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## Introduction to M&A Tax: S Corporations and Section 336(e)

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# Introduction to M&A Tax: S Corporations and Section 336(e)

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## Introduction to Section 336(e) Regulations

### Background

- Section 336(e) was added to the Code in 1986.
- August 2008 – Regulations under section 336(e) finally proposed. REG-143544-04; 73 F.R. 49965-49981
- May 2013 – Regulations under section 336(e) are finalized, effective for “qualified stock dispositions” with a disposition date on or after May 15. T.D. 9619.

### Effect:

- If a section 336(e) election is made, the federal income tax consequences are to be substantially the same as for a section 338(h)(10) election. See, Reg. § 1.336-1(a).
- However, differences do exist. Important to understand how differences impact sale structures.

## Primary Objectives

- Buyer wants stepped-up basis (“SUB”).
- Seller wants (i) single level of tax and (ii) long-term capital gain.

## Taxable Sales

### Four Choices:

- Asset sale – Including taxable forward merger.
- Stock sale – No section 338(h)(10) election, no section 336(e) election.
- Stock sale – With a section 338(h)(10) election.
- Stock sale or other disposition– With a section 336(e) election.

## Taxable Stock Sales

Stock Sale – No Section 338(h)(10) Election, no Section 336(e) Election:

- All capital gain or loss to selling Target shareholders.
- But, no SUB – which often is a Buyer detriment.
- Tax attributes of Target continue post-closing, subject to certain limitations.

## Taxable Stock Sale With Section 338(h)(10) Election or Disposition With Section 336(e) Election

- Provides Buyer with a SUB equal to purchase price + Target liabilities deemed assumed + acquisition costs.
- Seller taxed as if Target sold its assets and then liquidated, distributing the sale proceeds to its shareholders in redemption of their Target stock.
- No gain or loss is recognized by Seller on the actual transfer of Target stock to Buyer.

## Taxable Stock Sale With Section 338(h)(10) Election or Disposition With Section 336(e) Election

- Section 338(h)(10) or 336(e) election not recommended if:
  - Target is an S corporation with a significant section 1374 tax liability; or
  - Target has significant gain in its ordinary assets and depreciable assets (rather than capital assets).
- Target shareholders typically are indemnified for additional tax cost of having some ordinary income and sometimes for additional state income taxes.



## Taxable Stock Sale With Section 338(h)(10) Election

Section 338(h)(10) provides in relevant part:

“Under regulations prescribed by the Secretary, an election may be made under which if--

(i) the target corporation was, before the transaction, a member of the selling consolidated group, and (ii) the target corporation recognizes gain or loss with respect to the transaction as if it sold all of its assets in a single transaction,

then the target corporation shall be treated as a member of the selling consolidated group with respect to such sale, and (to the extent provided in regulations) no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group.”

Query: How can this apply to a target S corporation? See, Reg. § 1.338(h)(10)-1.

## Taxable Stock Disposition With Section 336(e) Election

Section 336(e) provides in relevant part:

“Under regulations prescribed by the Secretary, if –

- (1) a corporation owns stock in another corporation meeting the requirements of section 1504(a)(2), and
- (2) such corporation sells, exchanges, or distributes all of such stock, an election may be made to treat such sale, exchange, or distribution as a disposition of all of the assets of such other corporation, and no gain or loss shall be recognized on the sale, exchange, or distribution of such stock.”

Query: How can this apply to a target S corporation? See, Reg. § 1.336-1(a).

## Requirements for Taxable Stock Acquisition With Section 338(h)(10) Election

- Buyer is a corporation (C or S).
  - Individual(s) and/or partnership(s) may form a non-transitory corporate Buyer to acquire and thereafter hold Target.
- Triggering Event: Buyer acquires 80% or more of Target stock in a taxable purchase in a 12 month period. This is a “qualified stock purchase” (“QSP”).
  - Acquisition via section 351, 354, 355, or 356 is not a QSP, even if taxable.
- Buyer and **all** shareholders of Target S corporation must make 338(h)(10) election.
  - Election made on IRS Form 8023 by the 15<sup>th</sup> day of 9<sup>th</sup> month beginning after the QSP date. See, Reg. § 1.338(h)(10)-1(c)

## Requirements for Taxable Stock Disposition With Section 336(e) Election

- Buyer is one or more persons, including corporations, partnerships, individuals, trusts and estates.
- Triggering Event: S corporation shareholders dispose of 80% or more of Target's stock in a taxable disposition in a 12 month period. This is a qualified stock disposition ("QSD").
  - Disposition via section 351, 354, 355, or 356 is not a QSD, even if taxable.
- If what would be a QSD also qualifies as a QSP, it is not a QSD.
- Target S corporation and **all** shareholders of Target S corporation must enter into binding, written agreement to make 336(e) election.
  - Election statement attached to Target S corporation's timely filed income tax return for the taxable year that includes the QSD date. See, Reg. § 1.336-1, -2(h)(3).

