

AN ALERT FROM THE BDO PRIVATE EQUITY PRACTICE

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## ► SUBJECT

### NEW DEEMED ASSET SALE STRUCTURING ALTERNATIVES UNDER SECTION 336(e)

## ► SUMMARY

For more than 25 years, taxpayers and practitioners have made extensive use of the deemed asset sale election under Internal Revenue Code Section (Sec.) 338(h)(10) in taxable stock acquisitions. In a taxable stock acquisition, the buyer generally takes a carryover basis in the underlying assets. Buyers usually prefer an asset purchase over a stock purchase, as it generates a fair market value basis in the target's assets (referred to as an asset basis step-up) and corresponding tax shield against future taxable income.

Under Sec. 338(h)(10), the seller and buyer may jointly elect to treat the stock sale as an asset sale only if the target is (1) a member of a consolidated return group other than the common parent, (2) a member of a nonconsolidated affiliated group other than the common parent, or (3) an S corporation. The buyer must acquire at least 80 percent of the target's stock in vote and value during a 12-month period, i.e., a qualified stock purchase (QSP).<sup>1</sup>

An election under Sec. 338(h)(10) causes the target to be deemed to have sold its assets in a taxable transaction and to have distributed the proceeds in liquidation, while still owned by the selling affiliate or S corporation shareholders or remaining a member of the selling consolidated group.

The playing field has changed with the recent promulgation of final regulations under Sec. 336(e). The regulations, which apply to any qualified stock disposition (QSD) on or after May 15, 2013, expand the types of stock dispositions that can result in an asset basis step-up for tax purposes, including non-corporate acquirers. A QSD encompasses the sale, exchange, or distribution of at least 80 percent (by vote and value) of a corporation's stock within the meaning of Sec. 1504(a)(2). The Sec. 336(e) deemed asset sale election applies where the sale, exchange or distribution does not otherwise qualify for an election under the Sec. 338 provisions.<sup>2</sup>

<sup>1</sup> There is effectively an added restriction for S corporation targets. Given that the target must be an S corporation immediately before the QSP, the stock acquisitions by the corporate purchaser must occur all at once, rather than in stages over a 12-month period.

<sup>2</sup> Sec. 338 not only provides for the election under Sec. 338(h)(10), but also contains an election under Sec. 338(g), which is most useful in the acquisition of foreign targets and is less frequently used. The election under Sec. 338(g) is beyond the scope of the present article.



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An election under Sec. 336(e) may be available in the following situations where an election under Sec. 338(h)(10) would not, including:

- The sale/exchange of U.S. corporate target stock to individuals and/or partnerships.
- Distributions of U.S. corporate target stock to stockholders when Sec. 355 does not apply.
- Distributions of U.S. corporate target stock to stockholders when Sec. 355 applies, but the distributing corporation is subject to tax under Sec. 355(d) or (e).

The following requirements must be met to qualify for the election:

- The seller must be a U.S. corporation or S corporation stockholder(s).
- The target must be a U.S. C corporation or S corporation.
- The transaction must be a QSD: At least 80 percent of the vote and value of target stock must be sold, exchanged, or distributed (including a combination of sales, exchanges and distributions) within a 12-month period.
- The stock must generally be sold, exchanged or distributed in a taxable transaction.
- The stock cannot be sold, exchanged or distributed to a related person. Persons are treated as related if stock in a corporation owned by one person would be attributed to the other person under the provisions of Sec. 318.
- The transaction does not otherwise qualify for an election under Sec. 338(h)(10) or Sec. 338(g).

## ► BDO INSIGHTS

### Application of Sec. 336(e) versus Sec. 338(h)(10)

The regulations provide that, except to the extent inconsistent with Sec. 336(e), the results of Sec. 336(e) should coincide with those of Sec. 338(h)(10).<sup>3</sup> The Sec. 336(e) election has the same purpose, and generally creates the same result, as a Sec. 338(h)(10) election. However, there are crucial differences in the scope of application of the respective elections.

The following chart illustrates the differences and similarities between the election under Sec. 338(h)(10) and the Sec. 336(e) election.

