Leveraging Final Sect. 336(e) Regulation Benefits in Acquisitions and Corporate Spin-Offs

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Leveraging Final Sect. 336(e) Regulation Benefits in Acquisitions and Corporate Spin-Offs

Aug. 22, 2013

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NOMENCLATURE
**Nomenclature**

- **Disposition Date**: The date on which a QSD occurs
- **New Target**: Target for periods beginning after the disposition date
- **Old Target**: Target for periods ending on or before the disposition date
- **PS**: Partnership
- **Purchasers**: Persons that purchase or receive by taxable distribution Target stock
- **QSD**: Qualified Stock Disposition - transaction or series of transactions within a 12-month period in which at least 80% of the stock of Target is sold, exchanged or distributed by Seller or S Shareholders
- **Reg**: Treasury Regulation
Nomenclature

- **S Shareholders**: The shareholders of a Target that is an S corporation
- **Seller**: A domestic corporation that owns at least 80% of the stock of Target. Seller may sell or distribute Target stock
- **Shareholders**: The shareholders of Seller
- **T**: Target
- **Target**: A domestic corporation that is either (i) a part of Seller’s affiliated or consolidated group or (ii) an S corporation
- **TP**: Taxpayer
BACKGROUND
Background of §336(e)

- 1986 Congress repealed General Utilities that permitted a corporation to liquidate and not recognize gain.

- As a result, gain embedded in the assets of a sold or distributed subsidiary generally subject to triple tax:
  - Gain on original sale/distribution of subsidiary T stock
  - Shareholder of selling corporation will have income or gain when proceeds exit selling corporation to shareholder
  - T subsidiary will have gain when sell assets
Background of §336(e)

- §336(e) was to provide relief from the potential multiple taxation of the same economic gain that results when a transfer of appreciated corporate stock is taxed to the corporate seller without providing a corresponding basis step up in the assets of the subsidiary target.

- §338(h)(10) was already in Code for limited relief in certain all corporate transactions.

- Purpose was to expand the §338(h)(10) type of relief.
Background of §336(e)

- Statute starts, “Under regulations prescribed by the Secretary if …”
- IRS position - not applicable until regulations were issued (CCA 201009013)
- 27 years later, regulations finally issued on May 10, 2013
  - Effective for dispositions with a “disposition date” on or after May 15, 2013
  - Only in the tax world can you have a newly effective statutory provision after almost 27 years after passage
Tax Policy Observation

- §338(h)(10) provides for election if T corporation was a member of the selling consolidated group.
  - Regulations expanded the scope to include S corporations (definitionally not in a consolidated group but concept of income being taxable elsewhere)

- §336(e)(1) provides “a corporation owns stock of another corporation ...”
  - S corporations cannot have another corporation as a shareholder. IRC §1361(b)(1)(B)
Tax Policy Observation

- Proposed regulations for §336(e) did not include S corporations
- Final regulations include S corporations on basis (h)(10) parity
- While I like the result and intend to use this expansion with great vigor for client benefit
  - Do two positions arguably contrary to the Code equal a right position?
  - Does one position (clearly contrary to language of Code but favorable to TP) equal a right position?
  - As tax professionals and/or taxpayers, are we comfortable with regulations interpreting intent when statutory language is clearly to the contrary?
  - We may like the exercise of power today, but not tomorrow
IRS heart is in right place
IRS action is with best intentions

Personal opinion. Although I like where this specific road goes, it will be well traveled, and understand the parity rationale, unfortunately the statutory language is not there and there is no grey to interpret

I fear the application of the adage: “The road to hell is paved with good intentions.”
OVERVIEW
Overview of §336(e)

- Elective deemed asset sale treatment with respect to 80% (vote and value) or more sale of stock by S corporation shareholders or corporation sale of subsidiary stock.
  - New T in hands of Purchaser (includes distributee) has stepped-up asset basis

- Similar to IRC §338(h)(10) in effect, but available to a much broader scope of transactions
  - Seller recognizes no gain or loss on disposition of T stock
  - T is deemed to sell all of its assets
Overview of Basic Requirements for a §336(e) Transaction - QSD

