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Tax Geek Tuesday: Tax Planning For Mergers And Acquisitions, Part I

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Taxes

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I know, I know…it's only Monday. But consider this a preemptive Tax Geek Tuesday, because by the time Tuesday morning rolls around, I plan to be far removed from this laptop and the interwebs, as I'll be spending the next two days in a hut deep in the Aspen backcountry.

Today's topic – planning and structuring mergers and acquisitions -- is one that intimidates many tax advisors. Feeling overwhelmed, we often make the mistake of advising clients that M&A consulting is "beyond our pay grade," or much, much worse, we refer them to attorneys. This should not be the case.

The goal for today is, well…the same as all Tax Geek Tuesdays – to demystify a complex tax issue and hopefully provide some illumination. Because this topic is particularly heavy, we'll be splitting it into two parts: in today's Part I, we'll tackle *taxable* *acquisitions,* and when we come back next week for Part II, we'll focus on *tax-free reorganizations* within the purview of Section 368.

Let's get started.

The primary reason many tax advisors feel overwhelmed when tasked with M&A structuring is because of the multitude of transaction types that are available for selling a business. But understand this: if we do our job correctly, rare is the M&A deal where a buyer and seller are left with a menu of suitable options to choose from. To the contrary; if we spend the time necessary to uncover and understand our clients' non-tax and tax goals, we will typically find that choosing an ideal transaction structure is largely a process of elimination, and when the dust settles, there will often be only one option that works.

To unearth the best fitting alternative, however, we must learn what our client wants out of the transaction. No stone should go unturned, for there is no detail too small or seemingly irrelevant to potentially help us either 1) eliminate a structuring alternative, or 2) zero in on the proper transaction form. For example:

Does our selling client want to immediately retire and live off his windfall? If so, he will require cash in the deal. As we will see below, this greatly restricts the ability to use the tax-free reorganization provisions.

What type of assets does our client's business own? If they are contracts and licenses, are they transferable? If not, an asset sale may be out of the question.

Does the client possess a corporate net operating loss carryforward that may be used to offset any corporate level gain recognized in the deal? If so, the client may be indifferent to the normally punishing ramifications (to be revealed below) of an asset sale.

The more we know about our client, the more we can narrow down the list of structuring options. This is precisely why tax advisors should think better of deferring M&A planning to attorneys – no one is more intimate with our clients' goals and tax history like we are, and for that reason, we should be heavily involved in all M&A structuring.

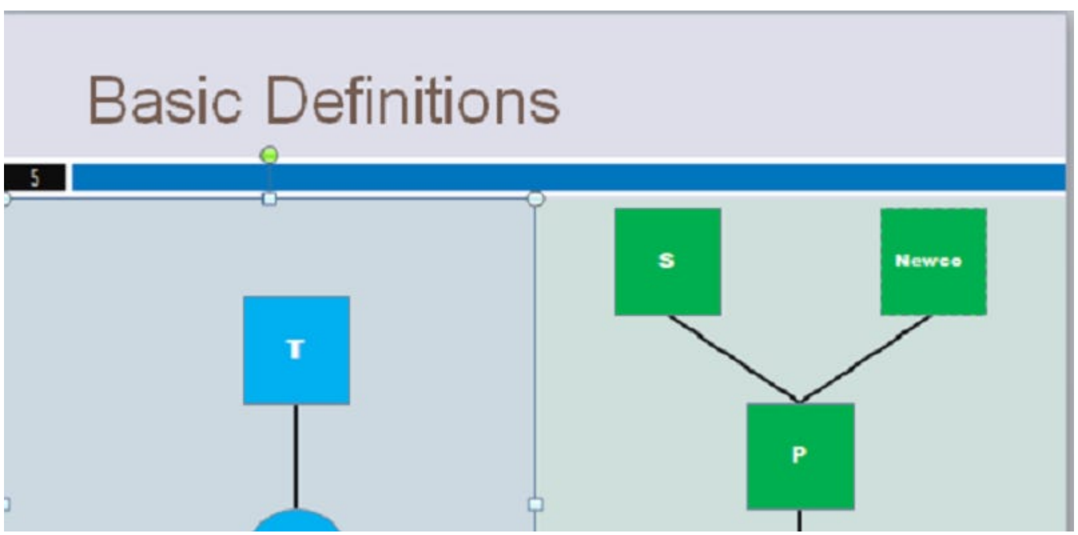
But before we can add value, we have to have a solid understanding of the structuring alternatives that exist, the pros and cons of each, and the varying tax consequences of those alternatives. And by the time Part II of this Tax Geek Tuesday is complete, I'd like to think we'll accomplish just that.

Definitions

Before we move forward, we must pause a moment to establish some vernacular. All M&A deals feature the same basic players, and for our purposes today and in Part II, we will use the following definitions:

- T is the target corporation; the one being acquired. For our purposes, T is a C corporation.
- A is an individual who owns 100% of the outstanding stock of T.
- P is the purchasing, acquiring entity, either directly or through a subsidiary. Both P and any such subsidiary will be a C corporation.
- Newco is a subsidiary of P and the purchasing or acquiring entity (rather than P) where the acquisition of T is made by a newly formed subsidiary. Newco is a C corporation.
- S is a subsidiary of P and the purchasing or acquiring entity (rather than P) where the acquisition of T is made by an existing subsidiary. S is a C corporation.