## Differences: Section 338(h)(10) v. Section 336(e)

### Differences include:

- QSD status is based on dispositions by shareholder(s), rather than purchases by Buyer.
- Section 336(e): Buyer need not be a corporation (in fact, cannot be if there is only one buyer because of the QSP/QSD overlap rule).
- Section 336(e): permitted if there are multiple Buyers, other than corporations that are members of the same affiliated group.
- QSD can occur in several transactions with different Buyers on different dates (“creeping QSD”).
- Section 336(e): election can be made without Buyer’s consent.

## Examples 1 & 2: M&A Structure Before and After Section 336(e)

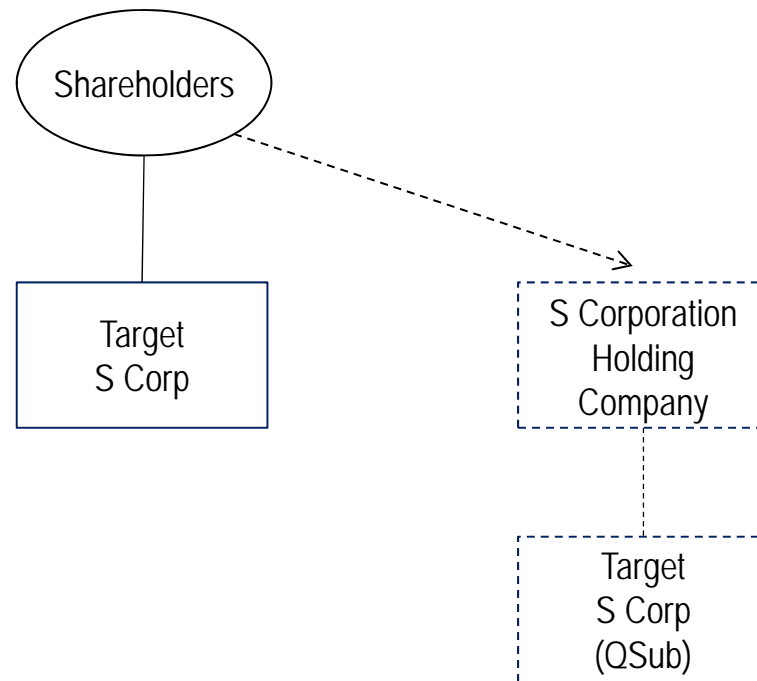
### Facts:

- Buyer is an individual or a partnership (perhaps a private equity fund).
- Buyer desires pass-through tax treatment post-closing.
- Target is an S corporation.
- Target shareholders sell 80% or more of Target stock.

### Questions:

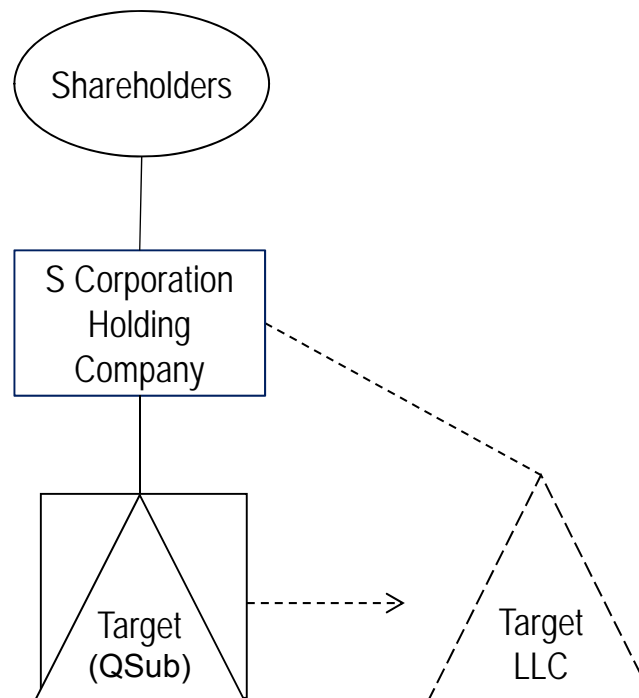
- How was deal structured before the section 336(e) regulations?
- How may deal be structured under the section 336(e) regulations?

