Investment banking services provided by Grand Avenue Capital will not include legal, accounting or tax advisory work and it is expected that Grand Avenue clients will employ separate legal, accounting and tax advisers in connection with engagements with the firm.

Frequently, the tax ramifications of the sale of stock of C corporations will be an issue for some clients, especially those with fixed asset-rich operations (as manufacturers, for example). In such situations, acquirers will want to structure the acquisition as asset purchase of the target company to step up the depreciated assets to fair market value. The election of Section 338 will be often be utilized in the transaction.

Our firm does **not** give tax advice, but relies on the counsel of the client's tax advisers. The following is an overview, compiled by others, to give a layman's overview of the Section 338 elections and how they are used in M&A transactions.

Section 338 Elections

There are two types of Section 338 elections described below.

General requirements for a Section 338 election:

- A Section 338 election cannot be made in a non-taxable stock deal.
- The buyer must acquire control of the target in a *qualified stock purchase* (QSP), defined as the purchase of at least 80% of the total voting power and value ("vote and value") of the target's stock within twelve consecutive months of the first purchase of such stock. Preferred stock is not included in computing voting power or value. The "acquisition date" is the date on which the 80% threshold is reached.
- The buyer must be a C corporation. For financial sponsors typically organized as LLCs, therefore, the Section 338 election is not usually an option. Individuals and partnerships cannot make a QSP, and are consequently unable to make a 338 election. However, individuals and partnerships can circumvent this restriction by forming a new corporation ("NewCo") to acquire the target's stock.
- Foreign targets are not eligible for the 338(h)(10) election, but are eligible for the 338(g) election.
- Any Section 338 election must be made by the fifteenth day of the ninth month after the month in which 80% control of the target is acquired (within 8.5 months).

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Section 338(h)(10) Election

A buyer is not entitled to a step-up in the tax basis of acquired net assets to fair value (FV) in taxable stock acquisitions but, rather, a carryover basis. However, if an Internal Revenue Code (IRC) Section 338 election is made in connection with a taxable stock sale, the transaction is treated as a hypothetical asset deal for tax purposes, and the buyer's basis is accordingly revalued to reflect the purchase price.

This election applies to acquisitions of *corporate subsidiaries* or *S corporations*. The election is made *jointly* by the acquirer and sellers before the deal is consummated, and the *seller* bears any incremental tax cost from the deemed asset sale.

The depreciation and amortization of all asset write-ups and intangibles, including goodwill, identified in the purchase price allocation then become tax-deductible expenses. Since the stock transaction is treated as an asset deal, IRC Section 197 applies and all intangible assets, including goodwill, recognized in the transaction are thus amortized over 15 years for tax purposes.

The disadvantage of a Section 338 election is that it triggers a taxable gain on the *deemed asset sale*. So, the Section 338 election only makes sense when the present value (PV) of future tax savings from tax-deductible depreciation and amortization expenses exceeds the current tax cost of the step-up. Additionally, a stock deal accompanied by a 338 election is still considered a stock deal for legal purposes, so the buyer inherits all of the target's liabilities. A stock deal maybe preferred by the acquirer, for instance, when the seller has contracts or permits that will not have to be renegotiated in a stock deal.

To qualify for a 338(h)(10) election, the target must be either 1) a U.S. corporate subsidiary of a selling consolidated group or selling affiliate (a parent company) or 2) an S corporation on the acquisition date. In the acquisition of a subsidiary, the *selling group*, rather than the buyer, pays tax on the gain from the deemed sale of the target's assets since the target owned by the selling group. As such, the 338(h)(10) election is made *jointly* by the buyer and seller. Also, the seller will demand a higher purchase price to agree to a 338(h)(10) election as compensation for its tax cost resulting from the election. However, the acquirer will only be able to compensate the seller for its immediate tax cost if the PV of tax savings from the election exceeds the tax cost.

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If the selling group's basis in the target's stock (outside basis) is *less than or equal to* its basis in the target's assets (inside basis), the 338(h)(10) election is always advantageous. However, if the selling group's outside basis is *greater than* its inside basis, as is more often the case, the 338(h)(10) election is only advantageous if the PV of tax savings from the election exceed the incremental tax cost.

Section 338(g) Election

This election applies to acquisitions of *freestanding C corporations*. The election is made *unilaterally* by the acquirer after purchasing stock from the target's shareholders. The *acquirer* generally bears the incremental tax burden from the gain on the deemed sale of the target's assets.

The tax treatment of the target's shareholders is unaffected by a 338(g) election since the deemed asset sale does not occur until *after* the transaction is complete and the selling shareholders have already sold their stock. Therefore, a 338(g) election results in two levels of tax: 1) selling shareholders recognize a taxable gain or loss on the actual stock sale and 2) the target entity recognizes a taxable gain on the deemed asset sale, which usually becomes a liability of the acquiring entity. A 338(g) election may be made unilaterally by the acquirer because only the acquirer is affected by the election.

