	200	177
V	Investment in T1	450	398
VII	Goodwill and going concern value.	400	354
	Total	3,250	2900

* All numbers rounded for convenience.

(vii) As illustrated by this example, reapplying §1.338–6(c)(3) results in a basis increase for some assets and a basis decrease for other assets. The amount of redetermined AGUB allocated to each acquisition date asset is determined as follows:

Asset	Original (c)(3) allocation	Redetermined (c)(3) allocation	Increase (decrease)
Portfolio of actively traded securities	$268	$266	$(2)
Accounts receivable	536	531	(5)
Inventory	268	266	(2)
Building	714	708	(6)
Land	178	177	(1)

Asset	Original (c)(3) allocation	Redetermined (c)(3) allocation	Increase (decrease)
Investment in T1	402	398	(4)
Goodwill and going concern value	134	354	220
Total	2,500	2,700	200

Example 4. (i) On January 1, 2001, P purchases all of the outstanding T stock and makes a section 338 election for T. P pays $700 of cash and promises also to pay a maximum $300 of contingent consideration at various times in the future. Assume that, under general principles of tax law, such later payments are properly taken into account by P when paid. Assume also, however, that the current fair market value of the contingent payments is reasonably ascertainable. The fair market value of T's assets (other than goodwill and going concern value) as of the beginning of the following day is as follows:

Asset class	Assets	Fair market value
V	Equipment	$200
V	Non-actively traded securities	100
V	Building	500
	Total	800

(ii) T has no liabilities. The AGUB is $700. In calculating ADSP, assume that, under § 1.1001–1, the current amount realized attributable to the contingent consideration is $200. ADSP is therefore $900 ($700 cash plus $200).

(iii) (A) The AGUB of $700 is ratably allocated among T's Class V acquisition date assets in proportion to their fair market values as follows:

Asset	Basis
Equipment ($700 × 200/800)	$175.00
Non-actively traded securities ($700 × 100/800)	87.50
Building ($700 × 500/800)	437.50
Total	700.00

(B) No amount is allocated to goodwill or going concern value.

(iv) (A) The ADSP of $900 is ratably allocated among T's Class V acquisition date assets in proportion to their fair market values as follows:

Asset	Basis
Equipment	$200
Non-actively traded securities	100
Building	500
Total	800

(B) The remaining ADSP, $100, is allocated to goodwill and going concern value (Class VII).

(v) P and T file a consolidated return for 2001 and each following year with P as the common parent of the affiliated group.

(vi) In 2004, a contingent amount of $120 is paid by P. For old T, this payment has no effect on ADSP, because the payment is accounted for as a separate transaction. We have assumed that, under general principles of tax law, the payment is properly taken into account by P at the time made. Therefore, in 2004, there is an increase in new T's AGUB of $120. The amount of the increase allocated to each acquisition date asset is determined as follows:

Asset	Original AGUB	Redetermined AGUB	Increase
Equipment	$175.00	$200.00	$25.00
Land	87.50	100.00	12.50
Building	437.50	500.00	62.50
Goodwill and going concern value	0.00	20.00	20.00
Total	700.00	820.00	120.00

[T.D. 8940, 66 FR 9929, Feb. 13, 2001]

§ 1.338–8 Asset and stock consistency.

(a) *Introduction*—(1) *Overview*. This section implements the consistency rules of sections 338(e) and (f). Under this section, no election under section 338 is deemed made or required with respect to target or any target affiliate. Instead, the person acquiring an asset may have a carryover basis in the asset.

(2) *General application*. The consistency rules generally apply if the purchasing corporation acquires an asset directly from target during the target consistency period and target is a subsidiary in a consolidated group. In such a case, gain from the sale of the asset is reflected under the investment adjustment provisions of the consolidated return regulations in the basis of target stock and may reduce gain from