- **Must have a Qualified Stock Disposition ("QSD")**
  - Transaction or series of transactions
  - Stock [80% or more in vote and value of shares (excluding §1504(a)(4) stock)] of a domestic corp
  - Sold, exchanged or distributed (or combination)
    - Stock reacquired by Seller or related person in 12-month disposition period not count
  - By another domestic corporation or S corp SH
  - In a disposition

- **Reg. §1.336-1(b)(6)**
Overview of Basic Requirements for a §336(e) Transaction-Disposition

- Taxable disposition or series of dispositions
  - Sale or distribution of stock in a taxable transaction
    - No transferred basis exchange or by 1014(a)
    - No transaction in which §§351, 354, 355 or 356 applies except §355(d)(2) and (e)(2)

- Not sold, exchanged or distributed to a related person (*related person restriction not in Code*)
Overview of Basic Requirements for a §336(e) Transaction

- By Domestic parent corporation or S corporation shareholders
- Of domestic T corporation
- Within a 12-month period (disposition period)
- Treas. Reg. §1.336-1(b)(5)
Overview of Basic Requirements for a §336(e) Transaction

- If the preceding requirements are met, must be a timely election:
  - Generally by Seller and T
  - If S corporation, all S shareholders must elect
  - Large amount of information involved in the complete election
Overview of Basic Requirements for a §336(e) Transaction – Related Person

- Related if stock in corp owned by one of the persons would be attributed to the other person under §318(a), other than §318(a)(4)
  - Partner/Partnership attribution modified to exclude partners with direct or indirect ownership interests representing less than 5% in value of the PS. Treas. Reg. §1.336-1(b)(5)(iii)

- Relationship tested “immediately after” last disposition. Reg. §1.336-1(b)(5) via cross reference to Reg. §1.338-3
Overview for a §336(e) Transaction – Related Person

- Rollover ramifications for non-corporate acquirers. Using LLC for example.

- Seller and acquirer LLC are related if, immediately after the transfer, stock owned by Seller is treated as owned by LLC or vice versa.

- If Seller exchanges T stock for cash plus 10% of acquirer LLC, no §336(e) election.

- If Seller directly retains such 10%, then assuming LLC has 80% or more, §336(e) applies.
Overview for a §336(e) Transaction – Related Person

- Given the activity of private equity and other non-corporate entities investing in corporations, and institutional buyers investing in a large number of such investment entities, may inadvertently fail the related party rule

- For example if a 5% or more limited partner or member of a pass-through entity that owns stock in Seller is also a 5% or more limited partner or member of Purchaser, the transaction will not qualify for §336(e)

- This information may be very difficult if not impossible to obtain
Qualified Stock Disposition ("QSD") Requirements

- Seller/distributee and T must be domestic corporations (including S corp)
- Stock sold or distributed meeting requirements of §1504(a)(2) [80% vote and value other than non-participating preferred of §1504(a)(4)]
- Sale, distribution or combination in dispositions within the 12-mo disposition period
- With limited exception if transaction is both a §338(d)(3) stock purchase and a QSD, §336(e) not apply
- Treas. Reg. §1.336-1(b)(6)(ii)
§338(h)(10) Principles Generally Applicable

- Per Reg. §1.336-1(a)(1), to the extent not inconsistent with §336(e) or regulations thereunder, the principles of §338 and regulations apply for purposes of the §336(e) regulations.
§338(h)(10) Principles Generally Applicable

- Expressly enumerated (h)(10) principles
  - Deemed asset sale model for basic §336(e) stock purchase and distribution
    - Sale to self model for §355(d)(2) and (e)(2) transactions is new
  - Disposition of stock must be fully taxable
  - Deemed sale of T’s assets are fully taxable
  - Installment method available for deemed asset sale
  - Consistency rules apply. (This can be an unpleasant surprise)
  - ADADP and AGUB concepts apply
    - With respect to “nonrecently acquired stock” for which a deemed or actual election is made, the gain on the deemed asset sale is recognized, BUT NOT THE LOSS. §1.338(h)-5(d)(iii)
§338(h)(10) Principles Generally Applicable (Cont’d)

- Non-expressly identified principles
  - Does the exception of §172(h)(3) to the equity reduction of interest deduction apply?
  - Anti-churning rules of Reg. §1.197-2(h)(8)?
  - Does Reg. §1.338-3(b)(5) testing of ownership for QSD purposes after taking into account redemptions by T apply?
Few Differences Between §336(e) and §338(h)(10)

