4 Steps for Effective Information Technology

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IRC § 336(e) 

By Leigh Griffith, JD, CPA

In 1986, in conjunction with the repeal of the General Utilities rule, Congress added §336(e) to the Code. This section was a supplement to IRC §338(h)(10) and was designed to apply to a wider range of taxpayers and transactions. Its purpose was to mitigate certain “triple tax” situations in which the parent corporation owned more than 80 percent of the appreciated stock of a subsidiary, and the parent corporation sold or distributed the stock of the subsidiary. Generally in such situations (i) gain is recognized on the sale of the stock, (ii) the consideration is in the corporate parent’s hands and, if distributed out of corporate solution, the shareholders are taxed, and (iii) the embedded gain in the assets within the sold subsidiary will be taxed when the subsidiary sells or distributes such assets. In 1986 Congress, despite repealing General Utilities, considered double taxation sufficient for a large segment of taxable stock acquisitions from corporate owners, and triple or more taxation was excessive.

Since the early 80s, corporate purchasers have utilized IRC §338(h)(10) in limited circumstances to have a stock transaction treated as an asset acquisition for federal income tax purposes. This section requires (i) a corporate purchaser (ii) of 80 percent or more of the vote and value of the stock of a domestic corporation (iii) be acquired from an unrelated corporate seller (or shareholders of an S corporation) (iv) in a taxable transaction. If all of those conditions are met and an election is timely made by the seller and target, the purchaser is deemed for tax purposes to have acquired the assets of the target corporation.

Section 336(e) in contrast only requires (i) a taxable sale, exchange or distribution of (ii) 80 percent or more in vote and value of the of target corporation stock (iii) by an unrelated corporate seller or S corporation shareholders. In today’s world, LLCs and other non-corporate entities are often purchasers. It is not uncommon for the assets of a target corporate subsidiary to include licenses, intellectual property or contracts that cannot be transferred by a sale without risk, large expense, or lengthy delay and, in some cases such assets are simply unable to be transferred. Although §336(e) was in the Code, until implemented by regulations, the section was inoperative. LLCs and other non-corporate purchaser(s) or groups of purchasers were simply “out of tax luck” and would either have to purchase the stock of the corporation with whatever basis the assets had in the hands of the corporation or not engage in the transaction.

Under the newly issued final regulations, the dormant §336(e) has come to life. If the transaction qualifies and a §336(e) election is made, the sale or exchange of target corporation stock is treated for federal income tax purposes as the target corporation selling its assets to a new fictional corporation in exchange for the consideration paid (plus certain liabilities of target as part of the deemed asset sale) and then liquidating. The buyers are treated as if they purchased the assets and contributed them to a new corporation. (This is referred to as the “basic model.”) For transactions involving a tax-free (at the shareholder level) distribution of corporate stock by another corporation pursuant to §355 of the Code that is taxable at the distributing corporation’s level, the target corporation is deemed to sell its assets to a third party and then repurchase such assets prior to the shares being distributed to the shareholders of the corporate parent. (This is called the “sale-to-self model”.) The purchasers of the Target are deemed to 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. The “new” §336(e) application tax planning and acquisition structure possibilities are numerous and include: 1. A §336(e) election can be utilized where sufficient stock of a corporate subsidiary is sold within a 12 month period to more than a single purchaser. The purchasers can include individuals, LLCs, partnerships and corporations. 2. An S corporation and its shareholders may utilize §336(e) to provide a stepped up basis to virtually any purchaser(s) of sufficient stock sold. If the purchaser(s) are qualified S corporation shareholder(s) and the company is to continue as an S corporation, a new S election will be required. All of the target S corporation shareholders (whether or not selling) must consent to the §336(e) election. 3. §336(e) can apply to stock distributions that qualify as tax-free under §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 either the distributing corporation or the distributed corporation. 4. §336(e) can apply to certain taxable stock distributions. 5. Stock of a corporate target subsidiary can be acquired by an LLC pursuant to a §336(e) election, and the target can be converted into an LLC promptly after the transaction without additional tax. This permits the ongoing operations to be in a pass-through entity.

There are caveats to the use of the §336(e) election including: 1. A seller’s basis in the stock may be higher than the target’s basis in its assets; 2. In the §355(d)(2) or (e)(2) taxable spin scenarios, losses on the deemed asset sale may be used to offset only gains on the deemed asset sale, but any additional losses are lost; 3. If S corporation stock is involved, the use of the §336(e) election will trigger gain at the corporate level, and non-selling shareholders will be taxed on their portion of the gain; 4. If C corporation stock is involved and a §336(e) election is made, the corporation will recognize gain on all of its assets even if all the stock is not sold. Shareholders who do not sell may feel the value of their stock has been reduced by the taxes on the corporate gain without the corporation receiving cash; and 5. If stock is sold, exchanged or distributed within an affiliated group prior to the transfer outside the group, a §336(e) election may be effective for the external transfer, but the election can result in the affiliated group recognizing multiple levels of gain, both on the target’s stock from the intragroup transaction and on target’s assets from the deemed disposition.

The new regulations provide specific rules for making the §336(e) election. The election is made by the S
corporation and all the S corporation shareholders (including those who are not selling) if S corporation stock is involved or by the target corporation and the selling corporation if C corporation stock is acquired. Indeed, written legal documentation constituting a legally binding obligation of the appropriate parties to make the election is required. This can be a foot fault that will trap many taxpayers.

The IRS has indicated that Form 8883 will be revised or a new form will be developed for making the §336(e) election. Until that occurs, taxpayers are instructed to use the old Form 8883 making appropriate adjustments. In the case of a transaction described in §355(d)(2) or (e)(2), the old target must file to Form 8883 (or successor forms) -- one in its capacity as seller of assets and one in its capacity of buyer of assets. The election must be made by the due date of the seller’s tax return (not the purchaser’s tax return). This can also be a trap for the unsuspecting taxpayer and the taxpayer’s return preparer.

Endnotes

1 The General Utilities case involved a dividend distribution of appreciated property by an ongoing business, but the term “General Utilities rule” was often used in a broader sense to refer to the nonrecognition treatment accorded in certain situations to liquidating as well as nonliquidating distributions to shareholders and to liquidating sales. The rule was reflected in Code sections 311, 336, and 337 of pre-1986 tax law. Section 311 governed the treatment of nonliquidating distributions of property (dividends and redemptions), while section 336 governed the treatment of liquidating distributions in kind. Section 337 provided nonrecognition treatment for certain sales of property pursuant to a plan of complete liquidation. (1986 Blue Book; JCS-10–87)

2 For this purpose, all members of an affiliated group as defined under IRC §1504(a) of the Code are considered a single corporate purchaser. IRC §338(h)(8).

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