### Scope of Sec. 338(h)(10) versus Sec. 336(e)

Section 338(h)(10)	Section 336(e)
Joint election required by seller and buyer	Joint election required by seller and target
Seller must be a member of a consolidated group or a nonconsolidated affiliated group, or target must be an S corporation	Seller must be either a domestic corporation or S corporation shareholder
Single Acquirer must be a corporation; under Sec. 338(h)(8), elections made by members of the same affiliated group are treated as made by one corporation.	Acquirer (or multiple acquirers) not required to be a corporation
Requires purchase of 80% or more within a 12-month period	Requires any combination of sales, exchanges, and distributions totaling 80% or more within a 12-month period
Applies to taxable sales	Applies to taxable sale, exchanges or distributions. All stock of a target that is sold, exchanged or distributed by a seller to different acquirers is aggregated for purposes of determining whether there has been a QSD.
Does not apply to any distributions	Applies to distributions of U.S. corporate target stock to shareholders when Sec. 355 does not apply, and distributions to which Sec. 355 applies, but the distributing corporation is subject to tax under Sec. 355(d) or (e).
Does not apply to tax-free transactions involving taxable "boot" (Sec. 351, Sec. 368)	
Not available for a disposition to related parties	
Not available if the seller or target is foreign	

<sup>3</sup> Regs. Sec. 1.336-1(a).

## Section 336(e) Planning Considerations

The final regulations under Sec. 336(e) present many planning opportunities for buyers, sellers and tax practitioners. Some of the more significant opportunities are discussed below.

First and foremost, the election avoids the complexities of a liquidation of the target prior to a sale to achieve the same after-tax goal. By allowing for continued corporate existence, transfer taxes, reassignments of assets, and many other unexpected surprises could be avoided.

This is because the making of a Sec. 336(e) election presents the possibility of obtaining the benefit of a step-up in the basis of the purchased assets and being able to operate the purchased business in flow-through form without the need to change the legal structure. However, if desired for other reasons, the purchased entity could convert to flow-through status after its acquisition.<sup>4</sup>

The second most important planning tool with the making of a Sec. 336(e) election is that it operates to mitigate the tax costs in a taxable or tax-free divisive transaction, including a spin-off, split-off, or split-up. This includes distributions that will be taxable to the distributing corporation under Secs. 355(d) or (e) as a result of certain shifts in ownership of the spun-off corporation or the distributing corporation.

In the case of a divisive transaction that is intended to be tax-free, a protective Sec. 336(e) election should be considered to provide a step-up in the basis of the corporation's assets in the event the spin-off were unexpectedly treated as taxable, including as a result of a post-spin-off acquisition of the spun-off corporation or the distributing corporation.

To guard against this risk, the new regulations allow a protective election to be made under Sec. 336(e). The protective election would be advisable if a taxpayer thinks the transaction might fail the requirements of Sec. 355(d) or (e), resulting in entity-level gain. The necessity for a protective election is reinforced by recent Rev. Proc. 2013-32,<sup>5</sup> which, among other issues, restricts the scope of Private Letter Rulings on issues with respect to transactions under Sec. 355.

## State & Local Considerations

As each state and locality has its own laws and regulations dealing with transactions that may qualify for elections under Sec. 338(h)(10) or Sec. 336(e), it is necessary to analyze the state and local tax impact of a transaction for each jurisdiction involved.

## Conclusion

The Sec. 336(e) election is an important new tool in corporate acquisitions, as it expands the Sec. 338(h)(10) concept to include taxable distributions under Sec. 355(d)(2) and Sec. 355(e)(2) distributions. These new rules under Sec. 336(e) are a welcome addition to the M&A tax practitioner as they provide us with an important new tool to work with when structuring corporate acquisitions that could potentially satisfy both the buyer and seller in taxable transactions.

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<sup>4</sup> In some cases, a target in a Sec. 336(e) disposition can either continue its S corporation status or have a new S corporation election made for it.

<sup>5</sup> 2013-28 IRB 55.



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