## Example 1: Individual or Partnership Buyers: No Section 336(e) Election – Step 1



- Target shareholders form new S Corporation Holding Company.
- Target shareholders contribute their Target stock to the new holding company which immediately elects QSub status for Target.

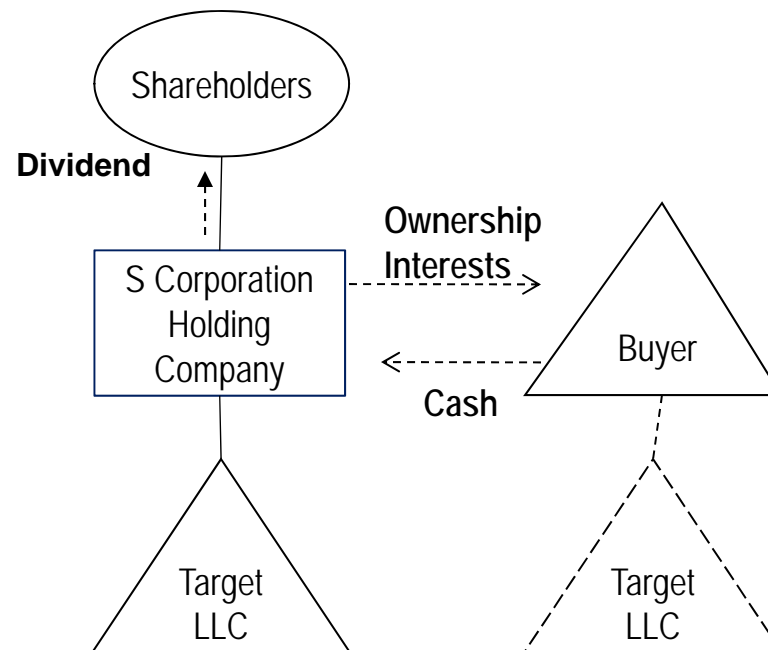
## Example 1: Individual or Partnership Buyers: No Section 336(e) Election – Step 2



- Target converts from a corporation into an LLC under state law.
- Note: Target may remain a QSub if Buyers are qualified S corporation shareholders. See, Reg. § 1.1361-5(b)(3), *Ex. 9*.

