Section 336(e) Elections: Tax Basis Step Up Through Deemed Asset Sale Treatment
Structuring Qualifying Stock Dispositions for Partnership and Private Equity Acquirers

TUESDAY, SEPTEMBER 26, 2017
1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today’s faculty features:

Meghan Jodz, Partner, Tax Services, Grant Thornton, Philadelphia
Adam J. Tejeda, Partner, K&L Gates, New York
Lori A. Hellkamp, Jones Day, Washington, D.C.

The audio portion of the conference may be accessed via the telephone or by using your computer’s speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact Customer Service at 1-800-926-7926 ext. 10.

NOTE: If you are seeking CPE credit, you must listen via your computer — phone listening is no longer permitted.
Tips for Optimal Quality

Sound Quality
If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial 1-866-328-9525 and enter your PIN when prompted. Otherwise, please send us a chat or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

NOTE: If you are seeking CPE credit, you must listen via your computer — phone listening is no longer permitted.

Viewing Quality
To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.
Continuing Education Credits

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For CPE credits, attendees must participate until the end of the Q&A session and respond to five prompts during the program plus a single verification code. In addition, you must confirm your participation by completing and submitting an Attendance Affirmation/Evaluation after the webinar and include the final verification code on the Affirmation of Attendance portion of the form.

For additional information about continuing education, call us at 1-800-926-7926 ext. 35.
Section 336(e) Elections: Tax Basis Step Up Through Deemed Asset Sale Treatment

September 26, 2017

Meghan Jodz, Grant Thornton
Adam Tejeda, K&L Gates
Lori Hellkamp, Jones Day
Preference for Asset Acquisitions

Unlike stock acquisitions, asset acquisitions generally provide buyers with a cost basis in the purchased assets that can be depreciated or amortized.

As a rule of thumb, $1 of goodwill/intangible step-up yields approximately $0.20 of net present value tax benefits to a Buyer.
Asset Purchase Structure—Direct Asset Sale

- P purchases assets directly from T, a C corporation owned by X.
- T is subject to tax on any gain recognized on the sale of the assets.
- Upon T’s distribution of the sale proceeds to X (T’s shareholder), X is generally subject to tax.
- P acquires the assets with basis equal to the purchase price.
Asset Purchase Structure—Formation and Sale of LLC

- T forms new, single-member LLC (“NewCo”), which is disregarded as separate from T for U.S. federal income tax purposes, and contributes the wanted assets to NewCo.
- T’s sale of all the NewCo interests to P is treated as an asset sale for U.S. federal income tax purposes.
- T is subject to tax on any gain recognized.
- Upon T’s distribution of the sale proceeds, X is generally subject to tax.
- P acquires the assets with a basis equal to purchase price of NewCo interests.
Asset Purchase Structure—Sale of QSub

- S Co is a subchapter S corporation ("S corporation") with a qualified subchapter S subsidiary, QSUB.
- Because S Co is an S corporation, tax items generally flow through directly to its shareholder, X.
- S Co sells all of the interests in QSUB to P, which is treated as an asset sale for U.S. federal income tax purposes. See Treas. Reg. section 1.1361-5(b)(3), Example 9.
- This transaction results in a single level of tax at the shareholder level.
- If S Co’s S election were invalid, then QSUB would not be a qualified subchapter S subsidiary, which would treat P’s purchase as a stock acquisition, rather than an asset acquisition.
A section 338(h)(10) election allows certain sales of stock to be taxed as asset sales for U.S. federal income tax purposes. The election is made by the buyer and seller(s).

This transaction results in a single level of tax imposed on T on the deemed sale of the assets.

A section 338(h)(10) election requires an unrelated corporate purchaser make a “qualified stock purchase” of T’s stock.

A section 338(h)(10) election requires that T be a member of an affiliated group that files a consolidated return or that T is an S corporation. T cannot be a foreign corporation.

As a result of a joint, section 338(h)(10) election (IRS Form 8023), New T will hold assets with a cost basis.

IRS Form 8023 due by the 15th day of the ninth month following the QSP.
A section 338(g) election allows certain sales of stock to be taxed as asset sales for U.S. federal income tax purposes.