It looks like so:



(As an aside, don't tell me my charts are upside down. Maybe YOUR CHARTS are upside down. Have you ever thought of that?)

You may be wondering why all of the players are C corporations. Does it matter in an M&A deal? The answer is no. And yes.

In Part I, we will be focusing on *taxable transactions* in which the chosen structure does not meet the definition of one of the tax-free reorganizations defined in Section 368. For taxable transactions, it generally doesn't matter if the buyer or target is a C corporation, S corporation or partnership; any type of entity can enter into a taxable asset sale, and any type of entity can have its ownership interests sold. Of course, there are ancillary consequences specific to an entity choice – for example:

- The sale of S corporation or partnership assets will only be subject to a single level of taxation, while the sale of C corporation assets will be subject to double taxation (more on this later),
- The purchase of the stock of an S corporation by an ineligible shareholder will terminate the S election, and

- The sale of the stock in a C or S corporation will generate capital gain, while the sale of the interests in a partnership may give rise to ordinary income attributable to certain “hot assets.”

Despite these variances, the fact remains that any type of entity can participate in a taxable transaction, either as a buyer or a target.

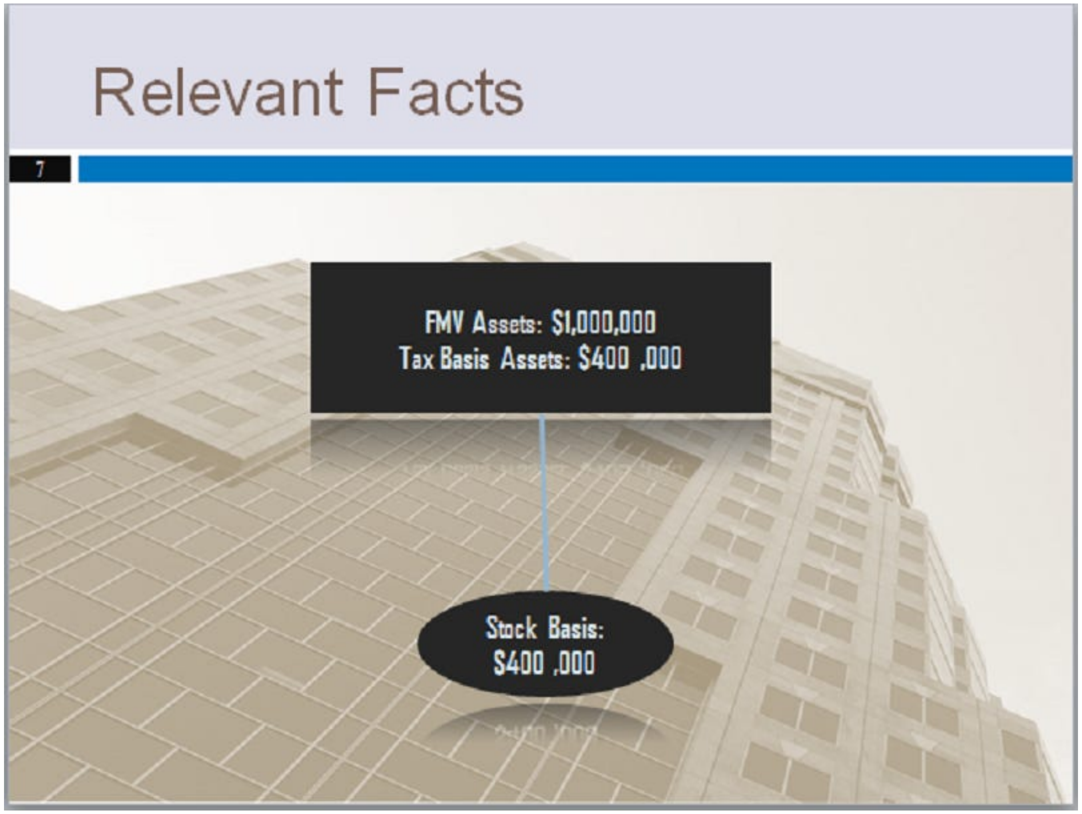
So why use all C corporations in today's discussion? Because when we get to Part II, we’ll be focusing on tax-free reorganizations. And in order to use the tax-free reorganization provisions of Section 368, all the players must qualify as “parties to the reorganization,” which are limited to corporations. Thus, partnerships may not use *any* of the Section 368 reorganizations.

While the tax-free reorganization provisions are not limited to C corporations – they can be used by both S corporation buyers and targets – for our purposes, I believe it’s more illustrative to show the difference between the various options if we use C corporations – with their double level of taxation – as opposed to S corporations. So that’s what we’ll do. And since we'll be using C corporations in Part II, we may as well just start with them now.