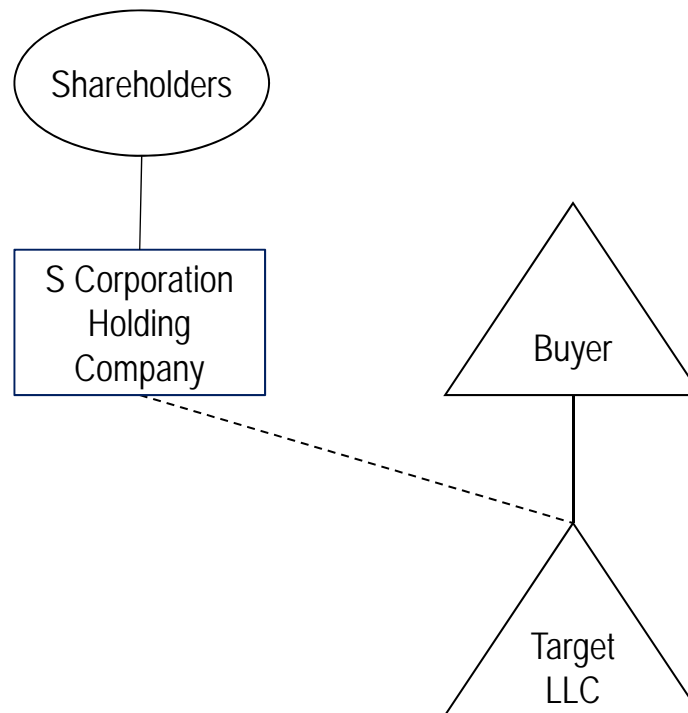


## Example 1: Individual or Partnership Buyers: No Section 336(e) Election – Step 3

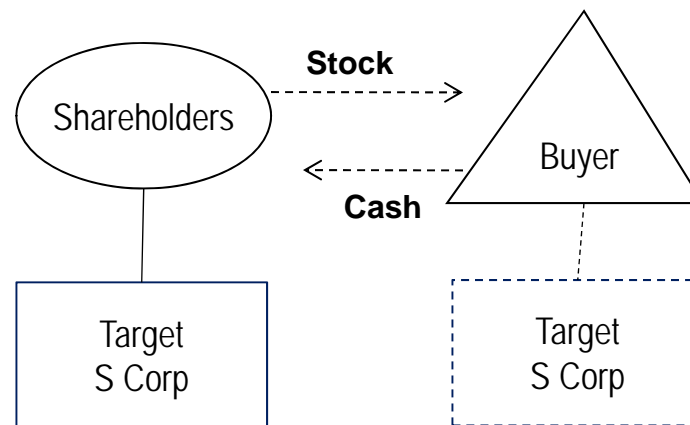


- S Corporation Holding Company sells Target to Buyers. May distribute cash proceeds “upstream” to Shareholders as a dividend (if it has continuing assets or operations), or as a liquidating distribution.
- Sale of 100% of Target LLC produces same tax result as a section 338(h)(10) election.
- S Corporation Holding Company can retain unwanted assets and excluded liabilities.

## Example 1: Individual or Partnership Buyers: No Section 336(e) Election – Final

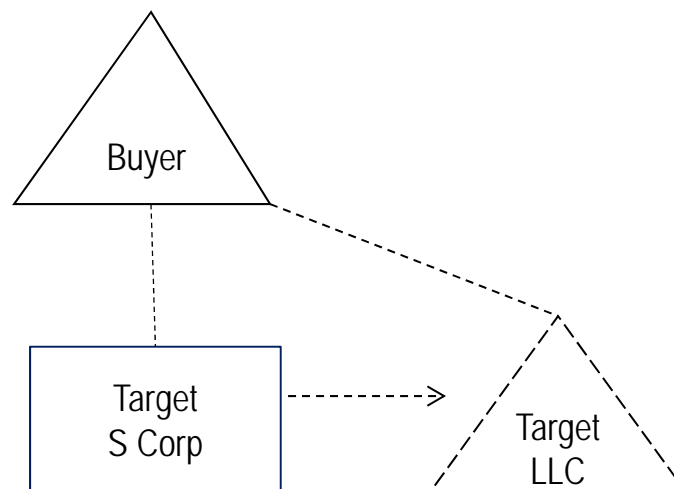


## Example 2: Individual or Partnership Buyers: With Section 336(e) Election – Step 1



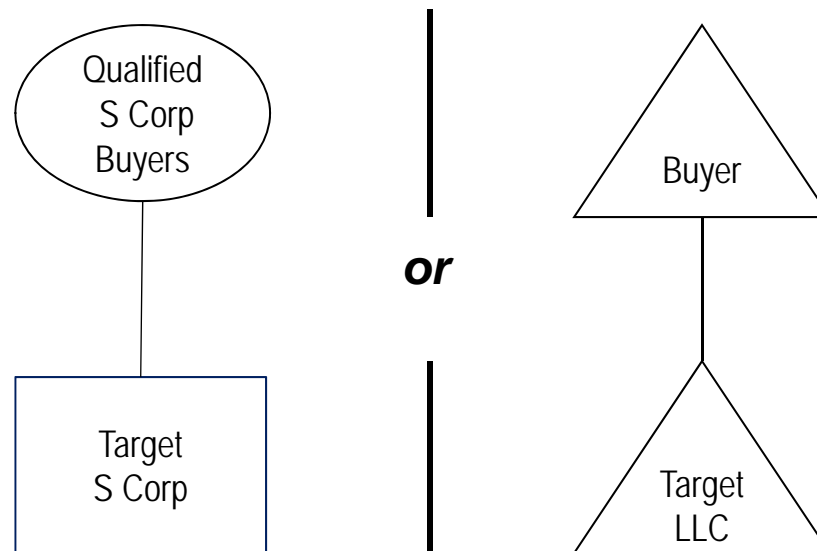
- Shareholders and Target S Corporation enter into binding, written agreement to make 336(e) election.
- Shareholders sell  $\geq 80\%$  of Target S Corporation stock to Buyer.

## Example 2: Individual or Partnership Buyers: With Section 336(e) Election – Step 2



- Target can elect S corporation status if Buyers are qualified shareholders.
- If Target is not eligible for S corporation status (as shown above), Buyers may immediately convert Target into an LLC post-closing.
- Conversion will be a taxable event under sections 331 and 336, but conversion should not result in additional tax cost (assuming section 336(e) election and sale at FMV).

## Example 2: Individual or Partnership Buyers: With Section 336(e) Election -- Final



- Post-closing structure assuming Buyers are qualified S corporation shareholders, or alternatively, a partnership (e.g., PE fund).

