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

Proposed Regulations Would Allow a Corporation to Treat Certain Dispositions of Stock of a Subsidiary as a Sale of Its Assets

SUMMARY
The IRS has proposed regulations (the “Proposed Regulations”) under Section 336(e) of the Internal Revenue Code (the “Code”). The Proposed Regulations would allow a corporation that sells stock of a subsidiary or, in some cases, distributes stock of a subsidiary to its shareholders to elect to treat the disposition for federal income tax purposes as if it was a sale of the subsidiary’s assets, thus stepping up to fair market value the tax basis of the subsidiary in its assets. The Proposed Regulations generally use the rules that would apply if stock of a subsidiary were sold and the purchaser and seller made a Section 338(h)(10) election to treat the sale as a sale of the subsidiary’s assets. The new election will not be available if the subsidiary or the corporation that disposes of the subsidiary is a foreign corporation, if the disposition is between related persons or, except in the case of distributions to shareholders that are taxable to the distributing corporation but not to its shareholders, if the disposition is a tax-free spin off or other tax-free transaction. The new election is important because it will allow an elective step-up in the basis of a subsidiary’s assets in cases where, because there are multiple purchasers of the stock of the subsidiary, the purchaser is not a corporation, or the disposition is a distribution to shareholders, no election could be made to step up the basis in the subsidiary’s assets under Section 338(h)(10). Under the Proposed Regulations, an election may not be made under Section 336(e) if an election could be made under Section 338(h)(10).

PROPOSED REGULATIONS
In a Notice of Proposed Rulemaking issued August 22, 2008 (the “Notice”), the IRS issued Proposed Regulations under Section 336(e), which contemplates the issuance of regulations that would allow an
election to treat the sale or other disposition of stock of a subsidiary as a sale of its assets if the corporation owns at least 80%, by vote and value, of the subsidiary, and sells, exchanges, or distributes the subsidiary’s stock. An election to treat the sale or other disposition of stock of a subsidiary as a sale of its assets would thereafter benefit from an increased basis in its assets.

An election may be made by the purchaser and the seller to treat a sale of the stock of a subsidiary as a sale of the subsidiary’s assets under Section 338(h)(10) if the purchaser is a corporation and the purchase is a “qualified stock purchase” — generally, an acquisition by purchase of 80% of the stock of the subsidiary. The Notice explains that the election under 336(e) is intended, like the election currently available under Section 338(h)(10), to provide taxpayers relief from potential multiple taxation at the corporate level in the case of a taxable stock sale without a corresponding step-up in the basis of the assets. Under the Proposed Regulations, an election under Section 336(e) could be made in circumstances where a Section 338(h)(10) election would not be available — for example, if a corporation were to sell 50% of its stock in a wholly-owned subsidiary to a purchaser, distribute an additional 30% of the subsidiary’s stock to its shareholders within the same year, and retain the remaining 20%.

In order to make an election under the Proposed Regulations, the seller must be a domestic corporation, and the seller (or members of the seller’s consolidated group) must own 80% by vote and value of another corporation (the target corporation), and must make a “qualified stock disposition” by transferring or distributing target stock. A qualified stock disposition is any transaction or series of transactions in which an 80% interest held by the seller (or by the seller and members of its consolidated group) is sold, exchanged, or distributed within a span of 12 months (either to a single acquiror or multiple acquirors).

The date on which the requirements have first been met for a qualified stock disposition is the disposition date.

The election itself is made unilaterally by the seller by attaching a statement to its federal income tax return or consolidated group return for the tax year which includes the disposition date.

If an election is made, the Proposed Regulations, in the case of a sale or exchange, treat the target (which the Proposed Regulations refer to as “old target”) 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 paid for the stock (as adjusted for liabilities), and then liquidated into the seller. If a distribution is made by the seller instead of, or in addition to, a sale or exchange, the distribution is treated as if the asset sale to new target and liquidation of old target had taken place, followed by a purchase of new target stock by the seller and a distribution of such new target stock to its shareholders, such distribution itself resulting in no gain or loss to seller.

