
Deal Structuring: The Magic of IRC Section 338

M&A Source
Thursday March 19, 2009, Webinar

Presented By:

Monty W. Walker CPA, CBI , BCB
Walker Advisory Associates
www.waa-online.com
Ph # (940) 322-5086
mwalker@waa-online.com

FEDERAL TAX ISSUES

Internal Revenue Code Section 338

- Section 338 permits a corporation that has purchased a controlling interest in another corporation, through a qualified stock purchase, to elect to have the acquisition of the target's stock treated as a purchase of assets rather than stock.

- This is known as a:

Deemed Asset Sale

Code Section 338 Election Options

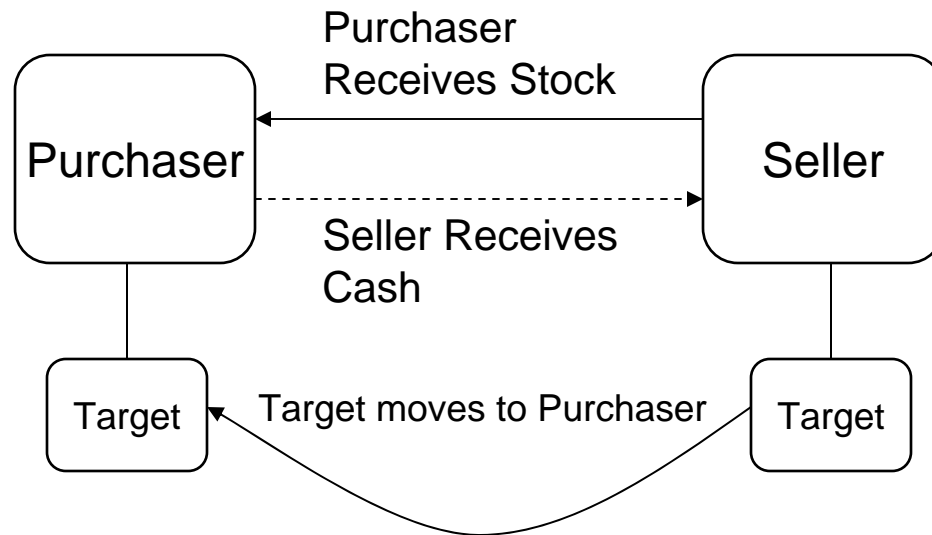
- Section 338(g) Election is considered a regular election
- Section 338(h)(10) Election is considered an alternative election.

Code Section 338 Election Restrictions

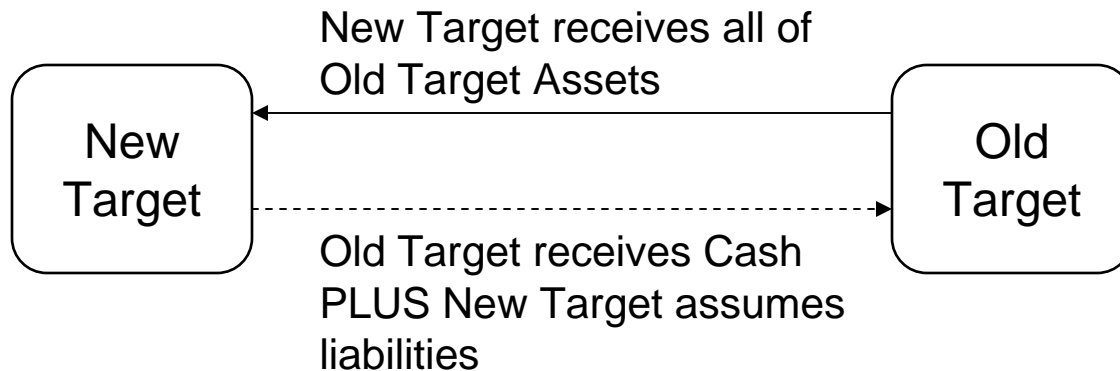
- Entity being sold must be a corporation
- Purchaser must be another corporation
- An Individual, partnership, LLC taxed as a partnership, trust, etc... cannot be the party that purchases the Selling Corporation.

