

## *Section 336(e): Final Regulations Related to Deemed Asset Purchases Provide New Flexibility in Structuring Acquisitions*

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The Internal Revenue Service has recently issued final regulations implementing Section 336(e) of the Internal Revenue Code (the "Final Regulations") that should provide another alternative to structure transactions that are treated as sales of equity for corporate law purposes as taxable sales of assets, combining the benefits of a simpler transaction structure with step-up in the tax basis of the target's assets. Before the Final Regulations were issued, a step-up in the tax basis of the target assets could be achieved in connection with equity transactions by parties making elections under Section 338 or 754 of the Code or by acquiring 100% of the interest in a limited liability company or other entity treated as a partnership for tax purposes. The Final Regulations provide corporate sellers of C corporation stock and S corporation shareholders with an alternative to a Section 338(h)(10) election in a transaction (i) that is structured as an equity transaction for corporate law purpose, (ii) creates a stepped-up basis in the tax basis of the C corporation or S corporation assets, and (iii) avoids, in the case of corporate sellers of C corporation stock, two levels of tax, eliminating a layer of corporate tax that was an unintended consequence of the major structural changes implemented by the Tax Reform Act of 1986.

One of the most significant aspects of the Tax Reform Act of 1986 was the repeal of the *General Utilities* doctrine, which caused a corporate-level tax to be imposed on the appreciation inherent in corporate assets in most cases. This has been referred to as the "double taxation" of corporate gains. Section 336(e) was included in the 1986 Act to mitigate certain "triple tax" situations in which one corporation owned more than 80% of the stock of another corporation. Finally, after 27 years, the Treasury Department has issued the Final Regulations implementing Section 336(e). Proposed regulations on the topic were proposed in 2008 (the "Proposed Regulations").

A number of the fundamental concepts of the Final Regulations will be familiar to tax professionals and dealmakers because, in general, they mirror several provisions of the now familiar Section 338 statutory provisions and regulations. Since the 1980s, Section 338 has proven to be a valuable tool to achieve the tax consequences of an asset sale and purchase (and deemed liquidation of the selling corporation), while allowing the transaction to be structured as a less complicated stock sale and purchase, from a corporate form perspective. However, Section 336(e) is more flexible in application than Section 338, and thus, provides additional opportunities to obtain beneficial tax treatment in a wider range of transactions.

The main conceptual difference between an election under Section 338 (i.e., either a Section 338(g) or a Section 338(h)(10) election) and a Section 336(e) election is that a Section 338 election requires as a building block the taxable purchase of the requisite amount of target corporation stock by a corporate purchaser from either a corporate seller or S corporation shareholders. In contrast, a Section 336(e) election only requires as a building block the taxable sale, exchange, or distribution of the requisite amount of target corporation stock by a corporate seller or S corporation shareholders, without the requirement of a corporate purchaser. Thus, for example, a Section 336(e) election could be available to step-up the inside tax basis of the target's assets if a corporation distributed 80% or more of the stock of its corporate subsidiary in a taxable transaction to a diverse group of shareholders. A Section 338(h)(10) election would not be available under this fact pattern.

In general, a Section 336(e) election is available to the selling corporation (and the 80% owned target) if a corporate seller makes a disposition of another corporation in a "qualified stock disposition." The stock dispositions taken into account in determining whether a qualified stock disposition has occurred span a 12-month period commencing on the date of the first stock sale. Any sale, exchange or distribution to a "related person" is not counted towards the 80% threshold needed to achieve a qualified stock disposition. Importantly, Section 336(e) allows the 80% threshold to be met by sales, exchanges, distributions, or any combinations thereof, to multiple purchasers, and, unlike is the case with elections under Section 338 of the Internal Revenue Code, the purchasers do not have to be a corporation.

A Section 336(e) election is also available to S corporation shareholders selling their S corporation stock.

If the Section 336(e) election is made, the sale of the target corporation stock for corporate law purposes is not treated as a stock sale for tax purposes. Rather the target corporation is generally treated as selling its assets to a new fictional corporation in exchange for the consideration paid for the stock (and taking into account certain liabilities of the target as part of the deemed asset sale), recognizing all the tax consequences of the seller, and then liquidating. Alternatively, for transactions involving tax-free (at the shareholder level) distributions of corporate stock by another corporation pursuant to Section 355 of the Internal Revenue Code that are taxable at the distributing corporation level, the Final Regulations provide that the target corporation is deemed to repurchase its assets prior to its shares being distributed to the shareholders of its corporate parent. The purchasers of the shares of target become the owners of a new corporation that has a tax basis in its assets equal to the current fair market value of the assets (and the attendant valuable depreciation and amortization deductions).

The necessary "qualified stock disposition" may be in the form of a sale, exchange, or distribution or any combination thereof. Importantly, certain common "rollover" transactions will still require painstaking planning and multiple additional steps to avoid certain technical prohibitions against target shares being acquired in a Section 351 transaction or a tax-free reorganization. It is regrettable that drafters of the Final Regulations did not see fit to eliminate this trap for the unwary, however Treasury has agreed to continue to study the issue.

Dealmakers and tax professionals will welcome the additional structuring alternatives that the Final Regulations sanction. These include:

- An S corporation and its shareholders may utilize Section 336(e) to provide stepped-up tax basis to a purchaser in an equity transaction.
- There is no requirement that the target stock be sold to a single purchaser and the purchasers of the target stock can include persons other than corporations for tax purposes. A group of individuals and/or partnerships may be eligible purchasers and enjoy the benefits of an increased tax basis in the assets of the acquired corporation.
- Not all of the stock of the target corporation owned by the seller need be sold, distributed, and/or exchanged.
- A Section 336(e) election may be made for a distribution that qualifies as a tax-free distribution under Section 355 with respect to the shareholders of the distributing corporation but not with respect to the distributing corporation because of changes in the ownership of the distributing corporation or the distributed corporation.
- Sales or distributions of subsidiaries from consolidated groups to the public will allow the public shareholders to increase the tax basis of the assets of the distributed or sold corporation to their full fair market value, creating significant additional value in the now-public corporation. This is particularly valuable when the selling consolidated group has considerable net operating losses available to offset the corporate level tax on the deemed asset sale.

Important changes from the Proposed Regulations include:

- A relaxation of the “related party” definition to allow two partnerships with a common partner owning less than 5% in each to be treated as unrelated. This will facilitate transactions between entities such as private equity funds (and their affiliates) that may have a very small partner in common.
- A relaxation of the “loss disallowance rule” that allows a target corporation to recognize a loss in the deemed asset sale to the extent that gain is recognized on a distribution of the stock of the target by the seller.

The Final Regulations will be extremely useful to tax planners and dealmakers in implementing acquisition structures that provide the purchasers of targets with an increase in the tax basis of the purchased business in a structure that avoids the sometimes insurmountable practical complications of an asset purchase transaction. At the same time, corporate sellers should be able to design disposition strategies that eliminate a layer of corporate tax that was an unintended consequence of the major structural changes implemented by the 1986 Act.

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