No election may be made with respect to a distribution of stock of a subsidiary in a transaction that is tax-free to both the distributing corporation and its shareholders under Section 355. An eligible disposition would include, however, a distribution of stock that was taxable to the shareholders of the distributing corporation.
corporation, because it failed to meet the requirements of Section 355, and a distribution that was tax-free to the shareholders under Section 355(a) but taxable to the distributing corporation because of Section 355(d)(2) or Section 355(e)(2).10

As the Notice explains, without a Section 336(e) election, a distribution to shareholders that resulted in the recognition of gain to the corporation under Section 355(d)(2) or Section 355(e)(2) but not to its shareholders, could ultimately result in three layers of tax: (i) at the subsidiary level on the appreciation in its assets, (ii) at the level of the distributing corporation, on the distribution of appreciated stock, and (iii) at the shareholder level, on the eventual disposition of the low-basis shares acquired in the distribution. The ability under the Proposed Regulations to make a Section 336(e) election will alleviate this problem.

In addition, the Proposed Regulations will allow taxpayers to make a protective Section 336(e) election. A protective election might be made, for example, if there is a risk that a Section 355 transaction may be a qualified stock disposition because it may, although it is not intended to, result in gain to the distributing corporation under Section 355(d)(2) or Section 355(e)(2). The election will be binding if the transaction is a qualified stock disposition, but will otherwise have no effect.11

The Proposed Regulations include special rules which address specific types of transactions, including:

- In the case of a Section 355(d)(2) or Section 355(e)(2) distribution, old target is treated as having sold its assets to a third party, then repurchased such assets, followed by a distribution of old target shares to shareholders.12 The Notice explains that this approach in the case of a Section 355 distribution ensures the retention of tax attributes of the target.
- If a disposition is made by way of a distribution of target stock by a corporation, gain but not loss is recognized on the amount of the deemed asset sale attributable to the distribution.13 This provision attempts to mirror the treatment in a case where a seller made an actual distribution of assets. In such a case, the distributor generally would be prevented from recognizing loss.14
- In the case of a target which itself holds 80% of the stock in a subsidiary, the a target may elect under 336(e) to treat the sale of stock of the subsidiary (which would be a deemed, rather than an actual, sale of stock if the target’s parent made a Section 336(e) election) as a sale of the subsidiary’s assets. The Proposed Regulations contemplate that such elections may be made down a parent-subsidiary chain and provide generally for ordering rules to account for such situations.15
- While minority shareholders are generally unaffected by the provisions of the Proposed Regulations, a “gain recognition election” is permitted to 10% holders who did not acquire stock from the seller making a Section 336(e) Election.16

The Notice requests further comment on several issues, including appropriate treatment of dispositions to related persons, and application of similar provisions to foreign sellers or targets.

The Proposed Regulations are to go into effect with respect to any qualified stock disposition for which the disposition date is after the date of publication of the final regulations.

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1 Under Section 355(d)(2) or Section 355(e)(2) which generally provide, respectively, for the recognition of gain by the distributing corporation where the distribution is preceded by a purchase of 50% or more of the distributing corporation’s stock or the distribution is part of a plan pursuant to which there will be an acquisition of 50% or more of the stock of the distributed corporation or the subsidiary.


Section 336(e).


Section 311(a).


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CONTACTS

<table>
<thead>
<tr>
<th>New York</th>
<th>+1-212-558-4665</th>
<th><a href="mailto:creamerr@sullcrom.com">creamerr@sullcrom.com</a></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ronald E. Creamer Jr.</td>
<td></td>
<td><a href="mailto:creamerr@sullcrom.com">creamerr@sullcrom.com</a></td>
</tr>
<tr>
<td>Janna Freed</td>
<td>+1-212-558-3967</td>
<td><a href="mailto:freedj@sullcrom.com">freedj@sullcrom.com</a></td>
</tr>
<tr>
<td>Willard B. Taylor</td>
<td>+1-212-558-3604</td>
<td><a href="mailto:taylorw@sullcrom.com">taylorw@sullcrom.com</a></td>
</tr>
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