Section 338(g) Transaction

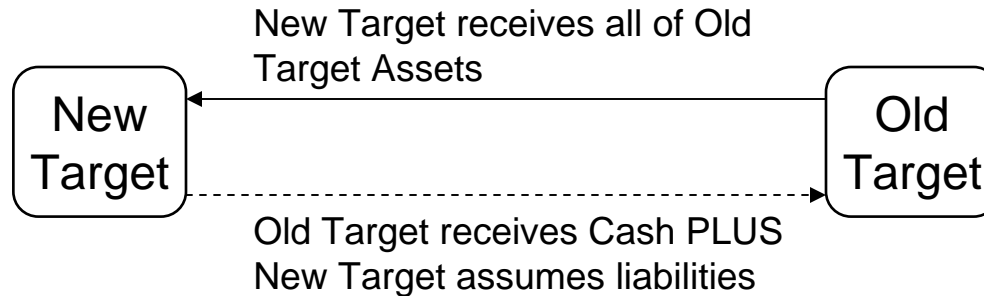
Actual:



Deemed Additional Transaction:

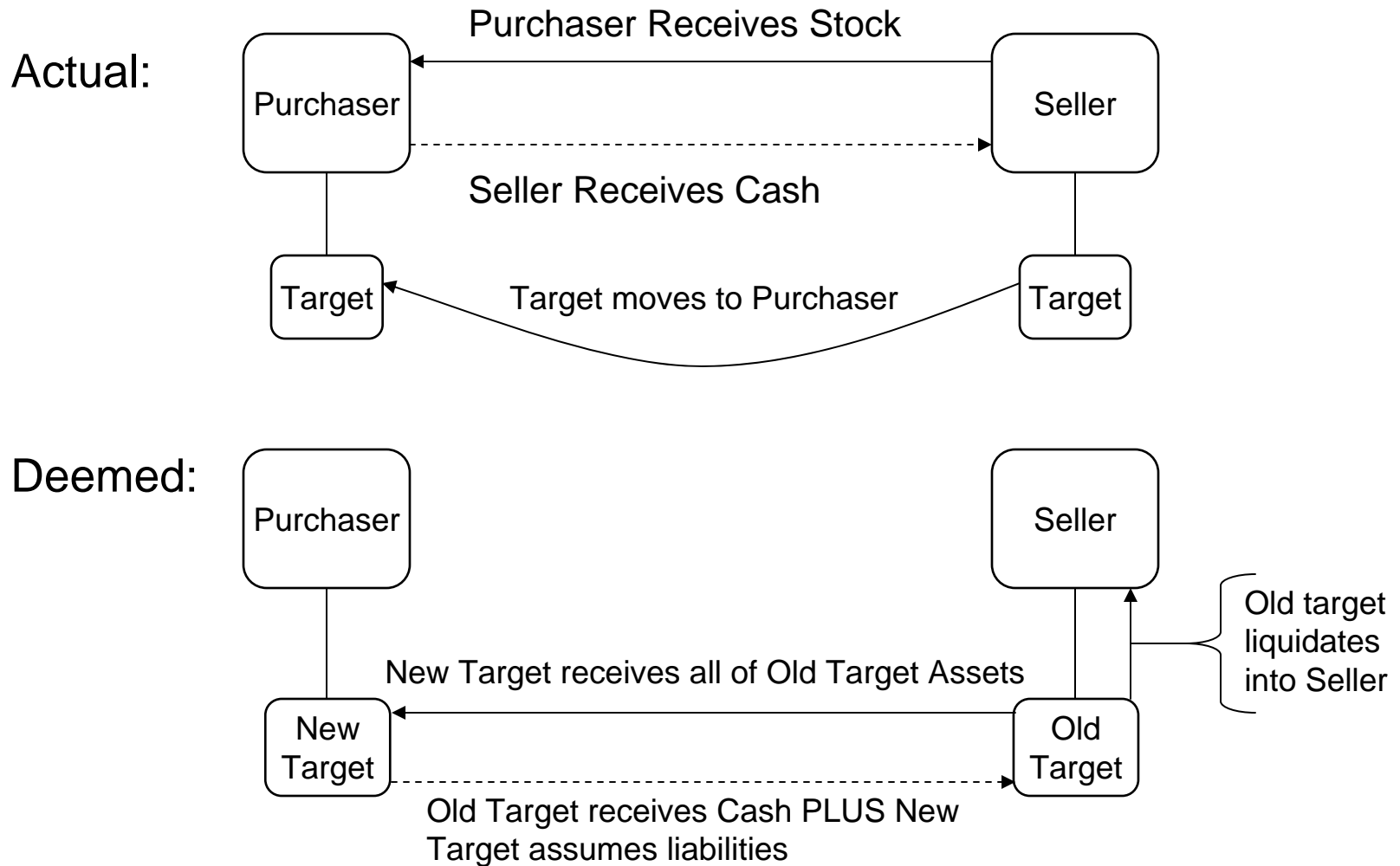


Impact of Section 338(g) Election

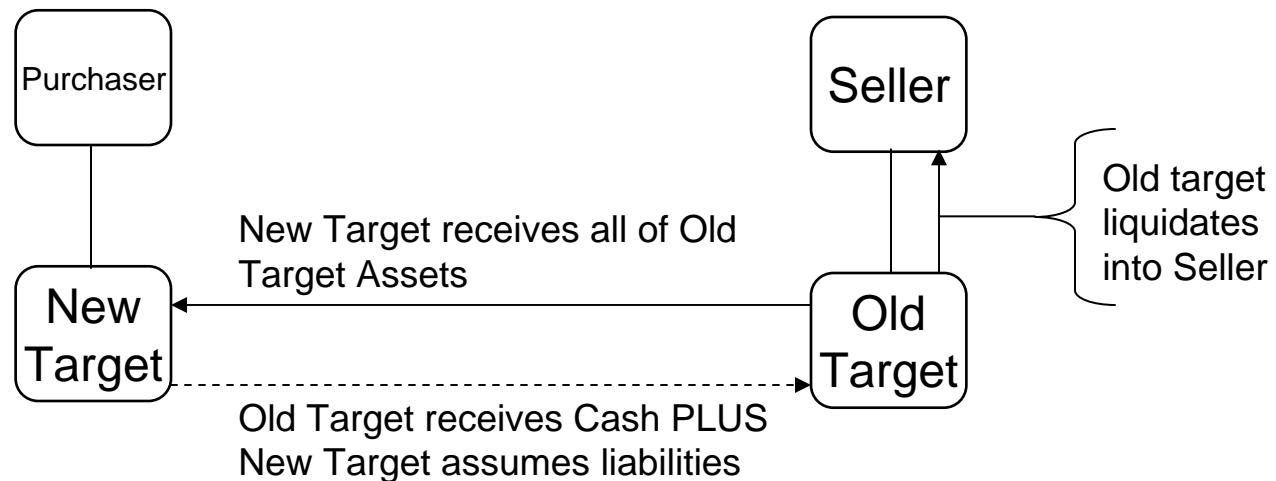


- Target is treated as having sold its assets for Fair Market Value
- Target's unused and remaining tax attributes disappear
- Target's Shareholders treated as selling Target Stock
- Target's Shareholders liable for tax on gain from stock sale
- Purchaser is liable for tax on gain from deemed asset sale

Section 338(h)(10) Transaction



Impact of Section 338(h)(10) Election



- Target's shareholder's stock sale is disregarded
- Target is treated as selling assets and distributing proceeds in a complete liquidation
- Target's shareholders are liable for tax on gain from deemed asset sale
- Purchaser receives step-up in basis on Target's assets
- Target's unused tax attributes carry over to selling shareholder if member of consolidated filing group

Case Review

- Management buyout of “S” Corporation
- Price of \$1.5 million plus assumption of \$225K of liabilities. Seller keeps AR and AP
- Seller would stay post close, buyer wanted stock purchase for continuity
- Seller’s CPA suggested stock sale, 50% of price as deferred compensation to seller – nixed by bank (thank goodness!)
- What to do?
- Solution: Use Code Section 338(h)(10) Election

Case Review - continued

- Convince Seller to hire outside advisor
- Seller's CPA agreed to step aside
- Deal structure agreed to by Buyer and his transaction team
- With final asset allocation, Seller paid nearly same tax as straight stock sale and Buyer got to write off entire transaction
- All parties were pleased and The THOR Group got paid!
- Would use this approach again

Requirements of a Section 338(g) and 338(h)(10) Elections

- Purchaser must be a corporation
- Purchaser makes a Qualified Stock Purchase “QSP”
 - Purchase - An actual taxable purchase must occur
 - 80-80 Test – Must acquire at least 80 % of the voting stock and at least 80% of the total shares of all other classes of stock except nonvoting preferred stock.
 - 12 Month Period – All applicable shares must be acquired within a 12 month period
- Purchaser must make Election by 15 day of the 9th month following the QSP Purchase
 - Election is made by filing IRS Form 8023
 - Both Purchaser and Seller must jointly file Election for a Section 338(h)(10)
- In a Section 338(h)(10) Election, Target must be an eligible Section 338(h)(10) Target

