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Tax Management Memorandum™

Use of Section 336(e) Elections by Pass-Through Entity Acquirers

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I. INTRODUCTION

For corporations that desire to acquire corporate subsidiaries from a consolidated group or acquire 100% of the stock of an S corporation, §338(h)(10) has long been the acquisition method of choice.[2] By using a corporation to purchase the stock of the target company and making a §338(h)(10) election, the acquiring corporation is treated as forming a new company, which in effect is treated as purchasing the assets of the target company in a fully taxable transaction. This causes the newly formed company to acquire a fair market value basis in the acquired assets, even though stock and not assets have been acquired.

For pass-through entity acquirers (including private equity funds and family investment entities) who desire to operate the target company as a pass-through entity, §338(h)(10) is not a viable option. While it is generally permissible to liquidate the target company shortly after making a §338(h)(10) election, if the acquiring company is liquidated shortly after the stock purchase, the §338 regulations assert that there may not have been a bona fide corporate purchaser, and, thus, one of the requirements for a §338(h)(10) election has not been satisfied.

Prior to 2013, pass-through entity acquirers had limited options to address this problem. These options included purchasing assets of the target company in a taxable transaction or merging the target company into a limited liability company by means of a forward cash merger. From a corporate perspective, both of these transactions raise potential consent issues.

On its face, the acquisition of a target company by a pass-through entity coupled with the making of a §336(e) election, followed by the conversion of the target company into a single member limited liability company under a state law conversion statute would appear to be the ideal solution: no corporate liquidation or transfer of assets is required and, thus, no consent solicitation obligation is triggered. However, in practice, the mechanical manner in which the §336(e) regulations allocate tax basis and purchase price among the target company's assets can result in situations where the immediate liquidation of a target company following its purchase and the making of a §336(e) election can result in phantom taxable income. For this reason, it is essential to model the likely one-day tax return that will result from the conversion of the target corporation to a limited liability company, in order to confirm that there is no phantom taxable income.

This article is organized into sections. Part II provides the background resulting in §336(e) and the underlying Treasury regulations. Part III compares the elections available under §336(e) and §338(h)(10). Part IV provides an overview of the mechanics of the §336(e) election. Part V raises potential traps for the unwary and problems under current law.

II. BACKGROUND

Multiple Levels of Taxation

A parent corporation that sells or distributes stock of a corporate subsidiary, or shareholders of an S corporation that sell stock of an S corporation, may be

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[2] Unless otherwise stated, all "section" references are to the Internal Revenue Code, as amended, and the Treasury regulations thereunder.

subject to double taxation on the same economic gain in certain cases. A corporate parent is taxed on the gain from its sale of subsidiary stock and, because the transferred assets of the subsidiary retain any built-in gains, the acquirer of the subsidiary may be subject to a second level of corporate tax on the same economic gain upon the subsequent disposition of the acquired assets. Similarly, if a corporate parent distributes subsidiary stock to its shareholders and the distribution is not treated as tax free under §355, the distributing corporation is subject to tax on the built-in gain in the subsidiary stock, and because the transferred assets of the subsidiary again retain their built-in gains, the distributee shareholders also may be subject to a second level of tax upon a subsequent disposition of the acquired assets. Finally, the shareholders of an S corporation are subject to a single level of tax on the gain from the sale of their corporate stock. Because the basis of the S corporation's assets is not increased on the sale of its stock by its shareholders, any built-in gain in the S corporation's assets may be subject to corporate-level tax if the S corporation ceases to qualify as an S corporation before the recognition of the built-in gain. Furthermore, the acquirer of the S corporation shares may be subject to character and timing mismatches because the acquirer's basis in the S corporation shares exceeds the S corporation's basis in its assets and, thus, a shareholder may have capital gain or loss treatment with respect to subsequent sales or exchanges of their shares while receiving pass-through ordinary income treatment with respect to the assets held by the S corporation. Further, an S corporation shareholder may not be able to offset losses from the liquidation of an S corporation unless the liquidation occurs in the same year as the S corporation's asset sale.