## Examples 3 & 4: Impact of Stock Redemptions on M&A Structure Before and After Section 336(e)

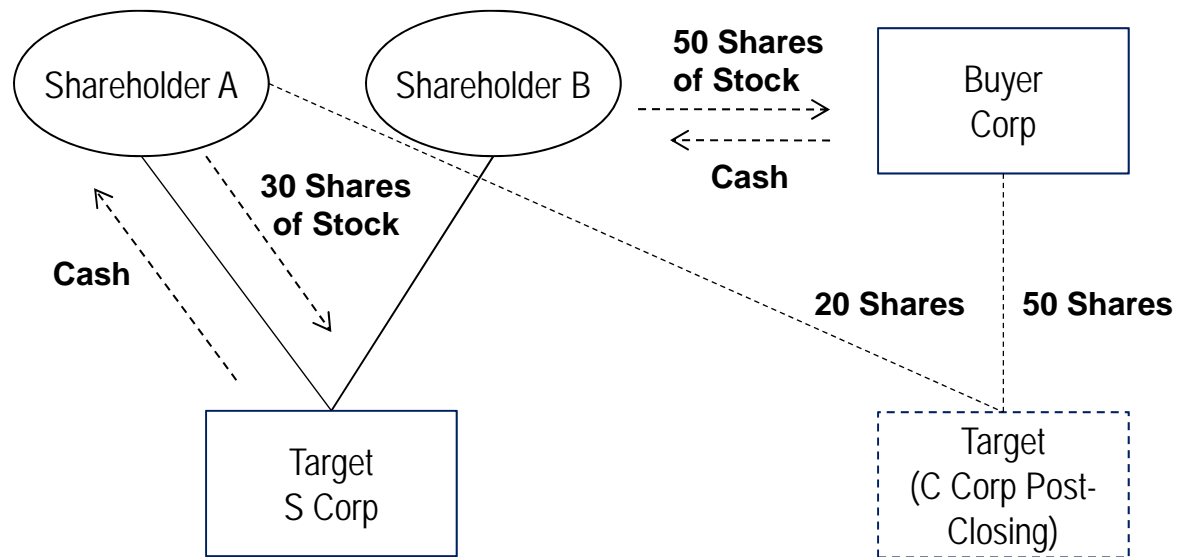
### Facts:

- Target S Corporation has 2 unrelated shareholders (A and B).
- Shareholder A and B each own 50 shares of stock (total of 100 shares outstanding).
- On September 1, 2013, Target distributes cash to Shareholder A in redemption of 30 shares of stock.
- Distribution qualifies as a taxable exchange under section 302(b).
- On January 15, 2014, Shareholder B sells 50 shares of Target stock to a corporate Buyer.

### Questions:

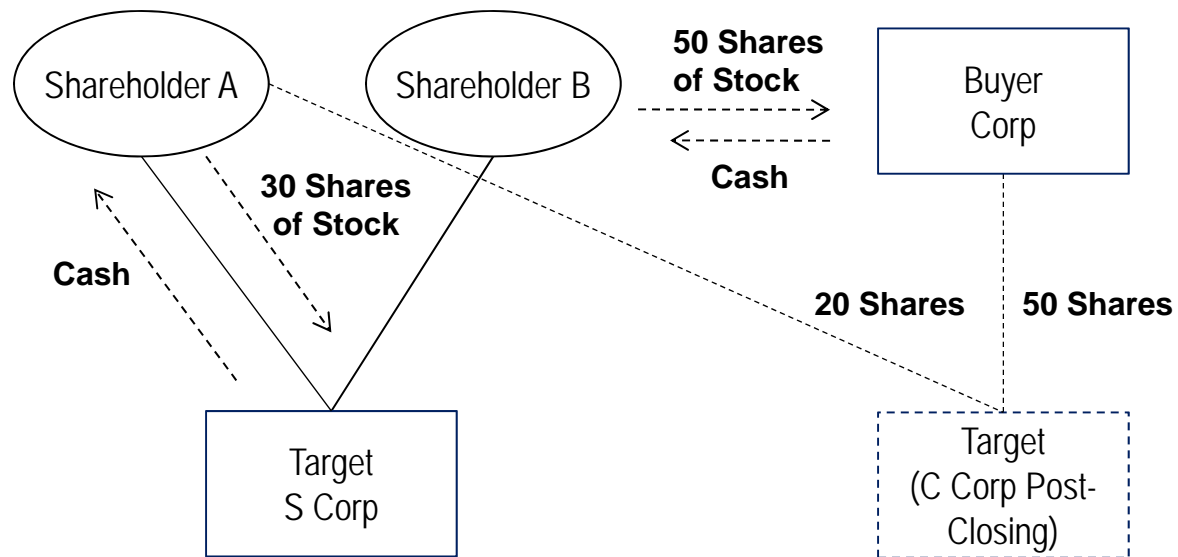
- Is sale to Buyer a QSP eligible for section 338(h)(10) election?
- Is sale to Buyer a QSD eligible for section 336(e) election?

