May 16, 2013

Tax Election to Treat Disposition of Stock of a Subsidiary as a Sale of Its Assets

IRS and Treasury Department Issue Final Regulations Under Section 336(e) of the Code that Allow a Corporation to Treat Certain Dispositions of Stock of a Subsidiary as a Sale of Its Assets

SUMMARY

On May 10, the Internal Revenue Service (the "IRS") and Treasury Department released final regulations (the "Final Regulations") under Section 336(e) of the Internal Revenue Code of 1986, as amended (the “Code”), relating to an election to treat certain dispositions of stock of a subsidiary as a sale of its assets. The Final Regulations, which generally adopt the approach of regulations proposed on August 22, 2008 (the “Proposed Regulations”), provide an election under which the sale or distribution of the stock of a domestic corporation by another domestic corporation or, in the case of an S corporation, by its shareholders, is treated, in certain circumstances, as if a sale of assets had occurred, thus permitting a step-up in the asset basis of the sold corporation. The Final Regulations generally use the rules that would apply if stock of a subsidiary were sold and purchaser and seller made a Section 338(h)(10) election to treat the sale as a sale of the subsidiary’s assets. Twenty-seven years after the enactment of Section 336(e) expressly inviting the issuance of such rules, the Final Regulations will finally allow an elective step-up in the basis of a subsidiary’s assets in cases where no election could be made under Section 338(h)(10) (for example, where there are multiple purchasers of stock, or purchaser is not a corporation), thus reducing the possibility of multiple layers of tax in respect of the same economic gain.

The Final Regulations differ from the Proposed Regulations in certain key respects, including:

- The Final Regulations enable S corporation shareholders to make a Section 336(e) election so long as all shareholders of such S corporation, whether selling shareholders or not, consent.
The Final Regulations modify the method of making a Section 336(e) election, generally requiring notice to or consent of the target or, in the case of an S corporation, shareholders.

The Final Regulations generally limit the disallowance of losses to the net loss that could result in the deemed asset disposition (i.e., if realized losses in the deemed asset disposition exceed the amount of realized gains) to the extent attributable to distributions of target stock during the 12-month disposition period.

**FINAL REGULATIONS**

As in the Proposed Regulations, the Final Regulations permit an election under Section 336(e) to be made in the case of a “qualified stock disposition,” which is defined as any transaction or series of transactions in which an 80% interest in the stock of a domestic corporation is sold, exchanged, or distributed, or any combination thereof, by another domestic corporation or by the shareholders of an S corporation within a span of 12 months.¹

Under the Final Regulations, if an election is made, in the case of a qualified stock disposition other than a “taxable spin” under Section 355(d)(2) or Section 355(e)(2), the domestic corporate target (i.e., “old target”) is treated as if it sold all of its assets to an unrelated corporation (“new target”) at the close of the disposition date in exchange for the amount actually paid for the stock (as adjusted for liabilities) and then liquidated into seller.² New target is treated as if it acquired all of its assets from an unrelated person at the close of the disposition date, with an adjusted grossed-up basis reflecting the consideration deemed paid.³

Under the Final Regulations, if an election is made with respect to a “taxable spin” under Section 355(d)(2) or Section 355(e)(2), the distribution is treated under a “sale to self” model as if old target sold its assets to an unrelated person and then repurchased those assets, followed by seller distributing the stock of old target to its shareholders.⁴

The Final Regulations make a number of technical changes to the asset sale that is deemed to take place. Under the Proposed Regulations, in a distribution of target stock (other than in Section 355(d)(2) and Section 355(e)(2) transactions), seller was treated as acquiring directly from new target an amount of new target stock equal to the amount of target stock actually distributed. The Final Regulations treat seller as acquiring new target stock from an unrelated person, as opposed to acquiring new target stock directly from new target.⁵ The modification is intended to ensure that purchaser will have a fair market value basis in target stock without any possible application of Section 351. In the case of a “taxable spin” under Section 355(d)(2) or Section 355(e)(2), the Final Regulations clarify that the wash sale rules of Section 1091 and the anti-churning rules of Section 197(f)(9) will not apply to old target’s deemed sale and repurchase of assets.⁶

**S Corporations.** The Final Regulations permit a Section 336(e) election to be made for S corporation targets and provide additional and special rules to allow Section 336(e) elections to be made with respect
to S corporation targets. All shareholders of an S corporation, even those that are not selling their S corporation target stock, must consent to the Section 336(e) election by entering into a written, binding agreement, which is then filed with the S corporation’s current-year tax return.

**Election.** In contrast to the Proposed Regulations which allowed seller alone to make an election under Section 336(e), the Final Regulations require: (1) seller (or in the case of an S corporation target, all of the S corporation shareholders) and target to enter into a written, binding agreement to make a Section 336(e) election, (2) in the case of a consolidated group, the common parent of the consolidated group to provide a copy of the election statement to target, and (3) in the case in which seller and target are members of an affiliated group but do not join in the filing of a consolidated return, both seller and target to file the election statement on their respective returns. The Final Regulations maintain the requirement that the Section 336(e) election be made by the due date (including extensions) for seller’s tax return, which is generally different from the Section 338(h)(10) timeline. The Final Regulations maintain the protective Section 336(e) election, which will be binding if the transaction is a qualified stock disposition, but will otherwise have no effect.

