

Final regulations on deemed asset sale elections offer taxpayers more flexibility

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In brief

The IRS on May 15 published final regulations under Section 336(e), which permits taxpayers to elect to treat certain dispositions of a target corporation's stock as a sale of the underlying assets of the target corporation. The final regulations provide more flexibility to taxpayers than the proposed regulations. The final regulations apply to any qualified stock disposition (QSD) for which the disposition date is on or after May 15, 2013.

In detail

Background

Section 336(e) was enacted in 1986 to provide relief to taxpayers from potential multiple taxation on the same economic gain. Following the repeal of General Utilities, such double taxation could occur when appreciated corporate stock is taxed without providing a corresponding step-up in the basis of the assets.

The proposed regulations issued in 2008, and the preamble to the proposed regulations, state that the regulations were intended to be prospective in nature and that Section 336(e) elections would be permissible only for stock dispositions occurring on or after the date final regulations were published. For a summary of the proposed

regulations, see "Proposed Regulations under Section 336(e)," [*This Month in M&A*](#), September 2008.

Final regulations

Under the final regulations, a domestic corporation or S corporation shareholder (Seller) can make a Section 336(e) election when there is a qualified disposition of stock (QSD). A QSD generally is any transaction or series of transactions in which stock meeting the requirements of Section 1504(a)(2) (80 percent of a corporation's vote and value) of a domestic corporation (Target) is either sold, exchanged, or distributed by a domestic corporation or S corporation shareholder during a 12-month period. The disposition cannot be to a related party and does not

include a nontaxable disposition of the stock, with the exception of certain Section 355 transactions (discussed below).

Section 338(h)(10) vs. Section 336(e)

The election under Section 336(e) is similar to a Section 338(h)(10) election. Each election requires a transfer of Target stock, but a Section 336(e) election looks to the disposition of stock while a Section 338(h)(10) election looks to the purchase of stock. If a disposition of stock satisfies the definition of a QSD and the definition of a qualified stock purchase (QSP) in Section 338(d)(3), the disposition generally will be treated as a QSP and not a QSD, with the result that only a Section 338(h)(10) election is available for the transaction.

The following table highlights some key differences and similarities between the elections.

Section 338(h)(10)	Section 336(e)
Election jointly made by Seller and Buyer	Election jointly made by Seller and Target
Seller must be a member of a consolidated group or Target must be an S Corporation	Seller must be a corporation or S corporation shareholders
Buyer must be a corporation	Buyer need not be a corporation, and there can be several Buyers
Requires a purchase of 80 percent	Requires any combination of sales, exchanges, and distributions totalling 80 percent
Sale	Sale/Exchange – treated similarly to Section 338(h)(10)
Distributions do not qualify	Distributions qualify
Not available for a disposition to related parties	Not available for a disposition to related parties
Not available if Seller or Target is foreign	Not available if Seller or Target is foreign

Mechanics of the deemed asset sale

When a Section 336(e) election is made, the regulations provide two different models for the deemed asset sale: the basic model and the model applicable only to distributions described in either Section 355(d)(2) or Section 355(e)(2).

Basic model. This model is similar to the fiction of a Section 338(h)(10) election. Under the basic model, a Section 336(e) election results in the target (Old Target) being treated as selling its assets to an unrelated person in a single transaction, in exchange for the aggregate deemed asset disposition price (ADADP). Old Target is subsequently deemed to liquidate into Seller. A new corporation (New Target) is treated as acquiring all its assets from an unrelated person in a single transaction for an amount equal to the adjusted grossed up basis (AGUB). If Seller distributes any Target stock, it is deemed to purchase such stock

from an unrelated person and then to make the distribution.

Old Target generally recognizes the gain realized on the deemed asset sale, but the recognition of losses is limited in transactions that involve a distribution. If there is an overall net loss on the deemed disposition of assets, the net loss is disallowed in proportion to any Target stock distributed in the 12-month disposition period of the QSD.

Section 355 model. If a Section 336(e) election is made with respect to a distribution described in either Section 355(d)(2) or Section 355(e)(2), Old Target is treated as selling its assets to an unrelated person in exchange for the ADADP. Unlike the basic model, Old Target is generally not deemed to liquidate. Instead, Old Target is treated as acquiring all of its assets from an unrelated person in exchange for an amount equal to the AGUB (sale-to-self model).

Key changes from the proposed regulations

The final regulations incorporate many of the provisions included in the proposed regulations, with some key differences.