**§336(e)**
- Election by Seller and T, also agreement
- Election by first return of seller and T
- Related person is §318(a) but not between partners and partnerships with less than 5% ownership
- Creeping disposition is broader as not require affiliated or consolidated group on disposition date

**§338(h)(10)**
- Election by Seller and Purchaser
- Election within 8.5 months
- Related person is §318(a)
- Creeping acquisition is narrower as T must actually be affiliated on the acquisition date
BASIC TRANSACTION STRUCTURES AND CONSEQUENCES OF THE 336(e) ELECTION
Transactions Eligible for 336(e) Election

- Sale of domestic corporation stock by an 80% corporate parent to one or more purchasers
- Sale of S corporation stock to one or more purchasers
- Taxable spin-off of domestic subsidiary
- Part sale, part distribution of domestic subsidiary stock
- Spin-off of domestic subsidiary in a Section 355(d)(2) or 355(e)(2) transaction
Transactions Not Eligible for 336(e) Election

- Target is a foreign corporation
- Seller is a foreign corporation
- Disposition of target corporation to “related parties”
- Disposition of target corporation in tax-free (or partially tax-free) or transferred basis transaction (other than 355(d)(2) or 355(e)(2) transactions)
Consequences of Making the Election

- Basic model applies to all QSDs other than Section 355(d)(2) and (e)(2) transactions
  - Generally follows the 338(h)(10) model, with differences to account for distributions
  - Reg. §1.336-2(b)(1)

- “Sale to self” model applies to Section 355(d)(2) and (e)(2) transactions
  - Target is not treated as liquidating
  - Reg. §1.336-2(b)(2)

- Target recognizes gain and loss (subject to certain limitations on losses) while owned by the Seller/S Shareholders

- Target generally obtains step-up in its assets while only one level of tax is imposed on the Seller/S Shareholders
Consequences of Making the Election

- Other than in 355(d)(2) and (e)(2) transactions, New Target is a new corporation for tax purposes, although it remains liable for the tax liabilities of Old Target (See Reg. §1.336-2(g))

- Principles in Section 338 regulations apply to the extent not inconsistent with the 336(e) regulations (See Reg. §1.336-1(a))

- Parties treated as actually engaging in deemed transactions for other purposes under the Code (See Reg. §1.336-2(e))
Deemed Transactions – Basic Model (Reg §1.336-2(b)(1))

1. Old Target is deemed to sell all its assets to an unrelated person in exchange for an amount equal to the “adjusted deemed asset disposition price” ("ADADP") at the end of the day on the disposition date
   - Target realizes gain/loss from the sale
   - To the extent Target stock is distributed to shareholders, a portion of net loss realized is disallowed

2. New Target is deemed to acquire all its assets from an unrelated person in exchange for an amount equal to the “adjusted grossed-up basis” ("AGUB")
   - Old Target is deemed to transfer to Seller the consideration deemed received from New Target in liquidation of Old Target
   - Typically will be treated as a Section 332 liquidation or Section 331 liquidation in the case of an S corporation
Deemed Transactions – Basic Model
(Reg §1.336-2(b)(1))

3. If the QSD included a distribution of Target stock, Seller is deemed to purchase from an unrelated person New Target stock and then to distribute such stock to shareholders.

4. No additional gain or loss is recognized by Seller.
**Example - Sale of Target Stock**

**Form of Transaction**
- Target is a member of Seller’s consolidated group
- Seller sells 100% of the Target stock to one or more unrelated Purchasers for $5M
- Target has no liabilities
- Purchasers treated as buying Target stock for $5M

**Deemed Transactions**
1. Old Target sells all its assets to an unrelated person in exchange for the ADADP of $5M
2. New Target acquires all the assets from an unrelated person for the AGUB of $5M
3. Old Target liquidates into Seller immediately after the deemed asset sale

**Results**
- Old Target recognizes gain/loss, which is included in Seller’s consolidated return
- New Target has a $5M basis in its assets
- Same deemed transactions and results if Target is an S corporation
Form of Transaction
• Seller distributes 100% of Target stock to its unrelated shareholders in a transaction that does not qualify under Section 355
• FMV of Target stock is $5M
• Target has no liabilities
• Shareholders treated as receiving a distribution under Section 301