Prior to the issuance of final regulations under §336(e), sellers and buyers of corporate stock had few alternatives available to avoid double taxation. Available planning opportunities included: (i) structuring a sale or distribution transaction as a sale or distribution of the assets of the subsidiary corporation; (ii) converting the target corporation into an entity classified as a partnership or disregarded entity and then selling the interests in such entity; and (iii) electing to treat certain qualifying stock sales as deemed asset sales under §338(h)(10). Although these planning techniques succeed in subjecting the selling corporation to a single level of corporate tax on the built-in gain of the transferred assets while allowing the buyer to obtain a stepped-up basis in the acquired assets, sellers and buyers are often unable to structure asset sales or distributions for a number of reasons. In the case of actual asset sales and sales of interests in entities, it is often administratively unfeasible, untimely, or difficult for business or legal reasons to obtain third-party consents for the transfer of certain assets or interests. In the case of deemed asset sales under §338(h)(10), the election is only available in limited qualifying circumstances, including specifically when the acquirer is a single domestic corporation or consolidated group of corporations.

General Utilities Repeal/Enactment of §336(e)

Prior to the 1986 repeal of the "*General Utilities* doctrine," a corporation could distribute assets to its shareholders or sell appreciated assets in certain cases without recognizing gain.[3] Congress repealed the *General Utilities* doctrine as part of the Tax Reform Act of 1986[4] and, thus, eliminated the limited available relief from double taxation. At the same time, however, Congress enacted §336(e), which provides:

> 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.

Thus, while Congress recognized that double taxation was not appropriate in all cases and attempted to provide limited relief, the consequence of doing so "[u]nder regulations prescribed by the Secretary" was that no relief was available until 27 years later.[5]

Following the issuance of proposed regulations in 2008,[6] the Treasury issued final regulations in 2013 to enact the Congressional purpose set forth in §336(e).[7] In the Preamble to the final regulations, the Treasury stated "[s]ection 336(e) is meant to provide taxpayers relief from a potential multiple taxation of the same economic gain that can result when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in the basis of the assets of the corporation."[8]

Motivations of Buyer and Seller in a Transaction

Typically, the parent corporation in a sale or distribution transaction will only be subject to a single

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[3] *See General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

[4] *See, e.g.,* §311(b), §1374.

[5] *See* CCA 201009013 ("absent the issuance of final regulations, a taxpayer may not make an election under §336(e)").

[6] *See* REG-143544-04, 73 Fed. Reg. 49,965 (Aug. 25, 2008).

[7] *See* T.D. 9619, 78 Fed. Reg. 28,467 (May 15, 2013).

[8] *Id.* at 28,467.

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level of corporate tax and it is the acquirer of the subsidiary stock that is subject to the second level of tax on the same economic gain. From a purely tax perspective, a selling or distributing corporation is motivated to engage in a stock sale if its outside basis in the subsidiary stock is higher than the subsidiary's inside basis in its assets (because the taxable gain on the stock sale is less than the taxable gain on the asset sale). In contrast, a selling or distributing corporation is motivated to engage in an asset sale if its outside basis in the subsidiary stock is lower than the subsidiary's inside basis in its assets. Thus, the parent corporation may be indifferent from a tax perspective whether it sells or distributes shares or assets, or indeed may prefer a sale of stock. There are additional considerations, however, including primarily the price that a willing buyer will pay to acquire shares versus assets.

When a transaction is structured as a sale or distribution of stock, the acquirer obtains all of the legal benefits and burdens of ownership of the corporation. From a tax perspective, the acquirer of shares does ***not*** receive a stepped-up basis in the acquired assets to offset future gain or from which to take depreciation or amortization deductions. Because there is an economic cost to a buyer of not receiving stepped-up basis in the assets, an acquirer is often motivated to structure a transaction as an asset sale and is willing to pay more for assets than for stock of the same corporation. Consequently, sellers often negotiate with buyers over the structure of a transaction as a sale of shares or assets.

The elections available under §336(e) and §338(h)(10) are useful because, under certain circumstances, they enable the sale of corporate stock, while simultaneously enabling the parties to treat the transaction as a sale of corporate assets with all of its attendant advantages. While §338(h)(10) has been available for many years, it is limited in its availability. Therefore, the broader applicability of §336(e) is of huge import to sellers and distributors of corporate stock.

III. COMPARISON TO SECTION 338(H)(10) ELECTION

The final regulations under §336(e) provide that:

> Generally, except to the extent inconsistent with section 336(e), the results of section 336(e) should coincide with those of section 338(h)(10). Accordingly, to the extent not inconsistent with section 336(e) or these regulations, the principles of section 338 and the regulations under section 338 apply for purposes of these regulations.[9]

The final regulations further provide that to the extent a transaction qualifies under both §336(e) and §338(h)(10), the rules of §338(h)(10) control unless the transaction involves the disposition of the stock of a subsidiary of the target.[10] Because of the overlap between §336(e) and §338(h)(10), a brief overview of §338(h)(10) and the key differences between the two elections is warranted.

