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Final Regulations Issued under I.R.C. Section 336(e)

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On 15 May 2013, the U.S. Treasury promulgated final regulations that finally allow taxpayers to make an election, under Section 336(e) of the U.S. Internal Revenue Code (the "Code"), to treat a disposition of stock of a U.S. corporate subsidiary (or of an S corporation) as a disposition of that corporation's assets. We refer to the Section 336(e) election as an "E Election". The E Election is similar to the one long permitted under Section 338(h)(10) (an "H10 Election") but applies to a broader range of M&A transactions. Section 336(e) was added to the Code in 1986, but the statutory language itself required regulations to implement the election. Proposed regulations were not issued until 2008, with the final regulations following five years later.

Like the H10 Election, the E Election avoids a noneconomic duplicated gain on appreciated assets. Absent these elections, a parent corporation ("P") selling stock of a subsidiary ("T") with appreciated assets would recognise gain on the sale of the T stock, and T itself would also recognise the same economic gain in the future if it sold the underlying appreciated assets. Under both the E Election and the H10 Election, T recognises gain on a deemed sale of its assets, and the buyer will take those assets with FMV basis. T is then treated as liquidating into P (generally tax-free under Section 332), and so P incurs no additional tax on its sale of T's stock.

One important difference between the E Election and the H10 Election concerns how it is made: the H10 Election is a joint election between P and buyer, but the E Election is a joint election between P and T. This will likely have significant consequences on the negotiation of M&A transactions in which E Elections are contemplated.

Final Regulations

Under the final regulations, the E Election is available for any "qualified stock disposition" ("QSD") completed on or after 15 May 2013. If P and T are U.S. corporations, a QSD occurs when P sells, exchanges or distributes at least 80% of the stock of T (by vote and value) within a 12 month period. Likewise, when T is an S corporation, a QSD occurs when the T shareholders collectively satisfy this requirement. Only taxable sales, exchanges and distributions are counted for this purpose, but distributions to which Section 355 applies are also included if the distributing corporation recognises gain by application of Section 355(d) or (e). Unlike with an H10 Election, there need not be a single corporate buyer; in fact, because a distribution can be a QSD, there need not be any buyer. Importantly, a disposition that also qualifies as a "qualified stock purchase" under Section 338 is, by definition, not a QSD under Section 336(e). Therefore, any transaction that qualifies for an H10 Election does not qualify for an E Election.

As a technical matter, an E Election made for a QSD that is a sale results in a series of deemed transactions that are very similar to those in an H10 Election. T is deemed to sell all of its assets to an unrelated third party and then liquidate into P. Next, a new corporation ("New T") owned by buyer is deemed to purchase all of T's assets from an unrelated third party. (If P distributes any T stock in the QSD, it is deemed to have purchased New T stock from an unrelated third party and distributed it.) The deemed transactions result in a FMV basis in T's assets (in the hands of the New T) but do not affect the FMV basis that the buyer or distributees will generally have in the T stock. An alternate deemed transaction applies where the QSD consists wholly or partly of a distribution to which Section 355(d) or (e) applies. In that case, the final regulations adopt a "sale to self" model in which T does not liquidate but instead repurchases its assets from an unrelated third party before the distribution.

To make an E Election, P and T must enter into a "written, binding agreement" to make the E Election. Both must make the election on their tax returns for the year of the QSD, except if P and T file a consolidated

return, the election is reported solely on the consolidated return for the selling group. If T is an S corporation, all of the S corporation shareholders must enter into an agreement to make the E Election and include a statement with their tax returns.

Transactional Implications

Before E Elections were allowed, buyers seeking to acquire and operate businesses with a basis step-up needed to use a corporate entity as buyer and make an H10 Election. Buyers can now achieve a basis step-up without an ongoing corporate-level tax by making a QSD of stock of a corporate T and then making an E Election, using a partnership as the buyer in the QSD. Then, after the closing (even the day after the closing), the partnership can cause New T to liquidate. While the liquidation would be taxable under Sections 331 and 337, there should be no additional gain or loss because both New T's stock and assets will have a FMV basis by virtue of the E Election.

In cases where P and T are members of a consolidated group, the only election statement that must be filed is with P's consolidated return, so the E Election is effectively unilateral on the part of the selling parties. P and buyer may have to negotiate whether or not an E Election will be made, and their decision should be reflected in the sale contract. If P's E Election (or failure to make an E Election) could have significant unexpected tax consequences on a buyer, the buyer might request applicable covenants from P (along with indemnity protection). One interesting technical question is whether the sale contract itself can constitute a "written, binding agreement" contemplated by the regulations governing E Elections. We see no reason why not, assuming P and T are both parties to the sale contract.

One final planning point. Taxpayers are allowed to make a protective E Election (i.e., an E Election that would have effect only if a transaction unexpectedly constitutes a QSD). For example in a spin-off, the unexpected application of Section 355(d) or (e) would cause P to have taxable gain on the distribution of T stock, causing the distribution to qualify as a QSD. In such a case, the protective E Election would cause T to have a stepped-up asset basis after the distribution. T's tax benefit from the step-up might then be used to reimburse P for a portion of its tax on the distribution. Of course, all of this would need to be set forth in the relevant contracts in the first instance.

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