Deemed Transactions
1. Old Target sells all its assets to an unrelated person in exchange for the ADADP of $5M
2. New Target acquires all the assets from an unrelated person for the AGUB of $5M
3. Old Target liquidates into Seller immediately after the deemed asset sale
4. Seller purchases 100% of New Target stock from an unrelated person and distributes such stock to its shareholders
**Example - Taxable Spin-Off**

**Results**

- Target recognizes gain, which is included in Seller’s consolidated return
- Net loss is disallowed
- New Target has a $5M basis in its assets
- No additional gain to Seller on deemed distribution of New Target to Shareholders
- Deemed transactions may affect treatment of Section 301 distribution to Shareholders, e.g., any increase in Seller’s E&P is taken into account
Form of Transaction
• Seller sells 50% of Target stock to unrelated Purchasers for $2.5M, distributes 45% of Target stock to its unrelated shareholders (with a value of $2.25M) and retains 5% of Target stock
• Target has no liabilities

Deemed Transactions
1. Old Target sells all its assets to an unrelated person in exchange for the ADADP of $5M
2. New Target acquires all the assets from an unrelated person for the AGUB of $5M
3. Old Target liquidates into Seller immediately after the deemed asset sale
4. Seller purchases 45% of New Target stock from an unrelated person and distributes such stock to its shareholders
5. Seller purchases 5% of New Target stock for FMV from unrelated person on day after disposition date
Example – Part Sale, Part Distribution

**Results**

- Target recognizes gain, which is included in Seller’s consolidated return
- 47% of net loss is disallowed
- New Target has a $5M basis in its assets
- No additional gain to Seller on deemed distribution of New Target to Shareholders
- Deemed transactions may affect treatment of Section 301 distribution to Shareholders, e.g., any increase in Seller’s E&P is taken into account
- Seller’s holding period for retained Target stock starts on the day after the disposition date
**Additional Considerations**

**Overlap with Qualified Stock Purchase** (See Reg. §1.336-1(b)(6)(ii))

- A transaction that meets both QSP and QSD requirements is not treated as a QSD
- Exception when a 336(e) election results in a deemed sale of a target subsidiary

**Creeping Dispositions**

- Purchasers are treated as acquiring Target stock on date of acquisition, even if prior to disposition date
- Seller is treated as not having disposed of such Target stock

**Tiered Targets**

- Deemed asset disposition of higher-tier subsidiary occurs first (See Reg. §1.336-2(b)(1)(i)(C)
- Deemed liquidation of lower-tier subsidiary occurs first (See Reg. §1.336-2(b)(1)(iii)(B))
Additional Considerations

**Minority Shareholders** (See Reg. §1.336-2(d))

- S Shareholders that retain stock do not recognize gain or loss with respect to Target shares
- However, Target still treated as disposing all of its assets, with any resulting gain passing through to all S Shareholders, including those that retain stock

**Purchaser Gain Recognition Election for Nonrecently Disposed Stock**

- See Reg. §1.336-4(c)
- Follows principles for gain recognition elections under Section 338 regulations
- Only gains are recognized, unreduced by losses
- Only applies to Purchasers that own at least 10% of Target stock on the disposition date
- Automatic gain recognition election for a Purchaser that owns 80% of Target
Deemed Transactions (See Reg. §1.336-2(b)(2))

1. Target is deemed to sell all its assets to an unrelated person in exchange for an amount equal to the ADADP at the end of the day on the disposition date
2. Target is deemed to acquire all its assets from an unrelated person in exchange for an amount equal to the AGUB
3. Seller is treated as distributing the Target stock actually distributed

Form of Transaction

- Seller distributes 100% of Target stock to its unrelated shareholders in a transaction subject to Section 355(d)(2) or (e)(2)
- FMV of Target stock is $5M
- Target has no liabilities