Section 338(h)(10) and the underlying Treasury regulations provide for an election in the case of a ''qualified stock purchase,'' under which a selling corporation may treat a sale of the stock of a member of its consolidated group as a sale of all of such member's assets. The circumstances under which the §338(h)(10) election is available are limited. The ''target'' corporation must be a subsidiary member of a consolidated group or an S corporation immediately before the acquisition date.[11] The acquirer must be a domestic corporation or an affiliated group of corporations that is not related to the target corporation.[12] Finally, the acquiring corporation must acquire at least 80% of the target stock by vote and value within a 12-month acquisition period.[13]

Where a §338(h)(10) election has been made, the IRS deems three transactions to occur: (i) the formation of a new corporation by the corporate purchaser of the subsidiary stock; (ii) a sale by the subsidiary of its assets to such new corporation in exchange for the consideration actually transferred; and (iii) the distribution by the subsidiary of such consideration, generally in liquidation of the subsidiary. As a consequence of the election and the deemed transactions, the purchaser obtains the desired stepped-up basis in the assets, while there is only one level of tax — i.e., only with respect to the built-in gain in the assets and not with respect to the gain on the sale of the subsidiary stock.

While the effects of the §338(h)(10) and §336(e) elections are similar, there are several key differences between the provisions. The most significant difference is that the acquirer under §338(h)(10) must be a single domestic corporation or consolidated corporate group, whereas individuals, entities treated as partnerships or that are disregarded, corporations, or any combination thereof can be an acquirer under §336(e).

Under both §338(h)(10) and §336(e), an acquisition by a ''related person'' does not count towards the 80%

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[9] Reg. §1.336-1(a)(1).

[10] *See* Reg. §1.336-1(b)(6)(ii)(B).

[11] *See* Reg. §1.338(h)(10)-1(b)(1), §1.338(h)(10)-1(b)(3), §1.338(h)(10)-1(b)(4).

[12] *See* §338(d)(1); Reg. §1.338-2(c)(11), §1.338-3(b)(3).

[13] *See* §338(d)(3), §338(h)(1); Reg. §1.338-2(c)(19), §1.338-3(b)(2),

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ownership test. The definition of related person under the two statutes, however, differs and the definition under §336(e) facilitates more transactions. For purposes of §338(h)(10), ''[t]wo persons are related if stock in a corporation owned by one of the persons would be attributed under section 318(a) (other than section 318(a)(4)) to the other.''[14] In contrast, for purposes of §336(e), ''[t]wo persons are related if stock of a corporation owned by one of the persons would be attributed under section 318(a), other than section 318(a)(4), to the other. However, neither section 318(a)(2)(A) nor section 318(a)(3)(A) 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, interests representing less than five percent of the value of the partnership.''[15] Thus, the IRS will not prohibit deemed asset disposition treatment where the cross-ownership is minimal.[16] Under the definition of related person applicable to §336(e) elections, an owner of the ''target'' corporation may also be a small partner in a partnership that acquires such target corporation.

Finally, the ''consistency rules'' applicable to elections under §338(h)(10) and §336(e) vary because §338(h)(10) is only available for a single domestic corporate acquirer and §336(e) allows multiple individual or entity acquirers. For purposes of §338(h)(10) transactions, a purchasing corporation is required to take carryover basis in the acquired assets if (i) the purchasing corporation or an affiliate purchases assets meeting certain requirements during the consistency period, (ii) gain from such sale is reflected in the basis of the stock of the selling corporation, and (iii) the purchasing corporation acquires the stock in a ''qualified stock purchase'' and does not make the §338(h)(10) election.[17] In contrast, the consistency rules of §336(e) only mandate carryover basis where the same or a related person acquires both the assets and more than a minimal amount — set at five percent by value — of the stock of the target corporation in a qualified stock disposition.[18]

IV. OVERVIEW OF MECHANICS

As noted in the Preamble to the final regulations, ''Section 336(e) of the Code authorizes the issuance of regulations under which an election may be made to treat the sale, exchange, or distribution of at least 80% of the voting power and value of the stock of a corporation (target) as a sale of all its underlying assets.''[19]