## Example 3: Impact of Stock Redemptions on M&A Structure Before Section 336(e)



- Redemption of stock held by Shareholder A reduces number of Target shares outstanding for purposes of determining whether sale to Buyer is a QSP, unless redemption is from a person related to Buyer. See, Reg. § 1.338-3(b)(5)(ii).
- Buyer acquired by purchase 71.43% of Target's outstanding stock (50/70).
- Sale to Buyer is not a QSP. Not eligible for section 338(h)(10).

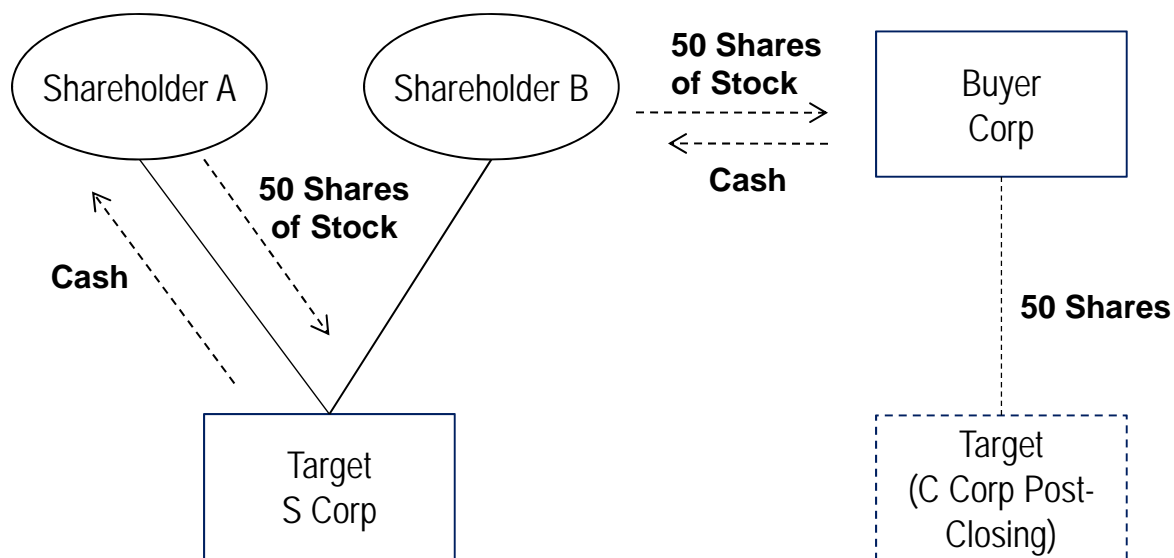
## Example 4: Impact of Stock Redemptions on M&A Structure With Section 336(e) Election



- Redemption of stock held by Shareholder A appears to be a “disposition” within the meaning of Reg. § 1.336-1(b)(5). However:
  - Can Target S Corp be a “purchaser” (as defined in Reg. § 1.336-1(b)(2)) with respect to the 30 shares of its own stock redeemed from Shareholder A, and
  - Are Target S Corp and Shareholder A “related persons” (as defined in Reg. § 1.336-1(b)(12))? See, section 318(a)(5)(E).



## Example 4 (Alternative): Impact of Stock Redemptions on M&A Structure With Section 336(e) Election



- Shareholder A fully redeemed. Thus, **not** “related” to Target S Corporation.
- Sale of remaining 50 shares qualifies both as a QSP and a QSD.
- Thus, parties must make a section 338(h)(10) election if Buyer wants to obtain a tax basis step-up.
- If Buyer were a partnership or individual(s), transaction would qualify as a QSD under section 336(e).

