



The Value of a Stepped-Up Tax Basis

When it comes to making an acquisition, stock and asset purchases have their advantages and disadvantages but there might be a way to combine the best of both worlds.

Buying a target corporation's stock is a relatively simple legal step. The buyer gains control of the target's assets with no hassle because it will own the other corporation's stock.

A taxable asset purchase, on the other hand, requires transferring the legal title to each asset the buyer acquires. If the target has a multitude of assets, the time and money spent can quickly mount up. In addition, with a direct asset purchase, you may not be able to obtain legal ownership of valuable non-transferable assets such as favorable building leases, licenses or contracts. That could be a deal breaker.

However, when it comes to the tax consequences, a direct asset purchase generally is the better deal for the buyer, providing a big tax break unavailable in a stock purchase. With an asset purchase, the buyer can step up the tax basis on the target corporation's appreciated assets to reflect the purchase price. This provides two advantages:

- Little or no income will be recognized when the target collects existing receivables and sells inventories.
- The buyer will get bigger depreciation and amortization deductions for the cost of appreciated buildings, equipment, and intangibles.

So, ultimately, the choice boils down to whether the buyer wants to purchase assets and deal with the legal hassles involved or buy stock and forego the stepped-up tax basis advantage.

A Three-Step Process

There are three steps to making a Section 338(h)(10) election:

1. A corporation buys at least 80 percent of the target C or S corporation's stock.
2. The two corporations join to make the special election so the transaction becomes, in effect, an asset purchase deal for federal income tax purposes.
3. Come tax time, the buyer takes the stepped-up tax basis advantage.

You generally need an appraisal to allocate the purchase price to the specific assets in order to establish their initial tax basis. Your tax professional should work closely with the appraiser to ensure the best tax outcome for your business.

Reasons for Making a Special Election

- The buyer wants a stepped-up tax basis for the appreciated assets owned by the target corporation.
- The seller insists on a Section 338(h)(10) election to avoid double taxation.
- The buyer doesn't want the expense and hassle of transferring legal ownership of target's assets.
- The target corporation owns valuable non-transferable assets that could not be acquired in an asset purchase.
- The buyer is willing and able to accept responsibility for the target corporation's liabilities.

Well, the buyer might be able to have it both ways.

A corporation can make an election to treat a qualifying stock purchase as an asset purchase for federal income tax purposes. When the election is made, under Section 338 of the Internal Revenue Code, the IRS treats the transaction as if the buyer was purchasing the target's assets for an amount based on the stock purchase price. So the buyer winds up with the important tax basis step-up advantage.

For state law legal purposes, the transaction is still treated as a normal stock purchase and the target corporation continues its state-law legal existence after the sale. Only the tax results are changed by making the Section 338 election.

More specifically, there are two types of Section 338 elections:

1. A regular Section 338 election can be made anytime on a qualifying purchase of 80 percent or more of the target corporation's stock. The target and the buyer can be either a C corporation or an S corporation. Generally, a regular Section 338 election is inadvisable because it can generate double taxation — once at the target corporation level for the deemed asset sale and again at the shareholder level for the actual sale of target corporation stock. However, if the target has unused net operating losses or capital losses, they can be used to offset the corporation's income and gains from the deemed asset sale.

2. A special 338(h)(10) election can be made for a qualifying purchase of a target S corporation or a C corporation's stock when the stock is owned by another corporation. The special election cannot be made if individuals own the C corporation's stock. The special election avoids double taxation because the IRS takes into account only the deemed asset sale and ignores the stock sale for tax purposes.

After the purchase with either election, the buyer owns the stock but the target remains a legal corporate entity. Any unknown or contingent liabilities remain locked inside the target corporation.

With a stock purchase, the buyer generally becomes responsible for the target's known and unknown liabilities once it takes legal ownership. Consult with a mergers & acquisitions professional to conduct a detailed due diligence investigation of the target to avoid unpleasant surprises about liabilities.

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