Qualified Stock Distributions

Under the regulatory framework, an election under §336(e) to step-up the basis of transferred assets is available only for ''qualified stock dispositions.''[20] A qualified stock disposition is any transaction or series of transactions in which:

1. at least 80% by vote and value of the stock (i.e., stock meeting the requirements of §1504(a)(2));
2. of a domestic corporation, including a subsidiary corporation, member of a consolidated group, or S corporation;
3. is sold, exchanged, or distributed in a taxable transaction;
4. by a domestic corporation or S corporation shareholders;
5. to or with unrelated parties;
6. within a 12-month disposition period.[21]

Notably, the purchaser or distributee does not need to be a single corporation and, therefore, one or more individuals or entities treated as partnerships or disregarded entities, or two or more corporations whether or not they are affiliates, or any combination can acquire the stock of the ''target.'' Further, the acquisition of the stock is not required to occur at one time and, instead, may be acquired within a 12-month period.

Election

In order to obtain the benefits of §336(e), the seller, which in the case of an S corporation target is determined to be all of the shareholders, and the target must enter into a written, binding agreement to make the election and attach the statement to the relevant tax return.[22] The election statement is also required to include certain information with respect to the selling/distributing corporation or S corporation shareholders, the ''target'' corporation, the disposition date, the percentage of stock disposed, any net losses realized on

[14] Reg. §1.338-2(c)(13).

[15] Reg. §1.336-1(b)(12).

[16] T.D. 9619, 78 Fed. Reg. at 28,472–73.

[17] *See* Reg. §1.338-8(b), §1.338-8(f).

[18] *See* Reg. §1.336-1(a)(2).

[19] T.D. 9619, 78 Fed. Reg. at 28,467.

[20] Reg. §1.336-2(a).

[21] Reg. §1.336-1(b)(6).

[22] *See* Reg. §1.336-2(h)

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the deemed asset disposition, and a copy of any gain recognition elections.[23]

Where a corporation is selling or distributing the stock of a member of its consolidated group, the election statement must be included with a timely filed consolidated return and the common parent of the consolidated group must provide a copy of the election statement to the target on or before the due date of the consolidated group's consolidated federal income tax return.[24] Where a corporation is selling or distributing stock of a member of an affiliated group that is not consolidated, the election statement must be included with the timely filed tax returns of both the selling/distributing corporation and the target corporation.[25] Finally, where S corporation shareholders are selling the stock of an S corporation, the election statement must be signed by each of the shareholders (including any who are not disposing of their stock) and included with a timely filed return of the S corporation.[26]

Basic Model

The IRS deems certain transactions to occur when a §336(e) election is made. The ''basic'' model applies to all qualified stock distributions other than distributions described in §355(d)(2) or §355(e)(2), and the ''sale-to-self'' model applies to §355(d)(2) and §355(e)(2) transactions.[27]

Under the basic model, the IRS deems three transactions to occur: (i) a deemed asset disposition; (ii) a deemed asset purchase; and (iii) a deemed liquidation. First, the ''old target'' is treated as selling all of its assets to an unrelated person in a single transaction at the close of the disposition date in exchange for the Aggregate Deemed Asset Disposition Price (ADADP).[28] The ADADP is allocated among disposition date assets to determine the amount realized from each asset and the target recognizes the tax consequences before the close of the ''disposition date.''[29] Under the ''disallowed loss rule,'' realized losses on the deemed asset sale may be used to offset the amount of realized gains, but any ''net loss'' attributable to a distribution of target stock during the 12-month disposition period is disallowed.[30] Next, the ''new target'' (which is the same entity after it has recognized the federal income tax consequences) is treated as acquiring all of its assets from an unrelated person in a single transaction at the close of the disposition date in exchange for amount equal to the Adjusted Grossed-Up Basis (AGUB).[31] The AGUB is allocated among the disposition date assets to determine the basis in each asset.[32] Finally, ''old target'' is treated as if it transferred all the consideration received from the acquirer of ''new target'' to the selling corporation or S corporation shareholders, and then ceased to exist.[33] Thus, the transfer is generally treated as a distribution in complete liquidation of ''old target.'' In the case of a distribution of target stock (rather than a sale), the distributing corporation is treated as if it purchased from an unrelated party the amount of stock distributed on the disposition date and distributed such stock to its shareholders without any recognition of gain or loss.[34]