One last thing before we start crunching numbers – while we will be discussing the non-tax and tax consequences to both the seller and buyer, I find it helpful if we look through the eyes of the *seller*. It is the seller who bears the more immediate tax consequences of an M&A deal, and while a corporation may buy several businesses during its life cycle, a client will typically only sell one business in his or her life, and thus the transaction is typically a much more emotionally meaningful event to the seller.**Case Study**

With that out of the way, let's establish a basic fact pattern that we can employ throughout our conversation to drive home the principles of M&A structuring. Let's assume that:

- A, the sole shareholder of T, desires to sell the business of T.
- P is looking to expand into the T line of business and has expressed interest in acquiring T.
- Relevant facts of T include:
    - Fair market value of the TOTAL T assets: $1,000,000
        - Fair market value of the T hard assets: $600,000
        - Fair market value of the T self-created intangible assets, i.e., goodwill: $400,000
    - T's tax basis of its assets: $400,000
    - A's basis in the T stock: $400,000
- Corporate level gain will be taxed at a combined 40% federal and state tax rate.
- Shareholder-level gain will be taxed at a combined 28.8% federal and state tax rate.



When you peel back the complicating layers, all M&A transactions are ultimately variations of the same two fundamental methods for selling a business. Either:

- T sells its assets to P; or
- A sells its T stock to P.

Aside from Section 338(h)(10) transactions – which represent a hybrid of an asset and stock sale and will be discussed later in Part I -- all types of transactions boil down to one of those two options: an asset sale or a stock sale.

Now, this is where you say, “But Tony, I know I've heard people talk about all sorts of fancy ways to transfer a business. For example, can’t T -

- Do a “C” reorganization?
- Merge into P for cash?
- Merge into P in an “A” reorganization?
- Do a forward triangular merger?"

Yes, T can. But guess what? As the discussion today and next week will reveal, *every one* of those options is essentially the same thing: the sale of assets from T to P. Some may be taxable and some tax-free, but if you understand the principles of a straight asset sale, you can make sense of any of the intimidating transaction structures listed above.

The same is true of stock sales. While you may have heard people discussing a “B” reorganization or a “reverse triangular merger," ultimately these are just two fancy ways of saying that A is selling the stock of T to P. **Taxable or Tax-Free Transactions?**

There is only one universal truth in all M&A deals – a client will NEVER approach you about a potential sale of his or her business and say, “I’m OK with paying whatever the tax bill is; just let me know where to send the check.” Rather, the client’s initial marching orders will always be for you to find a way to make the transaction tax-free. As I mentioned above, M&A structuring is a process of elimination. And while a client may ask us to minimize his tax liability, his non-tax goals may force us to quickly and definitively remove any type of tax-free transaction from consideration. How does this work?

As we will discuss in greater detail in Part II, all tax-free reorganizations require the seller to take back stock in the buyer (P) as part of the deal. The amount of stock varies, but even the most liberal tax-free reorganization requires that 40% of the total consideration be paid in P stock. This is a vital consideration, because depending on our client's goals, we may quickly be forced to explain that a tax-free reorganization is simply not a possibility.

For example, if our client is adamant that he wants to cash out of the business and not be stuck holding illiquid P stock, then he simply cannot have it both ways: if he wants all cash, the transaction will not fit within any of the Section 368 provisions, and will be fully taxable. As we will see in Part II, if he is willing to accept part cash and part P stock, the transaction may be partially tax-free if it fits within the ambit of Section 368, and if it doesn't, the entire consideration – both cash and P stock – will once again be taxable. Only if our client is willing to accept *all* P stock in exchange for his business can we structure the deal to be entirely tax free.

Thus, if a client insists on receiving some amount of cash in the deal -- which will almost always be the case -- he's going to have to accept that the transaction will be at least partially taxable to the extent of the cash received. And if he insists on receiving all cash; well, then the transaction will be fully taxable. **Case Study : Taxable Transactions**

For the remainder of Part I, we will focus only on such taxable transactions. To illustrate the options available to A, T and P in consummating a fully taxable transfer of the T business to P, assume the following:

- P will buy the business of T for its $1,000,000 fair market value by paying $1,000,000 in cash.

- No P stock will be issued.

As mentioned above, the use of all cash categorically removes the transaction from any Section 368 consideration, and renders the transaction fully taxable. (As we will discuss in Part II, the same result would occur if either T or P were a partnership rather than a C corporation, because a partnership may not participate in a tax-free reorganization.)

Taxable Transaction: A Tale of Two Differing Goals

Question: If all M&A deals take one of two forms – asset sale or stock sale – why are most sale negotiations long, drawn-out affairs involving nuanced tax projections, multiple document revisions, and heated calls with adversarial attorneys?

The answer lies in the fact that in almost every M&A deal, tax considerations will drive the buyer and seller to adopt opposing positions: the buyer will insist on purchasing assets, while the seller will demand to sell stock.