The unilateral election is made by the buyer.

This transaction results in two levels of tax imposed:
1) imposed on T on the deemed sale of the assets and
2) on Seller on the sale of the shares.

A section 338(g) election requires an unrelated corporate purchaser make a “qualified stock purchase” of T’s stock.

A section 338(g) election does not require that T be a member of an affiliated group. T can also be an S corporation or a foreign corporation.

As a result of a section 338(g) election (IRS Form 8023), New T will hold assets with a cost basis. P holds stock with cost basis, too.

Most useful if T has NOLs.

IRS Form 8023 due by the 15th day of the ninth month following the QSP.
**Background and Requirements of a Section 336(e) Election**

| **• Background to section 336(e)** | Enacted in 1986 as part of the repeal of the *General Utilities* doctrine.  
| | Permits certain sales, exchanges, or distributions to be treated as a disposition of all of the target’s assets, and no gain or loss will be recognized on the sale, exchange, or distribution of the target’s stock.  
| | The election was not activated until the May 15, 2013 effective date of the Regulations, long after Code Section 336(e) was added in 1986.  |
| **• Domestic seller:** | C corporation sellers (consolidated or stand alone).  
| | S corporation sellers.  
| | Members of consolidated group are treated as one seller.  |
| **• Dispose of a section 1504(a)(2) amount of target stock:** | Such a disposition is a “qualified stock disposition” or “QSD.”  
| | The QSD rules allow aggregation of sales, exchanges, and distributions to separate transferee.  
| | Any sale, exchange, or distribution can be part of a QSD, but only if—  
| | ▪ Purchaser does not take carryover basis in target stock, in whole or in part (i.e., no 351 transactions or reorganizations), and  
| | ▪ Not sold, exchanged, or distributed to a related person (see next slide).  
| | Unlike a section 338(h)(10) election, purchasers do not need to be corporations.  
| | Seller or affiliates may retain some target stock.  
| | QSD must take place within a 12-month disposition period.  |
General Section 336(e) Requirements—Ineligible Dispositions

- **Dispositions to related persons**
  - Transfers to “related persons” do not qualify as “dispositions” for purposes of making a QSD.
    - *Related Person*: Two persons are related persons if stock owned by one would be attributed to the other under section 318 (not counting attribution via option).
    - Special partnership rule: No attribution between partners and partnerships (upstream or downstream) if the partner owns, directly or indirectly, less than 5% of interests of the partnership by value.

- **Dispositions involving foreign corporations**
  - A section 336(e) election may not be made if seller or target is a foreign corporation.
General Section 336(e) Requirements—Basic Mechanics

- **Sell-Side / Unilateral Election:**
  - Written, binding agreement to make election must be made jointly by target and, as applicable, (i) consolidated sellers, (ii) non-consolidated seller, or (iii) all S corporation shareholders (including non-selling shareholders) on the relevant tax returns.
  - Like a section 338(h)(10) election involving an S corporation, if any S corporation shareholder resides in a community property state, such shareholder’s spouse should also sign the section 336(e) election.

- **Other Aspects:**
  - QSP (section 338) generally trumps QSD (section 336).
  - Protective section 336(e) elections are allowed.
  - Unlike with a section 338(h)(10), a partnership buyer can convert New T to a DRE by converting to an LLC (or merging into an LLC).
  - Can make section 338(g) election in respect of CFC held by Target, resetting E&P to zero and allowing amortizable step-up basis for E&P purposes.
<table>
<thead>
<tr>
<th>Section 336(e) Requirements—Basic Mechanics</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section 336(e)</strong> Applies to Taxable Sales Only:</td>
</tr>
<tr>
<td>• IRS has requested comments on whether to include non-taxable transactions (e.g., section 351 exchange or section 368 reorganization).</td>
</tr>
<tr>
<td>• However, can include distributions of stock taxable pursuant to section 311.</td>
</tr>
<tr>
<td><strong>Tiered Targets:</strong></td>
</tr>
<tr>
<td>• Deemed liquidation of a lower-tier target/subsidiary precedes the deemed liquidation of a higher tier subsidiary</td>
</tr>
<tr>
<td><strong>Form 8883:</strong></td>
</tr>
<tr>
<td>• Old Target and New Target must report deemed sale of assets on Form 8883 (same form as for section 338 election). Old Target must file two forms if section 336(e) election is made pursuant to section 355 transaction.</td>
</tr>
</tbody>
</table>
Effect of a Section 336(e) Election—Disposition by Sale or Exchange; Distributions