Notably, if the target is an S corporation, the election remains in effect for the deemed asset disposition through the close of the disposition date, and terminates upon the deemed liquidation.[35] Therefore, if the acquired corporation still qualifies as an S corporation after the acquisition and such treatment is desired, a new S election will have to be filed.[36] In addition, until the IRS provides a form specifically with respect to §336(e), a Form 8883, *Asset Allocation Statement Under Section 338*, should be filed to report the deemed asset disposition. Finally, if the selling corporation or S corporation shareholder retains any stock after the disposition date, it is treated as if it purchased such stock from an unrelated person on the date after the disposition date for its fair market value and §351 does not apply to the transaction.[37]

Sale-to-Self Model

The ''sale-to-self'' model applies in the case of §355(d)(2) and §355(e)(2) transactions. Under the sale-to-self model, the IRS deems three transactions to occur: (i) a deemed asset disposition; (ii) a deemed asset purchase; and (iii) a deemed distribution. Because no liquidation of the ''controlled corporation'' is deemed to occur, the target generally retains any tax attributes that it had prior to the §336(e) election.

Similar to the basic model, the first deemed transaction is the deemed asset disposition, under which the ''old target'' is treated as selling all of its assets to an unrelated person in a single transaction at the close

[23] *See* Reg. §1.336-2(h)(6).
[24] *See* Reg. §1.336-2(h)(1).
[25] *See* Reg. §1.336-2(h)(2).
[26] *See* Reg. §1.336-2(h)(3).
[27] *See* Reg. §1.336-2(b)(1), §1.336-2(b)(2).
[28] *See* Reg. §1.336-2(b)(1)(i)(A).
[29] *See id.*
[30] *See* Reg. §1.336-2(b)(1)(i)(B)(2)(ii).
[31] *See* Reg. §1.336-2(b)(1)(ii).
[32] *See id.*
[33] *See* Reg. §1.336-2(b)(1)(iii)(A).
[34] *See* Reg. §1.336-2(b)(1)(iv).
[35] *See* Reg. §1.336-2(b)(1)(i), §1.336-2(b)(1)(iii).
[36] *See* Reg. §1.336-2(b)(1)(ii).
[37] *See* Reg. §1.336-2(b)(1)(v).

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of the disposition date in exchange for the ADADP, which is allocated among disposition date assets to determine the amount realized from each asset, and the controlled corporation recognizes the tax consequences before the close of the disposition date.[38] Under the ''disallowed loss rule,'' realized losses on the deemed asset sale may be used to offset the amount of realized gains, but any ''net loss'' attributable to a distribution of target stock during the 12-month disposition period is disallowed.[39] Again, the second deemed transaction is the deemed asset purchase, under which the controlled corporation is treated as repurchasing its assets from an unrelated person in a single transaction at the close of the disposition date in exchange for an amount equal to the AGUB, which is allocated among the disposition date assets to determine the basis in each asset.[40] Finally, in the deemed distribution, the distributing corporation is treated as if it distributed the stock of the controlled corporation to its shareholders without any recognition of gain or loss.[41]

For purposes of the sale-to-self model, the ''wash sale'' rules of §1091 and the ''anti-churning'' rules of §197(f)(9) do not apply because the target is treated as a separate and distinct taxpayer for purposes of the deemed asset disposition and deemed asset purchase.[42] In addition, the deemed disposition and purchase of assets will not cause the distribution of the controlled corporation to fail to satisfy the requirements of §355.[43] Finally, similar to the case under the basic model, if the distributing corporation or selling shareholder retains any stock of the controlled corporation, they are treated as if they disposed of such retained stock on the disposition date without the recognition of any gain or loss, and then purchased such retained stock on the day after the disposition date from an unrelated person for its fair market value.[44]

V. TRAPS FOR THE UNWARY AND POTENTIAL PROBLEMS WITH THE SECTION 336(e) REGULATIONS

Potential Regulatory Fixes

The Treasury's 2015-2016 Priority Guidance Plan lists ''[r]egulations under §336(e) to revise the treatment of certain stock dispositions as asset sales'' as a priority project.[45] The IRS has received numerous comments from tax practitioners to identify issues or confusion from the final regulations and to recommend regulatory solutions. The IRS has stated publicly that it will soon issue additional regulations under §336(e) on the treatment of certain stock dispositions as asset sales.[46] The IRS has suggested that the anticipated regulations might address the treatment of creeping dispositions and the definition of related parties.

