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The 336(e) Election: Possible Deemed Asset Sale Treatment When a 338(h)(10) Election is Unavailable

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For U.S. federal income tax purposes, a purchaser in a corporate acquisition typically prefers to acquire assets of a target corporation (“Target”) rather than stock because a purchaser that acquires assets is able to “step up” the basis in the acquired assets and utilize the resulting depreciation or amortization deductions to offset income from operations. In order to achieve this tax result without incurring some administrative complexities of an actual asset transfer, purchasers and sellers have historically utilized an election under section 338(h)(10)¹ (“338(h)(10) Election”), which enables the parties to treat a stock sale as an asset sale for U.S. federal income tax purposes.

In general, a 338(h)(10) Election is limited to situations in which Target is an S-corporation or a corporate subsidiary of a consolidated group and the purchaser is a corporation. New Regulations finalized and promulgated in 2013 under section 336 expand the circumstances under which an election (“336(e) Election”) may be made to treat the disposition of stock of an S-corporation or a corporate subsidiary as an asset transfer for U.S. federal income tax purposes. For example, a 336(e) Election may be made where the purchaser of Target stock is a private equity fund taxed as a partnership. This e-alert generally describes the applicability and effects of the 336(e) Election, and compares and contrasts it with the 338(h)(10) Election.

Background

In general, section 336(e) authorizes the issuance of Regulations under which a 336(e) Election may be made to treat the sale, exchange or distribution of at least 80 percent of the voting power and value of stock of Target as a sale of its underlying assets for U.S. federal income tax purposes. As noted above, the 336(e) Election is similar to the often utilized 338(h)(10) Election. The U.S. Internal Revenue Service (“IRS”) and the U.S. Treasury Department recently finalized enabling Regulations under section 336(e) (the “336(e) Regulations”) that provide taxpayers with the ability to treat a “qualified stock disposition” (“QSD”) as the purchase and sale of the underlying assets of Target where a 338(h)(10) Election is unavailable.

Overview

A 336(e) Election is available for QSDs of domestic Target stock by domestic corporate sellers or S-corporation shareholders. A QSD is generally any transaction or series of transactions in which at least 80 percent of the vote and value of Target stock is sold, exchanged, or distributed by a domestic corporation or S-corporation shareholder to an unrelated party during a 12-month period. In general, a transaction satisfying the definition of QSD that would also be a “qualified stock purchase” for purposes of section 338(h)(10) will not be treated as a QSD. The 336(e) Regulations generally adopt the structure and principles established under section 338(h)(10) and the Regulations thereunder. However, there are certain key differences. For example, unlike section 338(h)(10) (which is available only if Target stock is acquired by purchase by a single corporate purchaser) a 336(e)

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Election may be made where the purchaser (or purchasers) of Target stock in a QSD is not a corporation and a 336(e) Election may be made with respect to certain corporate distributions of Target stock. The table below compares some of the principal provisions of the 338(h)(10) Election and the 336(e) Election.

338(h)(10) Election	336(e) Election
Seller(s) must be a member of a consolidated group or shareholders of an S-corporation.	Seller(s) may be any domestic corporation that makes a QSD or shareholders of an S-corporation that make a QSD. Generally, all members of a consolidated group that dispose of Target stock are treated as a single seller.
Purchaser must be a single corporation.	Purchaser is not required to be a corporation (e.g., purchaser may be an individual or a partnership) and there may be multiple purchasers.
Applies to a purchase of at least 80 percent of Target stock.	Applies to any combination of sales, exchanges, or distributions equaling at least 80 percent of Target stock.
Seller and Target cannot be foreign.	Seller and Target cannot be foreign.
Election jointly made by purchaser and seller. In the case of an S-corporation Target, all S-corporation shareholders (not just those disposing of their Target stock) must agree to make the election.	Election jointly made by seller and Target. In the case of an S-corporation Target, all S-corporation shareholders (not just those disposing of their Target stock) must agree to make the election.

Conclusion

The 336(e) Regulations provide taxpayers with additional planning opportunities to obtain the benefits of a deemed asset sale with respect to certain dispositions of Target stock where a 338(h)(10) Election may not be available. This new tax planning opportunity permitted by the 336(e) Regulations should not be overlooked or neglected in private equity, M&A and other acquisition and disposition transactions. We welcome inquiries into exploring the ability to make a 336(e) Election and the benefits that may exist with respect to a 336(e) Election.

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¹ Except as otherwise indicated herein, all "section" references are to the U.S. Internal Revenue Code of 1986, as amended (the "Code") and the U.S. Treasury Regulations (the "Regulations") issued thereunder.