Better Late than Never. New Section 336(e) Regulations

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Issue 2-2014—A common refrain heard through the course of one's life is that you should always look out for your own best interests, because no one else will. Nowhere is this truer than in the context of acquiring a business. Buyers and sellers will often fight tooth and nail to get the best deal for themselves, as they should. Frequently, a contentious point of negotiation is whether to structure an acquisition for federal income tax purposes as an asset purchase or a stock purchase. The distinction makes a difference. Buyers tend to prefer purchasing assets rather than stock because it allows them to receive a stepped-up tax basis in the acquired assets equal to the fair market value (with certain adjustments), which may yield valuable depreciation and amortization deductions, particularly if there is significant goodwill that is recognized as part of the transaction.

Sellers, on the other hand, tend to prefer selling stock rather than assets because of the administrative ease (which generally is also valuable to the buyer) and the favorable capital gains tax rates imposed on such sales if the seller is an individual. Moreover, in the context of the sale of a business that is conducted through a corporation, the sale of assets generally leads to the imposition of the dreaded and nefarious "double-tax," while a sale of stock does not, because in an asset sale the gain is first taxed at the corporate level and then again when the proceeds are distributed to the shareholders upon liquidation. After all, it was Boris Bittker and James Eustice, two intellectual giants in the realm of federal income tax, who compared a corporation to a lobster pot: It's easy to enter, difficult to live in, and painful to get out of.

In a rare showing of attentiveness to the needs of taxpayers, in 1986 Congress enacted Section 336(e) as part of the broader Tax Reform Act. As discussed in further detail below, Section 336(e) provides that if certain requirements are met and an election is made, what is considered a sale of stock for legal purposes is recast as a sale of assets for federal income tax purposes.

And there was much rejoicing. Taxpayers generally viewed Section 336(e) with delight because it was perceived to be a useful tool to help bridge the gap between buyers and sellers, and mitigate the double tax, or in certain cases even triple tax that may be incurred when a corporation sells its assets. But the ever-watchful IRS bestirred itself from its proverbial iron throne and declared that Section 336(e) was not yet operative, and therefore taxpayers could not avail themselves of it, because the statute was not "self-executing," meaning that the Section 336(e) election was unavailable to taxpayers until such time that it had issued Treasury regulations.

One does not simply walk into Mordor. Similarly, one does not simply make a Section 336(e) election when the statute is not self-executing and no Treasury regulations have been issued. It was not until June 10, 2013, a mere 27 years after the passage of the Tax Reform Act of 1986, that the IRS published final Treasury regulations under Section 336(e). Finally, Section 336(e) is now operative for transactions occurring on or after May 15, 2013.

This edition of the *Tax Advisor Weekly* provides an overview of the Section 336(e) election and discusses certain considerations that taxpayers need to be aware of.

Background — Section 338 Framework

Prior to the issuance of the Section 336(e) regulations, taxpayers wishing to characterize stock acquisitions as asset acquisitions for federal income tax purposes looked to Section 338, specifically Section 338(h)(10). Generally, Section 338(h)(10) requires the following: (i) the acquisition by a corporation of at least 80 percent of stock (as measured by vote *and* value) during a 12-month period of either an S corporation or a domestic corporate subsidiary of a consolidated group; and (ii) a joint election by the buyer and seller. Assuming these requirements are satisfied, then the following is deemed to occur: (i) at the close of business on the acquisition date, the target corporation (referred to in tax parlance as "Old Target") is deemed to sell all of its assets to an unrelated third party and then liquidate; and (ii) on the day after the acquisition date, Old Target rises from the grave and reconstitutes itself (referred to in tax parlance as "New Target") and purchases its assets from the unrelated third party. Note that an election may also be made under Section 338(g), but a discussion of this provision is outside the scope of this article.

It is important to note that when a Section 338(h)(10) election is made in connection with the acquisition of stock of a corporation, the actual sale of the stock is ignored for federal income tax purposes, and the federal income tax implications are determined solely with respect to the deemed sale of the assets, resulting in only one level of federal income tax imposed. The end result is that New Target receives a stepped-up tax basis in its assets equal to fair market value (with certain adjustments).