• Sale or exchange:
  - Seller disregards actual sale or exchange of Old T stock.
  - Old T treated as selling assets to unrelated New T.
  - Old T then treated as liquidating into seller (usually under section 332).
  - New T has no tax attributes, no E&P, and cost basis in assets.
  - As in the section 338(h)(10) context, New T remains liable for tax liabilities of Old T notwithstanding Old T’s deemed liquidation. For example, New T remains liable for the tax liabilities of the members of any consolidated group that are attributable to tax years in which those corporations and Old T joined in the same consolidated return, under Treas. Reg. section 1.1502-6(a).

• Taxable distribution:
  - Generally has a similar effect as sale or exchange, with certain differences.
  - Net losses on deemed asset sale disallowed.
  - Seller deemed to purchase the amount of stock of New T distributed in the QSD (or retained by seller) and to distribute such stock to its shareholders (or retain such stock, as applicable).
  - Seller recognizes no gain or loss on the distribution.
Effect of a Section 336(e) Election (cont.)— 
Distributions Subject to Section 355(d)(2)/(e)(2)

- Controlled corporation (i.e., Old T) treated as if it sold its assets to an unrelated person in deemed asset sale and then repurchased those assets (“sale-to-self” treatment).
- Old T can net gains and losses from deemed asset sale. Net losses disallowed like in non-section 355(d)/(e) distribution.
- Old T generally not deemed to liquidate, except pursuant to, and solely for purposes of, an election under Treas. Reg. section 1.1502-13(f)(5)(ii)(E), allowing consolidated taxpayers to trigger a stock loss.
- Old T retains its own tax attributes, with adjustments to E&P to take into account deemed asset sale.

- Example: Distribution subject to section 355(d)(2). P and Q each buy 50 percent of T's stock and, within five year timeframe, T liquidates, distributing the stock of T-1 to P and the stock of T-2 to Q. T must recognize gain on both distributions.
- Example: Distribution subject to section 355(e)(2). T spins-off T-1 stock to its shareholders and then T-1 is acquired by P in a Type A reorganization where P shareholders end up owning more than 50% of T-1. Assuming the transactions are not severable, T is taxed on the gain in T-1 stock.
Effect of a Section 336(e) Election (cont.)—Subsidiaries

- C Corp Subsidiary
  - Generally no different if organic Target.

- S Corp Subsidiary
  - Generally only ordinary income recapture if sale occurs outside the built-in gains tax period.
| **Purchasers** | Generally, a section 336(e) election will not affect the U.S. federal income tax consequences to a purchaser.  
| | Purchaser will be treated as having acquired target stock on the date actually actually acquired. |
| **Minority Shareholders** | A minority shareholder recognizes gain or loss on a taxable sale, exchange, or distribution of Target stock, under general tax law principles. |
| **Target** | New T takes a stepped-up basis in the assets.  
| | New T retains its EIN, but starts fresh accounting methods and has no carry-over tax attributes. |
Best Practices: Drafting and Negotiation

• For Buyers:
  - Make clear in bid document, LOI, or term sheet that they want a deemed asset purchase, if desirable.
  - Make clear in Purchase Agreement that the seller will *or will not* make a section 336(e) election. For example, if there is a built-in loss in the target’s basis in the assets, it is critical that buyers ensure the election will *not* be made.