Non-Tax Considerations

Before we get to the tax motivations of P and S, I've got a public service announcement:

I'm a tax guy. Taxes put food in my kids bellies, and much more importantly, bikes in my garage and skis on my feet. As such, I have a healthy respect for the impact of taxes. When people are looking to buy or sell a business, however, they tend to be *overly* focused on minimizing the resulting tax liability and maximizing the future tax benefits. It's critical that tax advisors make their clients understand that tax considerations should not drive the M&A bus; there are countless non-tax considerations that should be given equal weight. As I've already mentioned and will repeat ad nauseam throughout the remainder of these two parts, M&A structuring is a process of elimination. Any one of the non-tax considerations listed below could play as large a role in dictating the chosen structure as a tax motivation. For example:

- Is P willing to inherit all of T's liabilities, both known and unknown? If so, a stock acquisition is in play. Or would P prefer to pick and choose only those liabilities of T it is willing to expressly assume? In that case, an asset acquisition will have to do.
- Does P want to pay with cash or P stock? If only cash, a tax-free reorganization is an impossibility.
- Do some or all of T's shareholders require cash – as opposed to P stock – for their T stock? Once again, if so, kiss a tax-free reorganization good-bye.
- Can P and T get shareholder approval for a merger of T into P? If not, a merger won't be possible.
- Does T have certain assets (i.e., contracts or licenses) that cannot be transferred to P, so that T must maintain its separate legal existence after the transaction and continue to hold its historical assets? If that's the case, an asset sale is out (but perhaps a stock sale with a Section 338(h)(10) election?).

This is why a full understanding of our client's non-tax and tax goals are vital to uncovering the proper structure for a sale of a client's business.

Next, let's examine the tax consequences when A, T and P agree to a taxable transaction – i.e., cash consideration only – but must decide on an asset sale or a stock sale.

What P Wants

If P is to acquire the business of T for $1,000,000 cash, in approximately 99.9% of cases, P will wish to purchase T's <u>assets</u>, rather than the stock of T. Why?

From a non-tax perspective, by purchasing the assets of T rather than its stock, P can pick and choose which liabilities of T it will assume in the transaction. If P were to purchase the stock of T, because T would retain its legal existence as a subsidiary corporation of P, P would indirectly become responsible for all of the liabilities – both known and unknown – of T. Conversely, if P purchases the assets of T, any liability not expressly assumed by P as part of the deal will remain with T.

The real motivation for purchasing T's assets, however, is the tax benefits that inure to P. By purchasing the assets of T, Section 1012 requires P to take a cost basis in the acquired assets equal to P's purchase price. In turn, because the entire business of P is being acquired, Section 1060 requires P to allocate the purchase price among the acquired assets. The purchase price is first allocated to hard assets (i.e., fixed assets) up to the fair market value of those tangible assets., or in our Case Study, $600,000. In doing so, P obtains a "stepped-up" basis in the acquired hard assets, and P may now depreciate this stepped-up basis of $600,000 rather than the historical tax basis of the acquired assets of $400,000.

It gets better. Under Section 1060, if P's purchase price exceeds the fair market value of the hard assets, the remaining purchase price is allocated to intangible assets of T. After 1993, Section 197 permits T to amortize this "acquired Section 197 intangible" over 15 years.

Applying the previous two paragraphs to our case study, if P spends $1,000,000 to purchase the assets of T, it will allocate the first $600,000 of the purchase price among the tangible assets of T, and begin depreciating the $600,000 cost over the applicable useful life of the hard assets. The next $400,000 of the purchase price will be allocated to the intangible goodwill of T, and P will begin amortizing the $400,000 cost of the acquired goodwill over 15 years beginning with the month of acquisition. Through these depreciation and amortization deductions, P will recover the entire $1,000,000 it spent to acquire the assets of T in the form of depreciation and amortization deductions over a period ranging from three to 39 years.

This benefit becomes dramatic when compared with the option of a stock purchase. If P acquires the *stock* of T, P once again acquires a stepped-up basis under Section 1012, but this time in the acquired stock. The basis of T's underlying assets remains unchanged, and T must continue along its existing depreciation schedule.

Making matters worse, stock basis, unlike the basis of machinery, furniture, a building or even intangible assets acquired under Section 197, is *not* depreciable or amortizable. Instead, P simply continues to hold a $1,000,000 basis in the T stock, and will not receive any benefit from that basis until P eventually disposes of the stock. Thus, unlike an asset acquisition, P receives no immediate benefit from its purchase price, making a stock acquisition wholly unattractive from a tax perspective.

What T Wants

T, generally unconcerned with the desires of P, will have its own motivations in transferring its business to P. Unfortunately, in approximately 99.9% of transactions, T's motivations will directly contradict those of P.

From a non-tax perspective, the T shareholders will wish to sell the T stock rather than its assets so that they may relieve themselves of all of T's liabilities – both known and unknown. Because T will remain intact, T retains labile for all of its debts. And because after the transaction P will own all the stock of T, P becomes indirectly liable for all the T liabilities.

While liability protection is usually enough to encourage a seller to seek a stock sale, it is the tax motivation that will have A begging to sell the T stock, rather than the T assets. Why?