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**Step 1**

- Shareholders
- Seller
- Target
- Unrelated person

$5M

100% T assets

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**Step 2**

- Shareholders
- Seller
- Target
- Unrelated person

100% T assets

$5M

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**Step 3**

- Shareholders
- Seller
- T stock
- Target
- Unrelated person

Asset Basis = $5M
Section 355(d)(2) and (e)(2) Transactions “Sale to Self” Model

**Results**

- Target recognizes gain, which is included in Seller’s consolidated return
- Net loss is disallowed
- Target is not deemed to liquidate
  - Target thus retains its tax attributes
  - E&P of Seller and Target are determined under 1.312-10 and 1.1502-33(e)
  - Increase or decrease in E&P from deemed asset sale is taken into account before applying 1.312-10
- Seller does not recognize gain or loss on deemed distribution
- Deemed transactions do not affect Section 355 qualification of distribution
- Target in its capacity as the seller of assets is a separate taxpayer from and unrelated to Target in its capacity as the buyer of assets for purposes of the wash sale and anti-churning rules
CALCULATION OF GAIN AND BASIS
Calculation of Gain – Aggregate Deemed Asset Disposition Price

- ADADP is the price T is deemed to sell its assets and equals:
  - Grossed Up Amount Realized on disposition of recently disposed T stock, plus
  - T liabilities

- T determines gain or loss by allocation of ADADP among its assets using residual method of Reg. §338-6

- Reg. §1.336-3(b)

- Particularly in case of creeping transaction, formula will not necessarily approximate stock or asset value on disposition date. Value may change over the disposition period
Calculation of Gain - Grossed-Up Amount Realized

- Per Reg. §1.336-3(c), formula for grossed-up amount realized for recently disposed stock:

- Grossed-up amount realized = \( \frac{(A + B)}{(C/D)} + E \)

  - \( A \) = amount realized on sale or exchange of recently disposed stock that is not distributed
  - \( B \) = FMV of distributed recently disposed stock determined on the date of distribution
  - \( C \) = value of recently disposed T stock (by value on the disposition date)
  - \( D \) = total value of T stock on the distribution date
  - \( E \) = Seller or S corp SH costs in connection with sale or exchange of recently disposed stock reducing the amount realized
Recently Disposed Target Stock

- Recently disposed stock means:
  - T stock not held by Seller (including consolidated group) or S corp SH immediately after close of disposition date
  - Which was disposed of by such during the 12-month disposition period

- Reg. §1.336-1(b)(17)
T’s Basis after Deemed Transactions – Adjusted Grossed-Up Basis (AGUB)

- AGUB is amount for which T is deemed to have purchased its assets in the deemed transactions

- Per Reg. §1.336-4, AGUB is the sum of:
  - Grossed-up basis in Purchaser’s recently disposed T stock Purchaser acquired, plus
  - Purchaser’s aggregate basis in nonrecently disposed stock, plus
  - T liabilities

- ABUB is allocated among the assets under residual method of Reg. §1.338-6
Grossed-Up Basis of Recently Disposed Stock – Reg. §1.336-4

- Grossed-up basis of recently disposed stock = ((A-B) x (C/D)) + B
  - A = Purchaser’s aggregate basis in recently disposed T stock
  - B = Capitalized acquisition costs that Purchaser(s) incurred in connection with acquisition of recently disposed T stock
  - C = 100 - % of T stock (by value as determined on disposition date) attributable to Purchaser’s nonrecently disposed T stock
  - D = % of T stock (by value as determined on disposition date) attributable to Purchaser’s recently disposed T stock
Nonrecently Disposed Stock

- One might assume that nonrecently disposed T stock is all stock other than recently disposed stock. Wrong. Three groups of stock:
  - Recently disposed T stock
  - Nonrecently disposed T stock
  - Other minority “old and cold” stock
Nonrecently Disposed Stock - General

- Nonrecently disposed T stock is divided into 2 bucket
  - Nonrecently disposed T stock held by less than 80% T SH;
  - Nonrecently disposed T stock held by 80% or greater T SH
Nonrecently Disposed Stock – General – Reg. §1.336-1(b)(18)

- Nonrecently disposed stock is T stock that is:
  - Not “recently disposed stock” (i.e., not acquired within the disposition period) but
  - Held on disposition date by a Purchaser holding 10% or more (either by vote or value) of T stock on the disposition date.