Code Section 338(h)(10) target eligibility

- Target is a member of a “Consolidated Group” (This is a group that does a consolidated tax filing.); or
- Target is a member of an “Affiliated Group” (This is a group that has the ability to file a consolidated return.); or
- Target is an S-Corporation

Treasury Reg. Section 1.338(h)(10)-1(c)

Code Section 338(h)(10) – Additional Issues

- Stock Basis vs. Inside Asset Basis
- Built-In Gains applies for S-Corporations

Examples of when a Section 338(g) may be useful

- The target corporation has unused net operating losses, capital losses or tax credit carryovers that will offset the tax liability created as a result of the election.
- The target corporation has depreciable assets and has had a tax liability within the last two or three years prior to the sale of the business. The deemed sale of the depreciable assets may create a net operating loss that can be carried back to obtain a tax refund from a prior year.
- The target corporation has non-depreciable built-in loss property and has depreciable built-in gain property. Subsequent to the sale, these gains and losses have the effect of canceling each other out. Additionally, the depreciable property will have a stepped up basis, which will provide a larger depreciation deduction going forward.
- The selling stockholders recognize minimal gains or a loss on the sale of the target corporation's stock.

Examples of when a Section 338(g) may be useful

Regarding a Section 338(g) Election:

Unless the target has Net Operating Losses (NOLs) or credits that can shelter the Federal Tax caused by this election, the Purchaser **WOULD NEVER** make a Code Section 338(g) Election.

Examples of when a 338(h)(10) may be useful

- The target corporation is a member of a consolidated return group that has tax attributes to offset the gain and any resulting tax liability from the deemed sale of assets.
- The target corporation is a member of a consolidated return group and has tax attributes beyond what is needed to absorb any gains resulting from the deemed sale of assets.
- The target corporation is an S Corporation.
- Target has large base of assets requiring title transfer
- Target has Contracts which are difficult to transfer
- Target has Authorizations which are difficult to transfer
- Target has Government preference status such as HUB
- Purchaser desires maximum consistency for ongoing operations
- Purchase desires maximum transparency for ownership change
- Target has long history which Purchaser would benefit by preserving
- Target has excellent insurance rates, Workers Comp Rates, State Unemployment Rates, etc...
- Purchaser is a key employee or group of employees
- Purchaser is a family member (i.e. Son, Daughter, etc...)
- Etc...

Section 338 – Election Recap

- Section 338(g) Election
 - Single election by Purchaser
 - Purchaser responsible for tax Liability
 - Unused tax attributes disappear
 - Very little application due to tax impact
- Section 338(h)(10) Election
 - Joint election by Seller and Purchaser
 - Seller responsible for tax liability
 - Unused tax attributes transfer to selling shareholder if selling shareholder is a corporation
 - Broad application

STATE TAX ISSUES

State Issues – Section 338(g) Election

- Most states honor 338(g) Elections because the tax consequences of the election can be readily isolated to the target level.

State Issues – Section 338(h)(10) Election

- State treatment of the a 338(h)(10) Election is less certain.
- Few states have statutes or regulations that address 338(h)(10) transactions.
- The filing status of the selling parent and the target (i.e. separate, unitary or consolidated) often plays a significant role in the determination of whether a 338(h)(10) Election will be respected in a state.

State Issues – Section 338(h)(10) Election

Four ways states generally treat Sell Side 338(h)(10) Elections:

- Recognize the Section 338(h)(10) regardless of the selling parent (or S-Corporation Shareholder) and target's filing status in the state
- Recognize the Section 338(h)(10) Election only if the seller and target file combined or consolidated in the state
- Recognize the Section 338(h)(10) Election but allocate target's deemed asset sale gain based on target's filing status
- Recognize the Section 338(h)(10) Election unless specifically opt out of the election at the state level (e.g., Wisconsin)

State Issues – Section 338(h)(10) Election

- In some states the deemed asset sale will be treated as an asset sale subject to state sales tax and/or state bulk sale notification requirements.

End