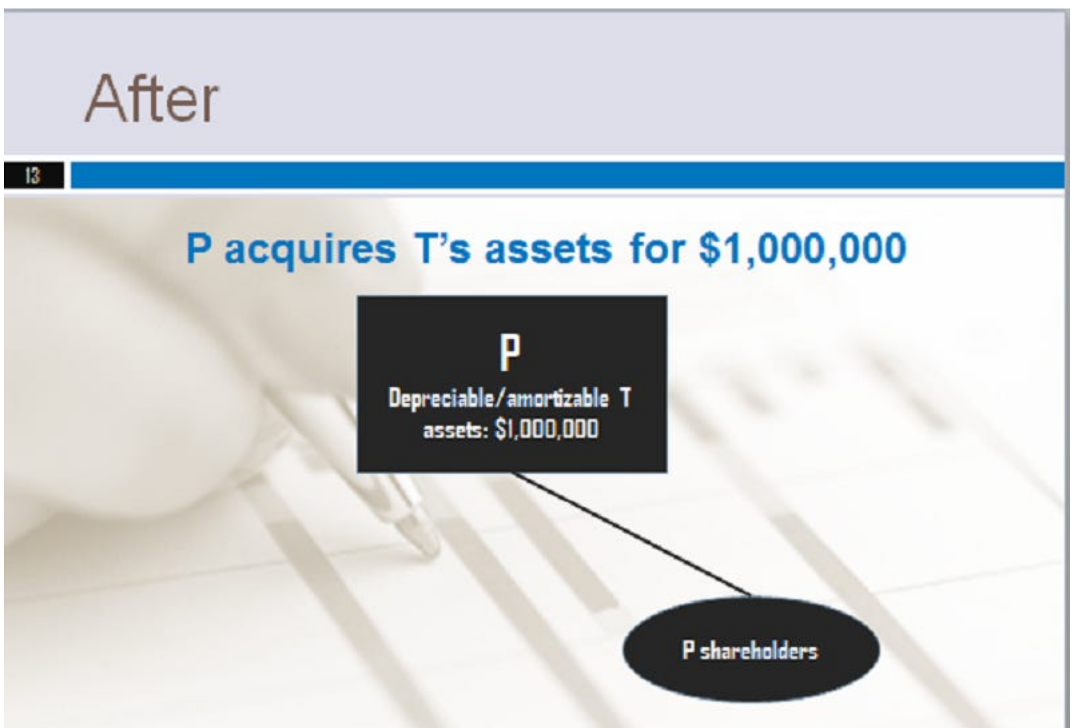
If T sells its assets, as P will desire – T will pay tax on any gain at the corporate-level at a federal rate of 35%. Tack on the state tax rate, and T will be paying damn near 40% on its gain. Then, when T distributes the cash proceeds to A, its shareholder, A will pay tax a second time on those proceeds, either as a current dividend or a liquidation distribution. This is the dreaded "double taxation" that is the hallmark of the subchapter C regime, and as illustrated below, the cost can be extreme.

If A can sell the T stock rather than the T assets, however, there will be no double tax. This is because no tax will be incurred by T at the corporate level; as the transaction takes place directly between A and P. As a result, only A will recognize gain, for the difference between the $1,000,000 purchase price and A's basis in the stock.

Sweetening the pot further, A's single level of gain will be subject to the preferential tax rates afforded long-term capital gain, which reach a federal maximum of 23.8% under current law. **Tax Consequences: Asset Sale**

Let's assume P wins the battle of the attorneys and A agrees to an asset sale. What are the consequences to A, T and P?

First, the transaction will look as follows:



General Tax Consequences of Asset Sale:

- Gain: T recognizes full gain or loss on the sale of its assets. The amount realized is $1,000,000. If T liquidates or distributes the proceeds, A recognizes capital gain or dividend income.
- Tax Rate: Corporate rate of 40% (blended federal and state) on corporate level gain; long-term capital gain rate of 28.8% (blended federal and state rate) on individual liquidation gain.
- Installment Sale: T can use the installment method on qualifying assets.
- P’s Basis: P taxes a basis in T’s assets equal to the purchase price paid by P of $1,000,000 (cash plus any liabilities expressly assumed).
- T’s NOLs: T can use its NOLs to offset any corporate level gain. Any remaining NOL or other attributes stay with T; they do NOT carry over to P.
- T’s liabilities: P can pick and choose the liabilities it wants to assume
- Tax year: T’s tax year does not end unless it chooses to liquidate.

T's Consequences

In the absence of a corporate net operating loss, the tax implications of an assets sale by T are painful. Using our facts:

- T recognizes $600,000 of gain taxed at 40% on the sale of its assets, resulting in a tax liability of $240,000.

- If T liquidates and distributes the after-tax cash of $760,000 to A, A will recognize a $360,000 gain on liquidation and an additional tax of $103,000 at a blended federal and state rate of 28.8%.

- A's after-tax cash received is thus $657,000 ($1,000,000 - $240,000 - $103,000).

- T is not required to close its tax year unless it liquidates.

- T's NOLs do NOT go to P.

- P takes a stepped-up basis of $1,000,000 in the T assets received, which it depreciates/amortizes.