Under the final regulations, a transfer of stock is not treated as a disposition included for the 80% test if such stock is transferred to a related person.[47] There is an exception from attribution in the case of a partner who owns less than five percent of a partnership.[48] Thus, for purposes of the related-person test, stock transferred to a partnership will not be attributed to a partner that owns less than five percent of the partnership. Practitioners have requested a broader safe harbor for partnership attribution. The Section of Taxation of the American Bar Association, for example, has suggested that the attribution exception for minority-interest partners be increased from its five percent exception to as high as 50%.[49] The IRS has indicated that the IRS may increase the safe harbor in its anticipated regulatory guidance.[50]

The IRS also has suggested that it may issue additional guidance on ''creeping dispositions,'' where a selling corporation or S corporation shareholder disposes of target stock over a period of time rather than in a single transaction.[51] The treatment and characterization of the target during the period between the first disposition and the disposition crossing the 80% threshold is likely to be clarified.

Allocation of Tax Basis

Section 336(e) does not include detailed rules for allocating the purchase price for the sale of a target to

[38] *See* Reg. §1.336-2(b)(2)(i)(A).

[39] *See* Reg. §1.336-2(b)(2)(i)(B)(2)(ii).

[40] *See* Reg. §1.336-2(b)(2)(ii)(A).

[41] *See* Reg. §1.336-2(b)(2)(iii)(A).

[42] *See* Reg. §1.336-2(b)(2)(ii)(C).

[43] *See* Reg. §1.336-2(b)(2)(v).

[44] *See* Reg. §1.336-2(b)(2)(iv).

[45] Department of the Treasury, 2015-2016 Priority Guidance Plan (July 31, 2015), *available at* https://www.irs.gov/uac/priority-guidance-plan.

[46] *See, e.g.,* Bologna, *IRS to Issue Regulations on Stock Dispositions as Asset Sales*, 98 Daily Tax Rep. G-7 (May 20, 2016); Davison, *IRS Applying Utilitarianism to Stock Sale Election Changes*, 24 Daily Tax Rep. G-5 (Feb. 5, 2016).

[47] *See* Reg. §1.336-1(b)(5), §1.336-1(b)(6).

[48] *See* Reg. §1.336-1(b)(12).

[49] *See, e.g.,* Davison, *ABA Tax Section: 336(e) Elections Can be User-Friendly*, 140 Daily Tax Rep. G-1 (July 22, 2015) (ABA comment letter in BNA TaxCore).

[50] *See* McAfee, *IRS Working to ''Clean Up'' Section 336(e) Rules, Official Says*, 232 Daily Tax Rep. G-7 (Dec. 3, 2015); Bologna, *IRS to Address Related-Person Restriction on Stock Sales*, 217 Daily Tax Rep. G-3 (Nov. 10, 2015).

[51] *See* McAfee, *IRS Working to ''Clean Up'' Section 336(e) Rules, Official Says*, 232 Daily Tax Rep. G-7 (Dec. 3, 2015); Bennett, *IRS: Rules Underway on ''Creeping Dispositions'' of Stock*, 204 Daily Tax Rep. G-3 (Oct. 22, 2015).

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the basis of the assets deemed purchased. Rather, Reg. §1.336-4 provides that generally, the principles of Reg. §1.338-5 apply in determining the AGUB for the target. AGUB is determined under §336(e) consistently with the principles of §338. If the amount realized with respect to each asset on the deemed liquidation of the target company on the making of the §336(e) election equaled the amount allocated to each asset under the AGUB rule, then there would be no tax consequences on the conversion of a target company to a disregarded entity following the making of the §336(e) election. However, in practice, AGUB will rarely equal the deemed sale price on the making of the §336(e) election, resulting in the possibility of gain recognition on the making of the deemed liquidation following the §336(e) election.

The allocation of consideration in a transaction governed by §336(e) falls under Reg. §1.338-6. The amount of consideration allocated to an asset cannot exceed that asset's fair market value. There are seven classes of assets to which consideration may be allocated, including marketable securities, debt instruments, inventory, §197 intangibles other than goodwill and going concern value, goodwill and going concern value, and a residual basket of everything else. In determining AGUB, Reg. §1.338-6 and §1.338-7 do not contain rules for the treatment of contingent liabilities. Under Reg. §1.338-6, AGUB will equal cash plus liabilities assumed. However, Reg. §1.338-7(a) makes clear that contingent liabilities are not taken into account in determining AGUB at the time of purchase.