- Other T stock held by minority SH (i.e., held by a person who is not a Purchaser or by a Purchaser with less than 10% (by vote or value) ) is not nonrecently disposed stock
Purchaser of T stock holding nonrecently disposed stock (i.e., acquired outside the 12-month disposition period) holding less than 80% of T stock on disposition date may make gain recognition election. Reg. §1.336-4(c)(1)

If not elect:
- No taxable gain to Purchaser
- AGUB reflects Purchaser's historic basis in nonrecently disposed stock (result is less than AGUB)
Nonrecently Disposed Stock Held by 80% or Greater SH of Target

- Purchaser with nonrecently disposed stock holding 80% or more (by vote or value) of T stock is deemed to have made gain recognition election!

- Result, taxable gain recognition to Purchaser on appreciation in its nonrecently disposed stock (but NO LOSS if depreciation, even if loss nets against gain)
Recognition Election for Nonrecently Disposed Stock – Gain Calculation

- If holder makes (or is deemed to make) election to recognized gain on nonrecently disposed stock, the nonrecently disposed stock is deemed to be sold on the disposition date.
- Holder recognized gain, but not loss (not even loss netted against gain) on the deemed sale of the stock.
Deemed “sales price” is equal to the “basis amount”

Formula: \( \text{Basis amount} = A \times \frac{B}{C} \)

- \( A = \) Holder’s basis in recently disposed stock at beginning of day after disposition date
- \( B = \% \) of T stock that is Holder’s no recently disposed T stock
- \( C = \% \) of T stock that is Holder’s recently disposed T stock

Per Reg. §1.336-4(c)(1)

Note, if Holder has only one class of T stock, the sales price per share is equal to the per share basis in the recently disposed T stock
Calculations Can Be Complex and Require Information from Purchaser(s)

- The preceding calculations can be complicated and certainly require information that the corporate return preparer will not have in ordinary course
  - Purchaser(s) will have to be cooperative and provide information timely for the calculations to be made
  - May want to understand what the calculations will show prior to making the irrevocable election
  - Agreement to make election should have requirement to provide timely information necessary for election and computations
Net Loss Limitation on §336(e)
Deemed Asset Dispositions

- Generally, if the deemed disposition generates a net loss to the T, old T recognizes the loss. Reg. §1.336-2(b)(2)

- If a distribution of T stock is involved, the portion of the net loss attributable to the distribution (as opposed to sale or taxable exchange) is disallowed
  - Flows through tiered targets as well
Gains and losses as a result of the deemed sale of the T’s assets are recognized. The losses can be used to offset the gains on such deemed sale. Reg. §1.336-2(b)(ii)

If the gain exceeds the losses (i.e. a net gain) on the deemed sale of assets, old T is subject to tax on such net gains

If a net loss is generated, unless a distribution of stock is involved, such net loss can be used
Net Loss Limitation on §336(e) Deemed Asset Dispositions

- Net losses generated on the deemed sale of assets attributable to a taxable sale or exchange of T stock are permitted to be used by old T
  - Offset current year income of old T
  - NOL for old T
  - No carry forward as old T is deemed to have liquidated
  - If in consolidated return, normal rules apply
With respect to net losses generated as a result of the deemed sale pursuant to distributed stock, those losses are limited to the gain recognized by the deemed transaction(s) and not deductible.

- Distributed stock includes those made to a related person or otherwise not qualify as part of QSD.
- If stock is distributed after the disposition date but before the end of the 12-month disposition period, such later distributed stock is included in the computation of the disallowance. Reg. §1.336-2(b)(ii)
Net Loss Limitation on §336(e)
Deemed Asset Dispositions

• The 12-month disposition period begins when the first disposition of stock included in the 12-month period
  – The QSD ends on the disposition date (i.e. 80% stock requirement is met)

• For purposes of loss limitation, however, the 12-month period continues until the expiration of 12 months from the first such stock disposition

• Planning tip. If Seller retains up to 20% of stock of T and deemed sale of assets generates a loss, wait at 12-months and one day before distributing stock
Determination of Disallowed Net Loss
Reg. §1.336-2(b)(2)(iii)

- Disallowed loss fraction  = A x B/C

- A = Net loss realized on deemed asset disposition

- B = Value of T stock (on disposition date) distributed by seller during the 12-month disposition period whether or not a part of the QSD

- C = Value of T stock disposed by sale or exchange plus value distributed (each value determined as of disposition date) during the 12-month disposition period (whether or not part of QSD)

- Note: subsequent stock dispositions within such 12 month period are included

- Note: values used are the value on the disposition date, not the value of the actual distributions or sales
Subsequent sale of stock by a minority shareholder within 12-month disposition period will impact the computation of the disallowed loss since such sale enters into disallowed loss fraction.