In picture form:

Tax Consequences of Asset Sale

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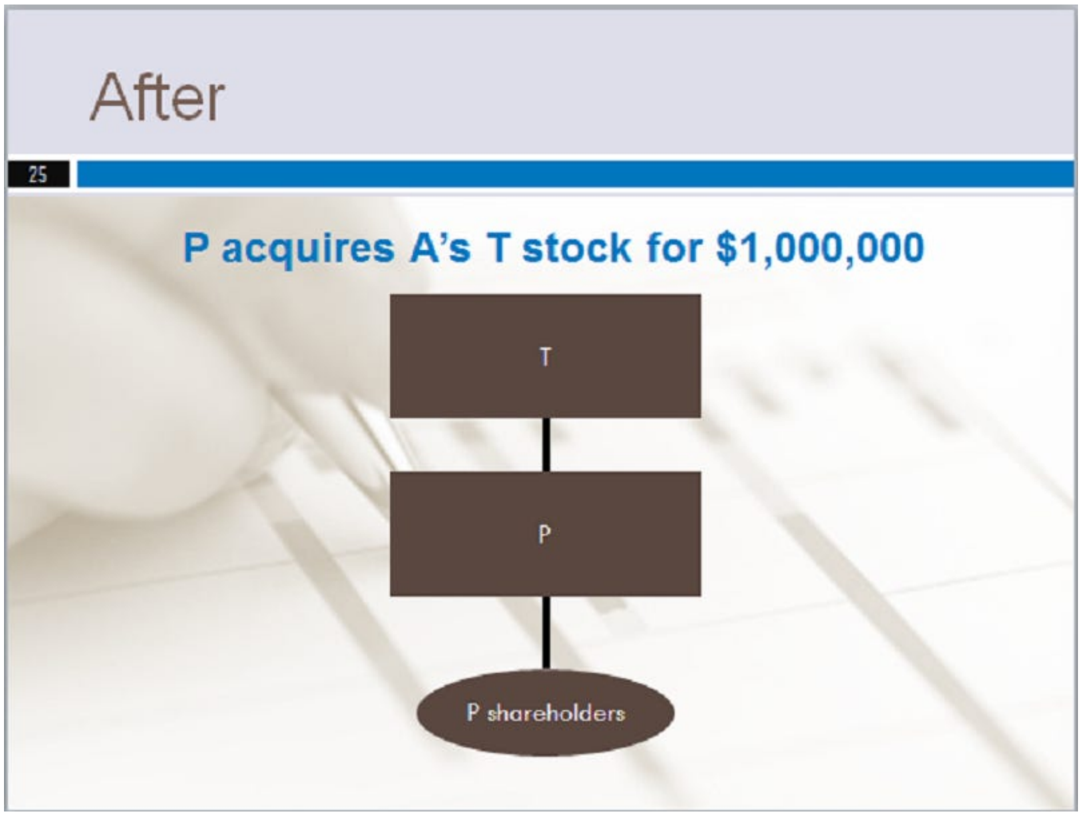
Gain to T	
Amount Realized:	$1,000,000
Tax Basis:	($400,000)
Gain	$600,000

Tax rate (fed and state)	40%
Tax due:	$240,000

That's a pretty steep tax price to pay on a $1,000,000 sale. As a result, A will be adamant in his desire to sell the T stock. Let's see what happens if he's successful.

Tax Consequences: Stock Sale

If A sells all of the T stock to P, the before and after of the transaction looks like so:



You will notice that the primary non-tax difference between the stock sale and asset sale is that in the stock sale, T remains completely intact; it is merely the *ownership* of T that has changed. Because T retains its legal existence and continues to hold its historical assets, a stock sale is often the only structuring alternative that will work when T has nontransferable assets.

General Tax Consequences, Stock Sale

The primary *tax* difference between the stock sale and asset sale is that the stock sale takes place directly between A -- the individual owner of T -- and P. Because there is no consideration paid from P to T, there is no corporate level gain recognized by T. This is great for A and T, because there is no double taxation; the transaction will only be taxed once, to A on the stock sale, and at a favorable tax rate to boot.

This is not so great for P, however, because by purchasing the stock of T rather than T's assets, it will lose the stepped-up basis in the assets -- and resulting depreciation and amortization deductions -- it would have obtained had it purchased T's assets.

- Gain: Taxed only at the shareholder level. T recognizes no corporate-level gain. The amount realized is $1,000,000, just as it was in an asset sale (because T has no liabilities, the value of its assets is also the value of its stock).

- Tax Rate: This gain is usually long-term capital gain taxed at 28.8%. (blended federal and state)

- Installment Sale: If A receives an installment note instead of cash, A generally can report the gain on the installment method (unless T is traded on an established securities market).

- P’s basis: P does not get a stepped-up basis in T’s assets. T’s basis in its assets remains unchanged after the acquisition. P’s basis in the T stock is equal to the purchase price plus P’s expenses of effectuating the acquisition.

- T’s NOLs: Because T retains its legal existence and is now owned by P, T’s tax attributes remain intact (NOLs, etc). However, they will be limited in their usefulness under Section 382, which generally prohibits a corporation from "trafficking" in NOLs by imposing an annual limitation on the use of NOLs acquired as part of a stock purchase. (another Tax Geek Tuesday topic, perhaps?)

- T’s liabilities: P becomes indirectly responsible for all of T’s disclosed and undisclosed liabilities.

One additional note of interest for tax preparers: T’s tax year generally does not close on the acquisition of its stock UNLESS it is joining or leaving a consolidated group filing a consolidated return. In that case, T must file a short-period return ending on the date of acquisition under Treas. Reg. Section 1.1502-76. Preparers often make the mistake of believing that just because ownership of a corporation has changed hands, it ends the corporation's tax year. That is not so.

As we will see next, it is the single level of taxation that is most meaningful to A and T, as the tax burden is reduced dramatically.

