
BUYERS OF S CORPORATION STOCK MUST CONSIDER SECTION 336(e)

Beginning in 2013, purchasers of S corporation stock need to determine whether their purchase is part of a deemed asset sale under Code Section 336(e).¹

Background

Code Section 336(e) was enacted in 1986 to permit an election (a “**336(e) Election**”) to treat certain stock dispositions as a disposition of the target corporation’s assets for U.S. federal income tax purposes, and is considered a “sister” election to the common Section 338(h)(10) election (the “**(h)(10) Election**”). However, Section 336(e) was a dormant provision from its enactment until implementing regulations were finalized this year.²

The regulations permit a 336(e) Election upon a “qualified stock disposition”, or “**QSD**” which generally is a transaction (or series of transactions) in which stock representing at least 80-percent of the voting power and value is sold, exchanged, or distributed (or any combination thereof) by a domestic corporation, or if the target corporation is an S corporation, by the S corporation shareholders, within a 12-month period.³

Importantly, the sellers/transferees, together with the target corporation, participate in making the 336(e) Election, *but the purchasers/transferees are not party to the election.*⁴

Effect of a 336(e) Election

Upon making a 336(e) Election, the target company (while owned by the sellers/transferees, “**old T**”) is deemed to sell all of its assets to a new target corporation (while owned by the purchasers/transferees, “**new T**”) in exchange for the “aggregate deemed asset disposition price.”⁵ Like the (h)(10) election, both the sellers/transferees and the buyers/transferees report for tax purposes as if this deemed asset sale actually took place. Buyers/transferees benefit from a step-up in the target’s aggregate asset basis from a 336(e) Election in prototypical cases where the target’s stock and assets have appreciated. In down markets however, the target may have an aggregate asset basis that is higher than the value of its stock, which would generally cause buyers/transferees to prefer that a 336(e) Election not be made, but with no control over the election process, these buyers/transferees must resort to contractual methods to prevent a 336(e) Election.

Election Procedure for S Corporation Targets

An S corporation target may make a 336(e) Election, in which case it must enter into a written, binding agreement with all of its pre-transaction shareholders to make the election (including any non-selling shareholders).⁶ However, buyer of S corporation stock are neither a party to the 336(e) Election nor the shareholder agreement to make the election. In most acquisitions of an entire S corporation, the buyer will consider the possibility of the election or will encounter the requisite shareholder agreement in the diligence process. However, purchasers of a minority in-

1 References to the “Code” refer to the Internal Revenue Code of 1986, as amended.

2 T.D. 9619. The 336(e) Election is available to QSDs (defined herein) occurring on or after May 15, 2013.

3 Treas. Reg. § 1.336-1(b)(6).

4 In published guidance, the IRS stated its view that purchasers are able to protect their interests by expressly prohibiting or providing for a 336(e) Election in their purchase contract. 73 F.R. 49965, 49970.

5 Treas. Reg. § 1.336-2(b)(1)(i)(A). This amount is generally equal to the cash and fair market value of assets paid for the target stock plus target’s liabilities assumed. Treas. Reg. § 1.336-3(b)(1).

6 Treas. Reg. § 1.336-2(h)(3).

terest in an S corporation may not consider the possibility that the sellers have bound the S corporation to make a 336(e) Election and may not even consider that their purchase is part of a series of transactions that constitutes a QSD. Accordingly, purchasers of any amount of stock in an S corporation should consider the possibility that the sellers have structured the transaction as a deemed sale of assets pursuant to a 336(e) Election.



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