Corp will presumably know of subsequent stock sale if recorded on books of corporation. If not, may not.

Since using value on disposition date, do not have to obtain subsequent sales price for this purpose.
The aggregate net loss to be realized is allocated among the loss assets.

- Total loss x loss allocation fraction.
- Loss allocation fraction = $\frac{A}{B}$.
- $A =$ Loss realized with respect to the asset.
- $B =$ Sum of amount of losses realized with respect to all assets in deemed sale transaction.
Special Disallowed Loss Rules for Tiered Subsidiaries

- If a subsidiary of T elects §336(e), T’s gain or loss on such stock is disregarded in determining the amount of disallowed loss of T. Reg. §1.336-2(b)(iv)

- The T subsidiary in turn will compute the gain or loss on its assets.

- The T subsidiary deemed liquidation is deemed to precede that of T. Reg. §1.336-2(b)(iii)(B)  

  J. Leigh Griffith]
MAKING THE 336(E) ELECTION

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Consolidated Group

- Reg. §1.336-2(h)(1)
- Election is made by Seller and Target
- Due date corresponds to the due date for the group’s return for the taxable year that includes the disposition date
- Seller and Target enter into a written, binding agreement to make the 336(e) election
- Seller (or common parent of the group) attaches an election statement to its return for the taxable year that includes the disposition date
- Transaction documents should address mechanics and each party’s responsibilities to provide relevant information
Affiliated Group

- Reg. §1.336-2(h)(2)
- Election is made by Seller and Target
- Due date is the earlier of the due date for Seller’s or Target’s return for the taxable year that includes the disposition date
- Seller and Target enter into a written, binding agreement to make the 336(e) election
- Seller and Target each attach an election statement to its return for the taxable year that includes the disposition date
- Transaction documents should address mechanics and each party’s responsibilities to provide relevant information
S Corporation Target

- Reg. §1.336-2(h)(3)
- Election is made by the S corporation Target and all the S Shareholders
  - Includes S Shareholders that do not dispose of stock in the QSD
- Due date is the due date for Target’s return for the taxable year that includes the disposition date
- Target and all the S Shareholders enter into a written, binding agreement to make the 336(e) election
- Target attaches an election statement to its return for the taxable year that includes the disposition date
- Transaction documents should address mechanics and each party’s responsibilities to provide relevant information
Tiered Targets

- Reg. §1.336-2(h)(4)
- Election requirements satisfied separately for each Target subsidiary
- Written agreement may be included in the agreement between the Seller and Target or may be a separate agreement
Reg. §1.336-2(h)(5), (6)

Election statement attached to the applicable tax return must state:

“THIS IS AN ELECTION UNDER SECTION 336(e) TO TREAT THE DISPOSITION OF STOCK OF [name and EIN of Target] AS A DEEMED SALE OF SUCH CORPORATION’S ASSETS”

Must include, among other things:

- Identifying information regarding the Target, the Seller/S Shareholders, the common parent of Seller and certain Purchasers
- Information regarding the QSD
  - Disposition date
  - Percentage of Target stock disposed of in the QSD and whether any such stock was disposed of prior to the disposition date
- Information regarding any net loss realized upon Target’s deemed asset disposition
Asset Allocation Statement

- Reg. §1.336-2(h)(7)
- Old Target and New Target must file asset allocation statements
- In Section 355(d)(2) or (e)(2) transactions, Target should file two statements; one as the seller and one as the purchaser of Target assets
- The IRS intends to modify Form 8883 or to create a new form
- In the meantime, taxpayers should use the current Form 8883 with appropriate adjustments
Protective Elections