Even though the 338(g) election results in treatment of a stock acquisition as an asset sale, the buyer assumes a stepped-up tax basis in both the acquired net assets *and* the target's stock. This is because taxes are paid by both the buyer and the target's shareholders on the deemed asset sale and the stock sale, respectively.

Section 338(g) elections are rare because the current tax cost of the deemed asset sale usually exceeds the PV of tax savings from the tax basis step-up. Generally, a 338(g) election is only advantageous when the target has substantial net operating loss (NOL) or tax credit carryovers that the *acquirer* can use to offset any taxable gain triggered by the deemed asset sale. These tax attributes are available only for immediate use and do not survive the acquisition if the target is liquidated.

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Section 338(h)(10) elections are more common than 338(g) elections for two reasons:

- The taxable gain on the deemed sale of the target subsidiary's assets may be offset by any losses in or tax attributes (e.g. NOLs) of other subsidiaries of the selling group (parent company).
- The proceeds from the liquidation of a subsidiary are tax-free to the subsidiary's shareholders (the parent company) under IRC Section 332, resulting in a single level of tax.

So, no gain or loss is recognized by the selling group on its sale of the target subsidiary's stock, but the target will recognize a gain as if it had sold all of its assets. The tax on this gain is generally paid by the parent (which explains why the 338(h)(10) election is made jointly). If the parent company then distributes the after-tax liquidation proceeds to its shareholders, the parent shareholders are subject to a dividend tax on the distribution.

Section 338(h)(10) elections may also be advantageous in the acquisition of S corporations because S corporations are not subject to corporate level tax. Note that since S corporations can have no corporate shareholders, the QSP (Qualified Stock Purchase) does not apply because any stock purchase before the acquisition date would disqualify the target from being a S corporation.

The target's tax attributes can be used by the *selling group* to immediately offset any taxable gain on the deemed asset sale, but any remaining tax attributes vanish if the target is liquidated. Since the tax attributes are used by the selling group, they do not transfer to the acquirer as in a 338(g) election.

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Aggregate Deemed Sale Price

When a Section 338(g) election is made in connection with a taxable stock acquisition, the amount for which the target is deemed to have sold its gross assets is known as the *aggregate deemed sale price* (ADSP), which is calculated as:

$$\mathbf{ADSP = G + L + \boldsymbol{t} \times (ADSP - B - N)}$$

where:

- G = grossed-up purchase price of target's stock less selling costs
- L = target's liabilities assumed by acquirer
- t = corporate tax rate
- B = target's tax basis in its gross assets
- N = target's tax attributes (e.g. NOLs) that can be used by the acquirer to offset any taxable gain

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"Grossed-up" means that the purchase price is adjusted to reflect the sale of 100% of the target's assets. For example, if the buyer acquires 80% of the target's stock for $800, the grossed-up purchase price would be $800 ÷ 80% = $1,000. Note that the quantity $t \times (\text{ADSP} - \text{B} - \text{N})$ is the tax liability arising from the deemed asset sale and assumed by the acquirer.

If a Section 338(h)(10) election is made in which the selling group, rather than the acquirer, assumes the tax cost of the deemed asset sale, the ADSP is simply:

ADSP = G + L

The ADSP becomes the buyer's new tax basis in the target's assets.

Comparison of Taxable Deal Structures

The following example shows how a Section 338(g) election compares with other taxable deal structures in a hypothetical acquisition of a freestanding C corporation:

Note that the tax cost to the acquirer of a 338(g) election exceeds the PV of tax savings from such an election, making the 338(g) election undesirable in this example. Also, note that the buyer receives a stepped-up basis in both the acquired assets and the target's stock when a 338(g) election is made.

Transaction Assumptions

Stock Purchase Price	$1,700.0	Corporate Tax Rate	35.0%
Asset Purchase Price	2,000.0	Capital Gains Tax Rate	15.0%
ADSP	2,000.0	Discount Rate	10.0%
Target Shareholders' Outside Stock Basis	300.0	Amort./Depr. Period	8
Target's Inside Asset Basis	400.0		