**Disallowed Loss.** The Final Regulations narrow the scope of a rule that, under the Proposed Regulations, broadly disallowed the recognition of losses resulting from the deemed asset disposition to the extent the qualified stock disposition consisted of one or more distributions of target stock. The Final Regulations generally permit target to realize losses in the deemed asset disposition. However, in the case of stock distributions, the Final Regulations disallow a net loss of target (that is, losses realized in excess of target’s realized gains) recognized on a deemed asset disposition, but only in proportion to the portion of target stock that was disposed of by seller in one or more distributions. The Final Regulations also expanded the scope of the disallowed loss rule to distributions that are within a 12-month disposition period, even if such distributions are not part of a qualified stock disposition (as would be the case for distributions occurring after seller had already disposed of 80% of the stock of target or were made to a related party). The preamble explains that the Final Regulations, as amended, deter taxpayers from delaying a portion of a stock disposition to limit the loss disallowed by this rule and ensure that distributions to related parties will have the same amount of losses disallowed as would be the case with respect to distributions to unrelated parties. Any loss disallowed under this rule is permanent with no corresponding increase in the basis of target’s assets.

The Final Regulations made the following additional changes or clarifications to the Proposed Regulations.

- The Final Regulations provide that in the case of a Section 355(d)(2) or Section 355(e)(2) transaction that is preceded by an intragroup transaction, for the limited purpose of a Treasury Regulations Section 1.1502-13(f)(5) election, immediately after the deemed asset disposition of the target’s assets, the target is deemed to liquidate into seller, thus providing seller with a stock loss that can offset some or all of the group’s intercompany gain with respect to the intragroup transfer of target stock.
The Final Regulations maintain the general prohibition against an election under Section 336(e) in the case of related-party transactions but modify the definition of related persons as pertaining to partnerships by providing that, solely for purposes of determining whether purchaser and seller are related for purposes of Section 336(e), the attribution rules of Section 318(a)(2)(A) and Section 318(a)(3)(A) will not apply to attribute stock ownership from a partnership to a partner, or from a partner to a partnership, if such partner owns, directly or indirectly, less than 5% of the value of the partnership. Otherwise, overlapping partners in a buying and selling partnership (not uncommon in private equity situations) could prevent a transaction from qualifying as a qualified stock disposition.

Regulations under Section 338(h)(10) generally provide that stock retained by target is treated as purchased by seller on the day after the disposition date. The Proposed Regulations adopted a similar rule but applied it only to stock that is retained after the 12-month disposition period. The Final Regulations conform to the Section 338(h)(10) regulations.

The Final Regulations implement the policy that a consistency rule should apply only if the same person (or a related person) acquires both the asset of the target (or subsidiary of the target) and more than a minimal amount of the stock of target. Specifically, they provide that the consistency rules apply to an asset only if the asset is owned, immediately after its acquisition and on the disposition date, by a person (or by a related person to such a person) that acquires 5% or more, by value, of the stock of target in a qualified stock disposition.

Treasury and the IRS will continue to study the application of Section 336(e) to transactions in which either seller or target is a foreign corporation, and may consider expanding the scope of the Final Regulations to address these transactions in future guidance. The Final Regulations were modified to achieve treatment consistent with the treatment of the allocation of foreign taxes under Section 901 and to reflect the fact that recently enacted Section 901(m) may apply to disallow foreign tax credits in certain transactions with a Section 336(e) election in effect, such as may be the case if target has foreign branch operations.

The preamble states that Treasury and the IRS intend to modify Form 8883, Asset Allocation Statement Under Section 338, or create a new form, to include an election under Section 336(e). In the interim, old target and new target are required to file Form 8883 to report the results of the deemed asset disposition, making appropriate adjustments as necessary to account for a Section 336(e) election.

The Final Regulations apply to any qualified stock disposition for which the disposition date is on or after May 15, 2013.
ENDNOTES

8. Id.
12. Id.
14. The IRS and Treasury will continue to study whether related-party transactions should qualify for a Section 336(e) election.
SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP
Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP
This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from John A. Castro (+1-212-558-4417; castrojoh@sullcrom.com) in our New York office.

CONTACTS

<table>
<thead>
<tr>
<th>New York</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ronald E. Creamer, Jr.</td>
<td>+1-212-558-4665</td>
<td><a href="mailto:creamerr@sullcrom.com">creamerr@sullcrom.com</a></td>
<td></td>
</tr>
<tr>
<td>Davis J. Wang</td>
<td>+1-212-558-3113</td>
<td><a href="mailto:wangd@sullcrom.com">wangd@sullcrom.com</a></td>
<td></td>
</tr>
<tr>
<td>Theodore D. Holt</td>
<td>+1-212-558-4354</td>
<td><a href="mailto:holtt@sullcrom.com">holtt@sullcrom.com</a></td>
<td></td>
</tr>
</tbody>
</table>

Tax Election to Treat Disposition of Stock of a Subsidiary as a Sale of Its Assets
May 16, 2013
SC1:3429281.6