Treatment of losses

Under the proposed regulations, if the QSD consisted solely of a distribution of stock and losses were realized in the deemed asset disposition, no losses would be recognized in accordance with Section 311(a). Further, a proportionate amount of losses would be disallowed on a partial distribution. Commentators argued that the disallowed loss rule was too harsh and that it frustrated the intent of Section 336(e), which is to mitigate multiple levels of taxation.

The IRS agreed and modified the loss disallowance rules to generally permit Target's realized losses to offset Target's realized gains in the deemed asset disposition. However, any realized losses in excess of realized

gains are permanently disallowed in proportion to the amount of Target stock disposed of by Seller in one or more distributions made within the 12-month disposition period.

S corporation targets

The final regulations expand the application of Section 336(e) to S corporation targets; this would not have been allowed under the proposed regulations. As with the Section 338(h)(10) election, all S corporation shareholders, including those who do not sell their S corporation stock, must consent to the Section 336(e) election.

When the Section 336(e) election is made for the S corporation Target, the Old Target's S election continues in effect through the disposition date, but will terminate when Old Target is deemed to liquidate. A new S election must be made if New Target wishes to operate as an S corporation.

Form of the election

Under the proposed regulations, only Seller would be required to make the Section 336(e) election. However, after receiving comments that a unilateral election by Seller could result in an unfair surprise to Target or Buyer, the IRS modified the proposed regulations to require Seller and Target to enter into a written binding agreement to make a Section 336(e) election. By contrast, a Section 338(h)(10) election must be made jointly by Seller and Buyer.

Treatment of related parties

The IRS also modified the related-party rules in the final regulations because it determined that the application in the proposed regulations of the Section 318 constructive ownership rules with respect to partnerships would be too restrictive. As applied to partnerships, there is no minimum ownership threshold in Section

318(a). If one partner held a minimal ownership interest in both the Buyer and the Seller through two unrelated partnerships, a Section 33(e) election could be prohibited.

The IRS concluded that the attribution rules should be modified to allow for minimal cross-ownership as it pertains to partnerships. The final regulations include a modification to the general attribution rules of Section 318(a) that limits the attribution of stock ownership from a partnership to a partner or from a partner to a partnership if the partner own, directly or indirectly, less than five percent of the value of the partnership. The IRS still is considering whether Section 336(e) should apply to other related-party transactions not addressed in the final regulations.

Other items

The final regulations also clarify the treatment of any Target stock retained by Seller and the Section 901(m) implications. Because a Section 336(e) election for Target is treated as an acquisition of assets for US income tax purposes, and is treated as the acquisition of stock of a corporation for foreign tax purposes, a Section 336(e) election for a Target corporation is a covered asset acquisition under Section 901(m).

The takeaway

The final regulations provide more flexibility to taxpayers than the proposed regulations. Additional provisions such as the ability of Old Target to offset losses to the extent of gains when there is a stock distribution and the ability of S corporation shareholders to make Section 336(e) elections, as well as the modifications to the treatment of related parties under Section 318(a), are taxpayer-friendly revisions that will allow more Buyers and Sellers to take advantage of the Section 336(e)

election. The IRS is still studying how Section 336(e) should apply to foreign corporations and to nontaxable transactions, and may consider expanding the scope of the regulations to address these transactions in the future.

General transaction implications

The flexibility of the Section 336(e) regulations allows transactions that previously did not qualify for a Section 338(h)(10) election to obtain the benefits of a step-up in Target's assets. For example, asset basis step-up previously may not have been available when there were multiple Buyers of Target's stock or there were noncorporate Buyers.

If there is a QSD, and a Section 336(e) election is made, Seller should consider negotiating additional consideration or possibly entering into a tax-sharing agreement with Buyer to share in the value of the step-up in basis the election creates. Also, Buyers and Sellers should consider adding provisions to purchase agreements such as provisions addressing approval or prohibition of Section 336(e) elections and distributions of Target stock that occur within the 12-month disposition period but not as part of the QSD, because such distributions could implicate the asset loss disallowance rule.

Section 355 transaction implications

Taxpayers should consider whether to make protective Section 336(e) elections in connection with a Section 355 distribution. The elections will have no effect if the transaction does not meet the qualifications of a QSD but otherwise will be binding and irrevocable. For example, if a purported Section 355 distribution is for some reason subsequently disqualified, the Section 336(e) election will become effective and provide a step-up for the inside basis

of the assets of the distributed corporation. However, protective elections may not be advisable when gain on Old Target's assets exceeds gain on Old Target's stock.

Let's talk

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