There are several types of liabilities that are concerning in transactions treated as asset acquisitions when determining basis. Three of the most common types are nonqualified deferred compensation, litigation liabilities, and above-market liabilities (such as above-market rents or above-market interest rate loans). Each of these liabilities presents unique problems.

With respect to nonqualified deferred compensation, the purchaser of a group of assets may take on the liability to pay employees at some point in the future. In this case, the purchaser will reduce the purchase price paid by the amount of the deferred compensation liability assumed. For example, assume that the gross asset value of a business is $1,000 and the amount owed to employees on a deferred basis is $200. The purchaser will pay a total of $800 for the assets. This will become the purchaser's AGUB in the assets so acquired.

With respect to litigation-related liabilities, assume that the asset to be acquired is a building worth $1,000, subject to contingent environmental liabilities estimated to equal $200. The buyer of the asset will pay a total of $800 for the building, because of the assumption of the $200 contingent liability associated with the building.

With respect to an above-market rate liability, assume that the assets of an ongoing business are worth $1,000, but the business is burdened by a lease with above-market rent, the present excess cost of which is estimated to be $200. Once again, the buyer will pay $800, and will allocate $800 of basis to the building.

Consider what happens in these situations where a target company with one of these asset classes is purchased, a §336(e) election is made, and the target is subsequently converted to a limited liability company in order to best operate the target as a pass-through entity. Consider the nonqualified deferred compensation situation first. On the conversion of the target company to a limited liability company, the target is deemed to liquidate in a fully taxable transaction. In such liquidation, the gain recognized equals the excess of the value of the assets deemed distributed in liquidation over the basis of such assets. In this case, the value of the assets distributed exceeds the basis in such assets by $200. The target company, on the tax return it files for the one day that it is a C corporation, may try to deduct the compensation which it effectively is paying through the reduction of the purchase price. The problem with this solution is that §404(a)(5) expressly provides that an employer may not deduct compensation expense before the employee includes the amount in income. Here, the new target company is assuming the liability, but no one is including any amounts in income. There is case authority for the proposition that the reduction of purchase price constitutes the payment of a liability.[52]

With respect to the contingent liability situation, on the deemed liquidation of the target company, the purchaser is in effect assuming the liability. However, if the contingency exists at the time of the deemed liquidation, the all events test would preclude the taking of the deduction. Thus, a target company which is statutorily converted may similarly face $200 of phantom income. Of course, the associated pass-through entity will be entitled to a $200 tax deduction if the contingent liability is fixed and paid, but the payment of that liability by the pass-through entity will not reduce the tax liability of the corporation.

Lastly, consider the application of this rule to an above-market lease. As described above, the basis of the assets will be $800 while the value of the assets will be $1,000. As the above-market rent is paid, the buyer will get a deduction for the full amount of rent

[52] *See, e.g., James M. Pierce Corp. v. Commissioner*, 325 F.2d 67 (8th Cir. 1964), *rev'd*, 38 T.C. 463 (1962). However, TAM 8939002 suggests that *Pierce* is not dispositive of deductions taken which are potentially limited by §404(a)(5) or the all events test of §461.

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paid each year, even though part of the rent paid in substance constitutes additional purchase price paid by the buyer. Once again, the excess deductions taken by the pass-through acquirer will in no way abate the corporate tax liability on the deemed liquidation of the LLC.

Bargain Purchases

Another situation in which the AGUB of a target's assets might not equal the value of the assets purchased is a "bargain purchase." Under general principles of income taxation, tax basis equals the cash (or value of the other property) paid and liabilities assumed, not the fair market value of the assets purchased. But what happens if the purchase price is less than the fair market value? In general, the bargain purchase element is not taxable upon the purchase; rather the difference between the amount paid and the fair market value is effectively taken into account through either reduced depreciation/amortization deductions or through additional gain on the sale of the acquired assets. When a bargain purchase occurs, the buyer must immediately book income equal to the bargain purchase element upon the purchase under GAAP accounting, even though there are no immediate income tax consequences from the purchase.