Section 336(e) Election

For the Section 336(e) election to be effectuated, there must be a qualified stock disposition, which is generally defined as a taxable disposition by a domestic corporation or the shareholders of an S corporation of at least 80 percent of the stock (as measured by vote *and* value) of a domestic corporation during a 12-month period. Provided there is a qualified stock disposition and the seller (upon agreement with Old Target) makes a Section 336(e) election, then the result is similar to what occurs in a Section 338(h)(10) election: (i) Old Target is deemed to sell all of its assets to an unrelated third party and then liquidate; and (ii) on the next day, New Target purchases its assets from the unrelated third party. The end result is that New Target receives a stepped-up tax basis in its assets equal to fair market value (with certain adjustments). Similar to a Section 338(h)(10) election, the federal income tax implications are determined solely with respect to the deemed sale of Old Target's assets, resulting in only one level of federal income tax imposed.

Note that while in the context of a Section 338(h)(10) election, the focus is on the acquisition of stock by a corporate buyer, in the context of a Section 336(e) election, the focus is solely on the seller's (or sellers') disposition of stock. Therefore, provided that there is a qualified stock disposition, then a Section 336(e) election may be made by the seller, regardless of who the buyer is or the number of buyers. As a result, individuals and partnerships, who are normally precluded from participating in the capacity as the buyer in transactions where a Section 338(h)(10) election is made, may engage in acquisitions where a Section 336(e) election is made.

A disposition can take the form of a sale, exchange, distribution or any combination thereof, provided that it is a taxable event. However, dispositions to related parties are not eligible for Section 336(e) treatment. Also note that the Section 336(e) election is effectively made at the discretion of the seller, unlike a Section 338(h)(10) election, where the election is required to be made by both the buyer and seller. Accordingly, if a buyer does not want the seller to make a Section 336(e) election in the context of an acquisition, a covenant must be inserted in the purchase agreement that the seller will not make such an election. Otherwise, the seller is free to make a Section 336(e) election if it is available and he or she so wishes, and the buyer is saddled with the consequences that flow from making such an election.

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

The Section 336(e) election can be thought of as a liberalized version of the Section 338(h)(10) election. While in the context of a Section 338(h)(10) election the focus is on the corporate buyer's acquisition of stock meeting the requirements discussed above, in a Section 336(e) election, the focus is on the seller and whether there is a qualified stock disposition. The buyer is not required to be a corporation as in a Section 338(h)(10) election. Also, as noted above, the Section 336(e) election is effectively made by the seller, while both the buyer and seller are required to make a Section 338(h)(10) election. The following table illustrates some of the major similarities and differences between Section 336(e) and Section 338(h)(10).

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The Section 336(e) election may be most appealing in circumstances in which the acquiring entity is an LLC or partnership. For example, a private equity fund no longer needs to establish a corporate acquirer solely to facilitate a deemed asset acquisition. Taxpayers who acquire corporations for which a Section 336(e) election was made in connection with the acquisition may generally convert such corporations to LLCs, a move that generally confers pass-through treatment for federal income tax purposes, without incurring any incremental federal income tax. This is a significant benefit to taxpayers wishing to keep their structures in pass-through form. This may allow taxpayers to achieve what might be considered the Holy Grail of M&A tax planning: structuring a business such that a buyer receives a step-up in the tax basis of the acquired assets in a future acquisition (which should, in principle, increase deal value). In the context of a taxable spin-off transaction, it is now easier for the parent corporation to deliver a step-up in tax basis to the shareholders of the corporation that is being spun out. These new Treasury regulations should provide another useful planning tool to taxpayers wishing to optimize their acquisitions from a federal income tax perspective.

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Purchase Price Allocations: Get It Right Up Front!

Issue 35-2013 — If you are acquiring assets, make sure you really believe — and are willing to live with — the purchase price allocation agreed to and reflected in your purchase agreement. In other words, if you think you can do a more detailed review and adjust this allocation later, think again! In a recent decision (Peco Foods Inc. v. Commissioner, No. 12-12169 (11th Cir. July 2, 2013)), the U.S. Court of Appeals for the Eleventh Circuit upheld a Tax Court decision that a taxpayer could not retroactively modify a purchase price allocation by changing the descriptions in its allocation agreements related to the asset purchases of two plants. Specifically, Peco (the taxpayer) could not use the results from a cost segregation study to accelerate deductions in a manner that was inconsistent with the original contractually agreed to purchase price allocation.

Avoid the Surprise: Know Your IRC Section 338(h)(10) State Rules

Many buyers and sellers of businesses do not consider state income tax consequences until after a deal has been completed.

Ignoring state tax considerations at the outset of a transaction may put you in an adverse negotiation position, particularly in a deemed asset sale under Internal Revenue Code (IRC) Section 338(h)(10). It may come as a surprise that significant state taxes can result from such an election.

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