T's Consequences

- T recognizes no gain or loss.
- A recognizes $600,000 of gain ($1,000,000 purchase price less $400,000 stock basis).
- A pays $173,000 of federal and state tax, walking away with $827,000 of after-tax cash. Compare this with the $657,000 A walked away with in an asset sale!
- T becomes a subsidiary of P. If P and T file a consolidated return, T must file a short-period return ending on the date of acquisition.
- T's tax basis in its assets remains unchanged, and it continues along its old depreciation schedule.
- T's NOLs carry over, but are limited under Section 382 and the SRLY rules (but not both).

In picture form:

Tax Consequences to T Shareholders

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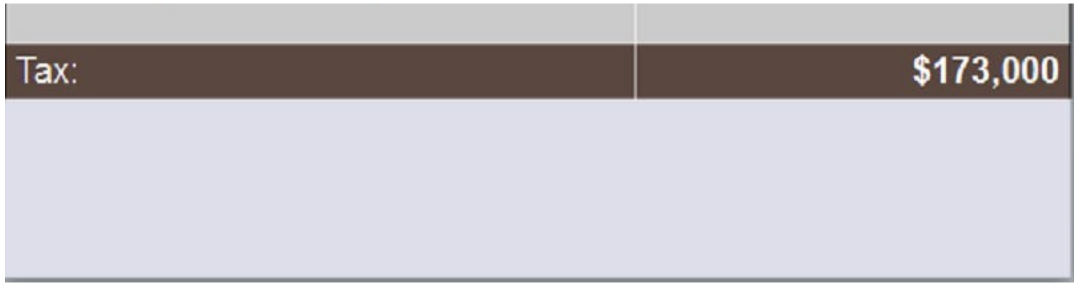
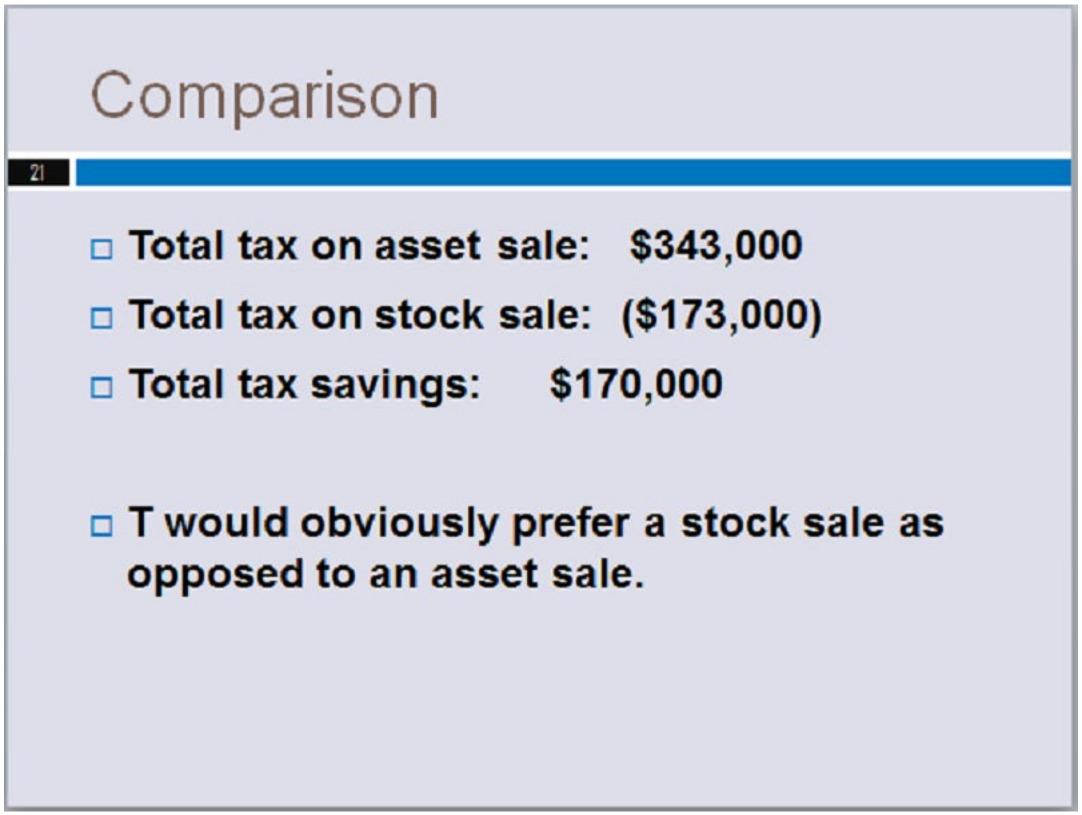
T shareholders sell the stock directly:	
Amount Realized:	$1,000,000
Tax basis	($400,000)
Gain	$600,000
Tax rate (fed and state)	28.8%



Tax:	$173,000

The savings are dramatic for A and T when compared to an asset sale.



Agreeing to Disagree

If P will also desire an asset purchase, and A and T will always prefer a stock sale, how do deals ever get done? Interestingly, it may be either a non-tax or tax consideration that ultimately gets both sides to agree on a structure; one more reason we need to understand every aspect of our clients' goals and tax history.