To illustrate how problems can arise from a bargain purchase, assume that a buyer agrees to pay $1,000 for a company. In connection with appraising the company's assets for a purchase price allocation, the buyer determines that the value of the assets is $1,100. Alternatively, assume that after a contract is signed to purchase the company for $1,000, an asset is discovered that was not taken into account by the parties in valuing the company (for example, a contingent claim), and that total asset value equals $1,100. If a buyer purchased the assets for $1,000 but received assets worth $1,100, there would be no income tax consequences from the bargain purchase. On the other hand, if a buyer purchased the stock of target for $1,000, a §336(e) election were made, and the target subsequently converted from a corporation to a limited liability company, then the corporation would have an immediate $100 gain on the deemed liquidation.

Does the *Kimbell-Diamond* Doctrine Exist Today?

While §336(e) was intended to be permissive and to make it easier to structure stock acquisitions without incurring adverse tax consequences, some adverse problems may arise in practice from transactions that would have been treated as asset acquisitions. One way for the tax problems described above to be eliminated would be for Treasury to issue regulations providing that there will be no tax consequences if the target company disposes of its assets in a taxable transaction within some short period following the §336(e) election. However, in recent comments by the American Bar Association to the Treasury Department, no mention was made of this problem (the committee making the comment did not include any members of the pass-through committee of the ABA Tax Section).

Another way for a taxpayer to receive the same result is by asserting that under current law, the "*Kimbell-Diamond* doctrine" allows the taxpayer to claim a fair market value basis in target assets as if the target company were liquidated promptly after its acquisition in a qualified stock purchase. Under the *Kimbell-Diamond* doctrine, the acquisition of stock of a target company by an acquirer followed by a liquidation or merger of the target into the acquirer pursuant to an integrated transaction is treated as an acquisition of the target company's assets for the consideration paid for the target corporation's shareholders. The *Kimbell-Diamond* doctrine was repealed with respect to the "qualified stock purchase" of a target corporation under §338, however, it is unclear whether the doctrine applies with respect to non-corporate purchasers following the repeal of the *General Utilities* doctrine. In PLR 8717056, the IRS suggested that the *Kimbell-Diamond* doctrine could survive in the context of a stock purchase by a non-corporate purchaser. If the doctrine survives, then the formation of new target as a corporation coupled with its subsequent liquidation will be disregarded, resulting in the same tax consequences that would result if the pass-through entity purchased all of the assets of the old target company for cash. However, the American Bar Association in its recent comments regarding the §336(e) regulations suggested that the Treasury should confirm that the *Kimbell-Diamond* doctrine does not survive for any purpose.

For pass-through entity acquirers, it would be preferable if Treasury could confirm that even if §338 or §336(e) were intended to be the exclusive laws covering qualified stock purchases, that the *Kimbell-Diamond* doctrine should apply for the limited purpose of eliminating phantom gain on a deemed liquidation following a §336(e) election.

VI. SUMMARY

In the absence of the survival of the *Kimbell-Diamond* doctrine or some other general ruling confirming that the purpose of §336(e) was to allow it to be used broadly and not to be a trap, what else can be done? For most acquirers, even if they have the types of liabilities described above or acquire a target pur-

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suant to a bargain purchase, when it comes time to make the purchase price allocation using AGUB concepts, they will simply reduce the amount allocated to goodwill and going concern value. It is only where a company has no goodwill or going concern value and the amount of liabilities by which the purchase price was reduced reduces the tax basis of ''hard'' assets that are more easily valued that it will become readily apparent that gain could be recognized on the conversion of target into a limited liability company. Theoretically, if liabilities like those described above reduce the purchase price paid so that the amount allocated to goodwill is less than the fair market value of the goodwill, then gain would be recognized on the deemed liquidation. However, in practice, this seems unlikely because the amount allocated to goodwill is generally backed into, without any separate appraisal being done for the goodwill.

Section 336(e) elections are powerful tools for acquiring stock of target companies and causing the targets to be converted into disregarded entities to be owned by pass-through entities. However, it may be impossible at the time that a stock purchase agreement is signed or even at closing to know with certainty whether adverse tax consequences will arise on the conversion of the target company to a limited liability company following a §336(e) election. For this reason, extensive tax and accounting due diligence is needed prior to making a §336(e) election. If the necessary information cannot be obtained and analyzed before execution of a stock purchase agreement, it may be better for the pass-through acquirer either to purchase assets or to merge the target company into a single member limited liability company owned by the pass-through entity than to commit to making a §336(e) election.

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