• For Sellers:
  - Seller should make it clear in sales document or CIM if they are willing to make a section 336(e) election or section 338(h)(10) election. Ideally, this should be drafted to draw out additional purchase price in exchange for the step-up delivered to the buyer.
  - Sellers should make sure they are compensated in the Purchase Agreement for the election. At a minimum: the incremental tax burden. At a maximum: the entire step-up.
EXAMPLES
Example 1a: Sale of 100% of T Stock (Higher Inside Basis)

- P sells all 100 Old T shares to A for $10,000 and timely makes a section 336(e) election with Old T.
- Old T treated as selling all its assets to New T for $10,000, the “aggregate deemed asset disposition price” or “ADADP,” calculated under specified rules and primarily based on the amount paid or the fair market value of the stock. In this simple case, it is the same as the amount paid.
- The ADADP is allocated $7,000 to Asset 1 and $3,000 to Asset 2 under the applicable rules (primarily by fair market value).
- Old T recognizes $2,000 gain on deemed sale of Asset 1 and $1,000 loss on deemed sale of Asset 2 (net $1,000 gain vs. $2,000 gain that would be recognized on sale of Old T stock for cash).
- Old T treated as liquidating into P under section 332. No gain or loss to P.

- New T treated as acquiring assets for $10,000, the “adjusted gross up basis” or “AGUB,” calculated under specified rules and primarily based on the amount paid or the fair market value of the stock.
- The AGUB is allocated $7,000 to Asset 1 and $3,000 to Asset 2 under the applicable rules (primarily by fair market value).
- New T holds Assets 1 and 2 with fair market value basis.
- A’s basis in New T stock is equal to the amount paid for the stock, $10,000.
Example 1b: Sale of 100% of T Stock (Higher Outside Basis)

- P sells all 100 Old T shares to A for $10,000 and timely makes a section 336(e) election with Old T.
- Old T treated as selling all its assets to New T for $10,000, the “aggregate deemed asset disposition price” or “ADADP,” calculated under specified rules and primarily based on the amount paid or the fair market value of the stock. In this simple case, it is the same as the amount paid.
- The ADADP is allocated $7,000 to Asset 1 and $3,000 to Asset 2 under the applicable rules (primarily by fair market value).
- Old T recognizes $2,000 gain on deemed sale of Asset 1 and $1,000 loss on deemed sale of Asset 2 (net $1,000 gain vs. $500 gain that would be recognized on sale of Old T stock for cash).
- Old T treated as liquidating into P under section 332. No gain or loss to P.

- New T treated as acquiring assets for $10,000, the “adjusted gross up basis” or “AGUB,” calculated under specified rules and primarily based on the amount paid or the fair market value of the stock.
- The AGUB is allocated $7,000 to Asset 1 and $3,000 to Asset 2 under the applicable rules (primarily by fair market value).
- New T holds Assets 1 and 2 with fair market value basis.
- A’s basis in New T stock is equal to the amount paid for the stock, $10,000.
Example 1c: Sale of 100% of T Stock (Built-In Loss)

- P sells all 100 Old T shares to A for $10,000 and timely makes a section 336(e) election with Old T.
- Old T treated as selling all its assets to New T for $10,000, the “aggregate deemed asset disposition price” or “ADADP,” calculated under specified rules and primarily based on the amount paid or the fair market value of the stock. In this simple case, it is the same as the amount paid.
- The ADADP is allocated $7,000 to Asset 1 and $3,000 to Asset 2 under the applicable rules (primarily by fair market value).
- Old T recognizes no gain or loss on deemed sale of Asset 1 and $1,000 loss on deemed sale of Asset 2 (net $1,000 loss vs. $2,000 gain that would be recognized on sale of Old T stock for cash).
- Old T treated as liquidating into P under section 332. No gain or loss to P.

- New T treated as acquiring assets for $10,000, the “adjusted gross up basis” or “AGUB,” calculated under specified rules and primarily based on the amount paid or the fair market value of the stock.
- The AGUB is allocated $7,000 to Asset 1 and $3,000 to Asset 2 under the applicable rules (primarily by fair market value).
- New T holds Assets 1 and 2 with fair market value basis.
- A’s basis in New T stock is equal to the amount paid for the stock, $10,000.
- However, New T has lost the ability to utilize the $1,000 built-in loss.
Example 2: Sale of 80% of T Stock

- P sells 80 T shares to A for $8,000 and timely makes a section 336(e) election with T.
- ADADP = $10,000, allocated $7,000 to Asset 1 and $3,000 to Asset 2 under the applicable rules.
- Old T recognizes $2,000 gain on deemed sale of Asset 1 and $1,000 loss on deemed sale of Asset 2 (same as previous example).
- Old T treated as liquidating into P under section 332. No gain or loss to P.