	Stock Deal		Asset Deal	
	No 338(g) Election	338(g) Election	No Liquidation	Liquidation
Acquirer Entity Consequences:				
Purchase Price	$1,700.0	$1,700.0	$2,000.0	$2,000.0
Plus: Tax Cost	0.0	560.0	0.0	0.0
Less: PV of Tax Savings	0.0	(373.4)	(373.4)	(373.4)
Adjusted Cost	$1,700.0	$1,886.6	$1,626.6	$1,626.6
Tax Basis in Target's Assets	$400	$2,000	$2,000	$2,000
Tax Basis in Target's Stock	$1,700	$1,700	NA	NA
Target Entity Consequences:				
Cash Proceeds	$0.0	$0.0	$2,000.0	$2,000.0
Less: Tax Cost	0.0	0.0	(560.0)	(560.0)
Less: Liquidating Dividend	NA	NA	NA	(1,440.0)
After-Tax Proceeds	$0.0	$0.0	$1,440.0	$0.0
Target Shareholder Consequences:				
Cash Proceeds	$1,700.0	$1,700.0	NA	$1,440.0
Less: Shareholder Taxes	(210.0)	(210.0)	NA	(171.0)
After-Tax Proceeds	$1,490.0	$1,490.0	NA	$1,269.0
Total Tax Cost:	$210.0	$770.0	$560.0	$731.0

Example – Stock Acquisition With and Without a 338(h)(10) Election

Tango corporation is a wholly owned subsidiary of Sierra corporation. Sierra's basis in Tango's stock is $200 and Tango's inside asset basis is $200. Also, Sierra has NOLs of $500, of which $70 are attributable to Tango. Tango has $150 of liabilities. Alpha corporation has offered to pay $600 to acquire the all of the outstanding stock of Tango. The corporate tax rate is 35%.

(A) If Alpha purchases the stock of Tango without a Section 338 election, what are the tax consequences to Sierra?

Sierra realizes a gain on the stock sale of $600 – $200 = $400. It cannot use the $70 of NOLs attributable to Tango to offset this gain, as they are lost to Alpha in the deal. However, Sierra can use $400 of its other NOLs to completely offset the gain and reduce its taxable income to zero. Therefore, Sierra's after-tax proceeds are $600 – 35% × $0 = $600, and Sierra is left with $500 – $70 – $400 = $30 of NOLs.

(B) What are the tax consequences to Alpha in this scenario?

Alpha will assume a stepped-up basis in Tango's stock of $600, and a carryover basis in Tango's assets of $300. Tango's $70 of NOLs carry over to Alpha, but are subject to limitation under Section 382.

(C) If Alpha instead purchases the stock of Tango with a Section 338 election, what are the tax consequences to Sierra?

Sierra will not recognize a gain on the sale of Tango stock, but Tango will recognize a gain on the deemed asset sale equal to the ADSP less Tango's inside asset basis ($200). If we assume that Sierra bears the tax burden of the deemed asset sale, as would likely be the case in a 338(h)(10) stock sale, the ADSP equals the grossed-up purchase price ($600) plus the amount of liabilities assumed by the acquirer ($150). Sierra's taxable gain is $600 + $150 – $200 = $550. But since the deemed asset sale occurs while Tango is still a consolidated subsidiary of Sierra, Sierra can use *all* of its NOLs ($500), including those attributable to Tango, to offset all but $50 of the gain. Therefore, Sierra's after-tax proceeds are $600 – 35% × $50 = $582.5.

With a 338(h)(10) election, Sierra will have after-tax cash proceeds that are lower by $17.5, but post-transaction NOLs that are higher by $20. Sierra will only favor a 338(h)(10) election if the PV of tax savings from the incremental post-transaction NOLs adequately compensate it for the lower after-tax proceeds. In this case, even if all of the incremental $20 of NOLs were used immediately, they would generate just 35% × $20 = $7 in tax savings. So, Sierra will clearly *not* agree to a 338(h)(10) election unless Alpha offers a higher purchase price.

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(D) What are the tax consequences to Alpha in this scenario?

Alpha assumes a stepped-up outside basis in Tango's stock of $600, *and* a stepped-up inside basis in Tango's assets equal to the ADSP. Tango's NOLs do not carry over to Alpha, since they are used by Sierra. The depreciation and amortization of asset write-ups and intangibles, including goodwill, recognized in the purchase price allocation are tax-deductible expenses. Under Section 197, all intangibles thus recognized are amortized over 15 years.

So, even though Alpha loses the PV of tax savings from Tango's NOLs by agreeing to a 338(h)(10) election, it gains the PV of tax savings from stepped-up basis in Tango's assets. Since Tango's NOLs would be subject to limitation under Section 382 anyway, their loss is not a significant disadvantage to Alpha unless the NOLs are substantial. However, as the portion of the step-up allocated to non-depreciable or slowly depreciating assets increases, the PV of tax savings from the step-up decreases and the 338(h)(10) election loses its appeal. Whether or not Alpha prefers a 338(h)(10) election depends on the how much more it must pay Sierra to agree to the election and the relative magnitudes of the PVs of tax savings from Tango's NOLs and the step-up.

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