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Rule expands favorable tax treatment for sale of business

One of the key choices in buying a business is whether to purchase its stock or its assets.

Sometimes, the tax and corporate law considerations in this decision are not aligned, and the parties may want to structure a deal as an asset sale for tax purposes but a stock sale for corporate law purposes.

In this situation, the tax law has long allowed the parties to have the best of both worlds, by electing to treat a sale as an asset sale for tax purposes even though it is structured as a stock sale for corporate law purposes.

> **Many of the restrictions applicable to 338(h)(10) elections still apply to the new 336(e) election. The limitations need to be reviewed carefully.**

A new option has now expanded the availability of this approach. My goal in this article is to explain the basic considerations for deciding whether to treat a stock sale as an asset sale and to illustrate the expanded opportunities under the new rule.

From a corporate law and business perspective, asset sales are a mess. While many assets can be transferred by a simple assignment agreement, others present complications. Contracts, for example, may require consent from third parties. Real estate may require filings with the state and payment of transfer tax.

In addition, for certain types of companies, particularly those that work with the government, the change in tax identification numbers can cause substantial business disruption. Sales tax may also apply to the transfer of certain items.

From a tax perspective, however, assets sales can be much better than stock sales for buyers of C corporations. Because the buyer has bought each of the assets of the business, it establishes a basis for the assets that is equal to its purchase price. So when it sells an asset, the buyer will recognize only any gain that has occurred

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since the purchase. For depreciable assets, it can take deductions each year based on its purchase price.

Accordingly, buyers often want a stock sale for corporate purposes but an asset sale for tax purposes. But what about sellers?

Asset sales aren't great for sellers from a tax perspective. For individual sellers, there are two levels of tax on the sale, one when the company sells the assets and another when it distributes the proceeds. This can result in as much as 60 cents of tax for every dollar of consideration received.

For corporations selling a subsidiary, the burden of double taxation is lessened by a deduction for dividends received from the seller. However, where the basis of the parent in the subsidiary is higher than the basis of the subsidiary in its assets, an asset sale can also lead to greater tax. Astute sellers will require that buyers pay for the higher basis they receive in an asset sale by paying a higher purchase price. (I have not focused in this article on sales of S corporations, which present a different set of considerations.)

Let's say the buyer and seller have agreed that they want to have a stock sale but treat it as an asset sale for tax purposes.

Until now, this was generally accomplished by making a "338(h)(10)" election. If the selling shareholders and the buyer make the election, the target corporation is treated as making a sale of its assets and then liquidating, giving the parties the desired tax treatment.

However, this election is available only in certain circumstances. Most significantly, the buyer is required to be a corporation.

When Congress reformed the tax code in 1986, it contemplated that a second type of deemed asset sale election would be available under Section 336(e). It has taken over 25 years, but the Internal Revenue Service has finally issued rules that allow this election, under which the target is deemed to have sold its assets to a new corporation in a taxable sale prior to the acquisition.

The new election under Section 336(e) is available in certain situations when 338(h)(10) elections were not previously available:

- For a 338(h)(10) election, the buyer must be a corporation. However, a 336(e) election does not impose limits on the type of entity that must make the purchase. Accordingly, it may be made even if the buyer is an individual, a partnership or an LLC. This will expand the options available for acquisitions generally, but it is particularly important for private equity funds making acquisitions, because they are typically organized as partnerships.
- A 338(h)(10) election must be made by a single buyer. However, a 336(e) election can be made by multiple unaffiliated buyers. This expands the availability of deemed asset sale treatment to transactions in which a group of people are teaming up to make the purchase.
- The 336(e) election is not limited to stock purchases. For example, it can be made even if there is a corporate subsidiary distributed by a parent to its shareholders.

Many of the restrictions applicable to 338(h)(10) elections still apply to the new 336(e) election. The seller still generally must be a corporation, and at least 80 percent of the corporation by vote and value must be purchased during a one-year period. These limitations—and the many other technical rules and tax issues surrounding these elections—need to be reviewed carefully by the parties and their tax advisers.

Twenty-five years was certainly a long time to wait for the IRS to allow the 336(e) election. However, the election provides an important new opportunity for an expanded group of buyers to obtain deemed asset sale treatment on corporate acquisitions. Acquirers should consult with their advisers about whether either type of deemed asset sale election is advisable for their transaction.

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