## Example 5: Stock Sales Among S Corporation Shareholders After Section 336(e) Regulations

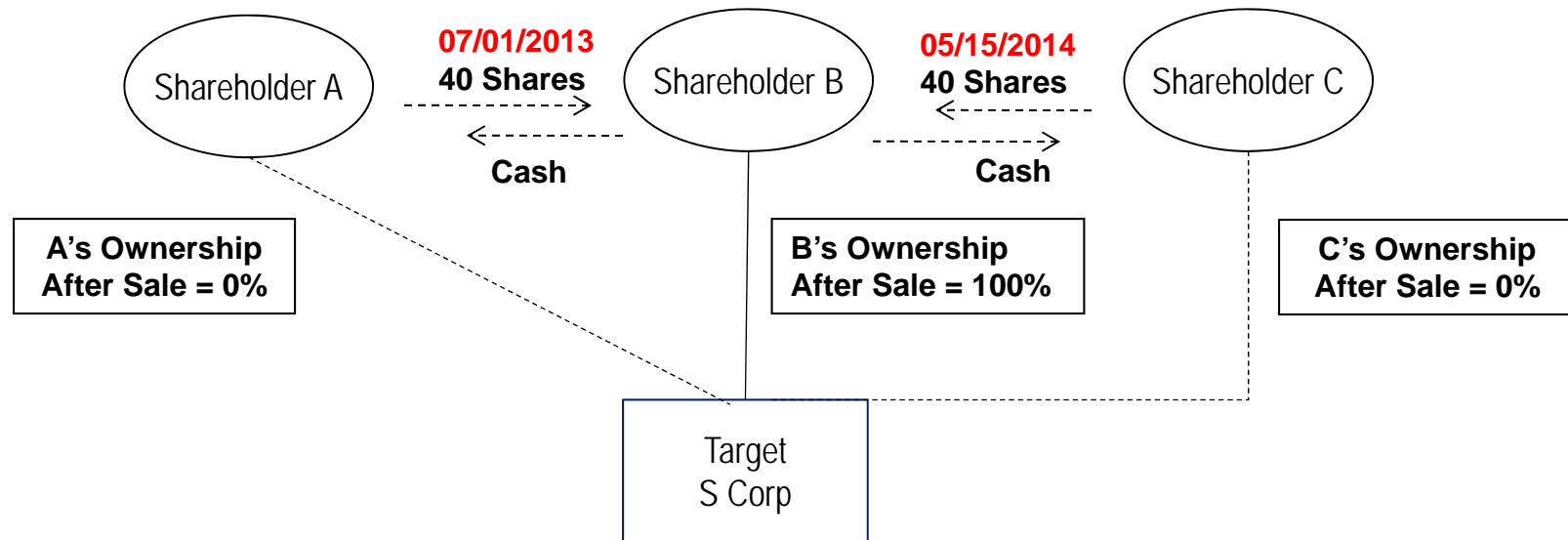
### Facts:

- Target S Corporation has 3 unrelated shareholders (A, B and C).
- Shareholder A and C each own 40 shares of Target stock. Shareholder B owns the remaining 20 shares of stock (total of 100 shares outstanding).
- On July 1, 2013, Shareholder B purchases 40 shares of Target stock from Shareholder A.
- On May 15, 2014, Shareholder B purchases 40 shares of Target stock from Shareholder C.

### Questions:

- Is sale to Buyer a QSP eligible for a section 338(h)(10) election?
- Is sale to Buyer a QSD eligible for a section 336(e) election?

## Example 5: Stock Sales Among S Corporation Shareholders After Section 336(e) Regulations



- Transaction not a QSP. Shareholder B is not a corporation.
- However, transaction is a valid QSD:
  - Shareholders A and C “disposed” of Target stock. See, Reg. § 1.336-1(b)(5).
  - Shareholder B is a “purchaser” of Target stock. See, Reg. § 1.336-1(b)(2).
- Questions: Who must consent to section 336(e) election? Who reports gain on deemed asset sale?