- AGUB = $10,000, allocated $7,000 to Asset 1 and $3,000 to Asset 2 under the applicable rules.
- On the day after the disposition date, P is treated as purchasing from an unrelated person the 20 shares of New T stock not sold to A for their $2,000 fair market value.
- A’s basis in the purchased stock is the amount paid for the stock, $8,000.
Example 3: Distribution of 100% of T Stock

- P distributes 100 Old T shares to its shareholders, all of whom are unrelated to P, in a transaction that does not qualify under section 355.
- P and Old T timely make a section 336(e) election.
- ADADP = $10,000, allocated $7,000 to Asset 1 and $3,000 to Asset 2 under applicable rules.
- Old T recognizes $2,000 gain on deemed sale of Asset 1 and because there is no net loss, recognizes the entire $1,000 loss on Asset 2.
- Old T is treated as liquidating into P under section 332.

- Immediately after deemed liquidation of Old T, P is deemed to purchase 100 shares of New T from an unrelated person and distribute those shares to its shareholders.
- P recognizes no gain or loss on deemed distribution.
- AGUB = $10,000, allocated $7,000 to Asset 1 and $3,000 to Asset 2 under applicable rules.
- New T holds Assets 1 and 2 with fair market value basis.
- P’s shareholders receive New T stock with a fair market value basis of $10,000.
Example 4: Part-Sale, Part-Distribution

- 1/1/Year 1: P sells 50 shares of T stock to A for $88/share ($4,400).
- 7/1/Year 1: P distributes 30 T shares to its unrelated SHs when the value of Old T common stock is $120/share.
- 80% of Old T stock was disposed of, so transactions qualify for section 336(e) election, and such election is timely made by P and Old T.
- ADADP = $10,000. Note that this is less than the assets are currently worth, because part of the stock was disposed of at a lower price than the current value.
- ADADP allocated $6,500 to Asset 1 and $3,500 to Asset 2.
- Old T recognizes $500 gain on Asset 1 and $1,000 gain on Asset 2.

AGUB of $10,000, allocated $6,500 to Asset 1 and $3,500 to Asset 2.
- Old T is treated as if liquidating into P under section 332, then P is deemed to purchase 30 shares of New T and distribute those shares, without recognizing gain or loss, to its shareholders.
- The day after the disposition date, P is deemed to purchase and retain 20 shares at their ADADP-determined fair market value of $100/share.
- A holds 50 shares with $88/share basis.
- Shareholders hold 30 shares with $120/share basis.
- P holds 20 shares with $100/share basis.
Example 5: Distribution in Complete Redemption

• Steps:
  • Seller distributes 80% of T stock to A in complete redemption of A’s 51% ownership in P in a transaction that does not qualify under section 355.
  • A valid section 336(e) election is made.
  • Prior to the redemption, A and P would have been related persons under section 318 because any stock P would be attributed to A because A owns more than 50% of P.
  • However, for purposes of a section 336(e) election, determination is made immediately after the redemption, at which point A no longer owns any of P. Accordingly, the redemption is a QSD.

• Deemed transactions:
  • Old T sells assets to unrelated person and New T acquires assets from unrelated person in one transaction.
  • Old T treated as liquidating into P in a section 332 liquidation. P recognizes no gain or loss on the liquidation.
  • P treated as purchasing 80% of New T shares from unrelated person and distributing those shares to A in exchange for A’s 51% interest in P. P recognizes no gain or loss on this distribution.
  • P is treated as purchasing 20% of New T for fair market value from an unrelated person on the day after the distribution.
  • Federal tax consequences to A are the same as if no section 336(e) election were made.