- Reg. §1.336-2(j)
- Protective elections are expressly permitted
- Protective elections have no effect if the applicable transaction is not a QSD
- Otherwise binding and irrevocable
- Helpful in connection with Section 355 transactions
TAX ALCHEMY?
Going from a C corporation to a non-corp pass-through entity without additional tax (or minor additional tax) may be considered tax alchemy - lead to gold

- Going from two levels of tax to one level
- In closely held context, the additional flexibility of special allocations and distributions
- The ability to grant profits interests to key management without triggering tax liability to key management
- The ability to receive capital contributions of appreciated property without restrictions of IRC §351 on contributor avoiding tax liability
- New individual rates may now create an ongoing operational cost between corporation tax and pass-through tax
Additional Steps and Tax Alchemy

- Going from a S corporation to a non-corp pass-through entity without additional tax (or minor additional tax) may be considered almost tax alchemy - silver to gold
  - Operationally still one level of tax. No ongoing tax penalty between forms as a result of the new tax rates
  - Benefit of special allocations, distributions, and use of profits interest
  - Ability to have contributions of appreciated property without confines of IRC §351 to avoid tax on the contributor
In the S corporation context, all shareholders recognized the gain or loss on the deemed sale of T’s assets at the deemed disposition price.

Presumably such price represents fair market value (particularly if a controlling block of stock is acquired on the disposition date).

- May be a small amount of gain or loss if a creeping disposition occurs between formula sales price and actual FMV, but presumably small. Verify!
Additional Steps and Tax Alchemy - Caveat

- The alchemy depends on the deemed sales price (ADADP) approximating the value of the assets.
- If a creeping disposition has occurred with variations in values, the formula price may differ significantly from the underlying asset value.
- Determine that net asset value is equal to or approximates the AGUB of the shareholders.
For More Detail...

- For a more detailed analysis of §336(e) and the tax alchemy, see the October/November issues of Taxes Magazine:

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MISCELLANEOUS
Tax Liability Trap

- The deemed transactions trigger gain and loss. Under the Regs, the old T is the party that reports the gain on the tax return.
- However, under state law, old T is the new T.
- In the affiliated group context in particular, the tax return of the Seller does not reflect the gain on the deemed sale of the assets.
- From a collection standpoint, the tax liability may remain at T. Documents should specifically address the tax liability and who is responsible.
The tax liability also impacts the deemed sale price and the calculation of gain and loss on the deemed dispositions. See Reg. §1.336-3(e).

- “...the amount of the tax liability itself may be a function of the size of the deemed disposition tax consequences.”

Transaction documents should not only provide who is responsible for the tax and if it is the Purchaser, provide a mechanism for the securing of funds to pay the tax.
Creeping disposition in which T leaves one consolidated group in an initial transaction and then becomes a member of another consolidated group in the initial transaction. Then there is a subsequent transaction that triggers §336(e)

- Deemed to be a member of Selling corp consolidated group for purposes. Who is liable for tax? Does T appear in two consolidated returns?

- William Alexander, IRS associate chief counsel (corporate) June 6 observed that maybe further guidance is needed and in the interim TP should not get themselves into the situation and instead should dispose of the stock all at once. 312 TNT 111-5
Selected Open Issues – S corporation

- Creeping S corporation stock sale transaction
  - Requirement that all shareholders elect. Reg. §1.336-2(h)(3)(i)
  - When have intervening transfer of S corp stock from historic shareholder, new shareholder then second new shareholder within 12-month disposition and prior to disposition date, are all three shareholders required to approve, the first and second, the first and third?
  - Until further guidance assume all three
  - Surprisingly, seems to be an open issue under Reg. §1.338(h)(10)-1(c)(3) for a §338(h)(10) election
Revocation of Irrevocable §336(e) Election

- The §336(e) election is irrevocable
- 80% vote and value transfer is required. Reg. §1.336-1(b)(6)
- Stock reacquired by Seller (including member of consolidated group) within the 12-month disposition period (not simply prior to the disposition date) is not considered disposed
- If reacquisition of sufficient stock (bring below 80%) occurs after disposition date and prior to expiration of 12-month period, the election is ineffective
Thanks.

Please join us for our next conference, “Managing NOLs in Federal and State Tax Compliance,” scheduled on Tuesday, September 24, starting at 1pm EDT.

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