When Will P Agree To A Stock Purchase?

It is going to be awfully hard to convince P to give up the depreciation and amortization benefits on its purchase price. As a result, P will typically only relent if it has its hand forced. This is most likely to occur when T's assets are nontransferable, such as key contracts or licenses. In that case, P will be required to acquire the stock of T so as to leave the separate legal existence of T -- and T's ownership of its assets -- unchanged.

When Will T Agree to an Asset Sale

As we have seen, the double taxation inherent in a corporate asset sale is prohibitive. But what if T could sell its assets and avoid double taxation? As a C corporation, this can only be accomplished if T has net operating losses that can be used to fully offset the corporate-level gain. If this is the case, T is largely indifferent to an asset sale because the transaction will become equivalent to a stock sale, as A will only pay a single level of tax when T either distributes the sale proceeds or liquidates. Improving matters even more for A and T, because P is typically so desirous of the basis step-up that is the result of an asset purchase, a T with an NOL that agrees to an asset sale can typically negotiate a higher purchase price than if T insists on a stock sale. Because T's NOL will wipe out the corporate-level gain, A walks away with more cash!

Taxable Merger

T and P may decide that it easiest to combine businesses by having T merge into P under state law, with P surviving. In a merger, the assets and liabilities of T transfer over to P by operation of law. Cash goes from P to T, and then out to the T shareholders in liquidation of T. The liquidation is required because as the target in the merger, T must go out of existence.

Question: Does the transaction described above sound like an assets sale or a stock sale? It sounds *exactly* like an asset sale, and that's how the IRS will treat a taxable merger. T will recognize corporate-level gain on the transfer of its assets to P in exchange for cash, and then A will recognize capital gain on the receipt of the proceeds as part of the required liquidation of T. In fact, the only difference between a taxable merger and taxable asset sale is that in a taxable asset sale, T has the option to continue in its existence, whereas in a merger, T must liquidate under operation of law.

Can P Ever Have It Both Ways?

P wants an asset step-up; this much we've established. But T may have nontransferable assets that make an asset sale impossible. Are there any options that may satisfy P's seemingly conflicting goals of acquiring assets but not terminating T's contracts or licenses?

There is, and it's found within Section 338(h)(10). In order to use this provision P must purchase at least 80% of the stock of T for cash over a one-year period. When P purchases the stock, T retains its legal existence and preserves the continuation of T's key contracts and licenses. But that does nothing to help P achieve a step-up in the acquired assets.

If both P and T agree to make a Section 338(h)(10) election, however, a fiction is created whereby for tax purposes only>

- T will be treated as if it sold its assets to a New T, which is owned by P.
- The stock sale by A will be disregarded.
- The cash proceeds received by A will be treated as if they were received by T in exchange for its assets, and then distributed to A in a required liquidation of T.

This tax fiction accomplishes the goal of granting P the desired stepped-up basis in the T assets. Upon the deemed sale of assets from T to New T, New T will take a stepped-up basis under Sections 1012 and 1060 just as any buyer would in an asset sale, and because P is the owner of New T, P will benefit from the step up.

There are downsides to a Section 338(h)(10) election to T, however. The tax fiction of the deemed asset sale from T to New T applies to T as well, meaning T must recognize gain on the asset sale, even though for legal purposes, A has sold the T stock. Section 338(h)(10) softens the blow by providing that while T must recognize gain as if it truly sold its assets, the stock sale by A will be disregarded.

So what's in it for A and T? If T is going to be forced to recognize corporate-level gain, which we've established is a rather large deterrent due to the high corporate-level tax, why would T agree to an election? The only reason T would do it is if it was indifferent to an asset sale, because either:

- Its inside basis of its assets is larger than A's outside basis in the T stock, or more likely,
- T has a net operating loss that can be used to offset the corporate-level gain.

Furthermore, Section 338(h)(10) tries to protect T from itself by providing that an election may only be made in situations where double taxation is an impossibility. This is accomplished by limiting a Section 338(h)(10) election to three types of targets:

1. S corporations. Because S corporation gain flows through to the shareholders and increases the shareholder's stock basis under Section 1367, no second level of taxation will occur when the S corporation liquidates after the deemed asset sale (which is required as part of the election).
2. Subsidiary members of a consolidated group. Once again, only a single level of taxation will occur, because upon the required liquidation of the selling target, no gain will be recognized by the parent corporation under Sections 332 and 337.
3. A corporation who is owned more than 80% by another corporation, but does not elect to file consolidated returns. Once again, when the target subsidiary is required to liquidate subsequent to its deemed asset sale, the subsidiary's shareholder corporation will be protected from a second level of gain by virtue of Sections 332 and 337.

Any time one of the qualifying corporations listed above holds nontransferable assets, a tax advisor consider structuring the deal as a stock sale with a Section 338(h)(10) election. By giving the buyer the desired step-up, the seller may be able to negotiate a better purchase price for its stock.

I don't know about you, but I think we've covered enough for one day. Let's reconvene next week and break down the options that exist when A and T are insistent on structuring the deal as a tax-free reorganization, and P is willing to oblige.

got an idea for a future Tax Geek Tuesday topic? Send it along to anitti@withum.com or on twitter @nittigrittytax

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