## Example 6: Distributions of Qualified Subchapter S Subsidiary

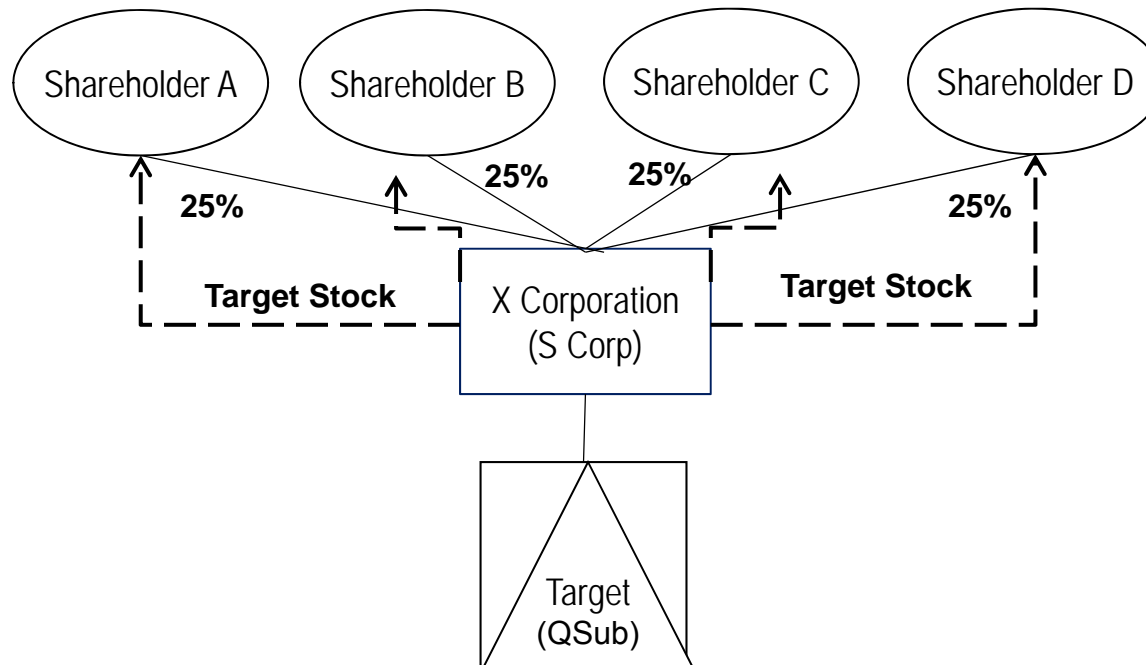
### Facts:

- X (an S Corporation) has 4 unrelated shareholders.
- Each shareholder owns 25% of X's outstanding stock.
- X owns 100% of a qualified subchapter S subsidiary ("QSub").
- QSub's assets are substantially appreciated with significant built-in gain.
- X distributes 100% of the QSub stock *pro rata* to its 4 shareholders.
- The distribution fails the active business requirement of section 355(b).

### Question:

- Is the distribution eligible for a section 336(e) election?

## Example 6: Distributions of Qualified Subchapter S Subsidiary



- A *pro rata* distribution of Target's stock is a distribution under section 1368.
- The built-in gain in the assets of Target will be taxable to the Shareholders. See, sections 311(b) and 1371(a).
- But, will the tax basis of Target's assets be adjusted to FMV?

## Example 6: Distributions of Qualified Subchapter S Subsidiary

### Analysis:

- The tax basis of Target's assets will be adjusted to FMV if the transaction is (i) treated as a taxable distribution of Target's assets, or (ii) a valid section 336(e) election is made.
- Distribution is to a "related person" as defined in Reg. § 1.336-1(b)(12), and thus cannot be a QSD.
- Generally, when a QSub election terminates, the S Corporation is deemed to contribute assets to a new corporation (immediately before cessation of its QSub status) in exchange for stock and the assumption of liabilities. See, section 1361(b)(3)(C)(i) and Reg. § 1.1361-5.
- If the deemed contribution qualifies under section 351, the tax basis of Target's assets will carry over. See, sections 358(a) and 362(a).

## Example 6: Distributions of Qualified Subchapter S Subsidiary

### Analysis (Cont'd):

- A distribution of QSub stock can qualify under sections 355 and 368(a)(1)(D) as a distribution of stock if the transaction otherwise satisfies the requirements for a spin-off. See, Reg. § 1.1361-5(b)(3), *Ex. (4)*.
- However, a transfer of 100% of QSub stock to an unrelated person can qualify as (i) a deemed sale of the QSub's asset by the S corporation, (ii) followed by a deemed contribution of such assets by the purchaser to a new corporation. See, Reg. § 1.1361-5(b)(3), *Ex. (9)*.
- What is the result where the spin-off is *pro rata*, but fails to qualify under section 355?
- Should the parties convert the QSub to a disregarded LLC prior to distribution?

## Example 6: Distributions of Qualified Subchapter S Subsidiary

### Facts:

- Same as Example 6, except:
  - X (the S Corporation) distributes 100% of Target stock to Shareholder A in complete redemption of her stock.
  - Transaction qualifies as an exchange under section 302.

### Question:

- Is the distribution eligible for a section 336(e) election?

### Answer:

- Yes – if the transaction is respected as a distribution of stock in a subsidiary, because the redeemed shareholder is no longer a “related person” with respect to X (the S corporation)





**Questions or Comments?**