Understanding Sec. 338 and 338(h)(10) Elections

As a general rule, buyers prefer to purchase the assets of a corporate business. One of the principal nontax reasons for buying assets (as opposed to the stock) of a target corporation (T) is that a purchaser (P) can exclude pre-acquisition liabilities from the purchase, and generally acquire only those assets (and liabilities) it deems appropriate for its business. From a tax perspective, P will want to buy the assets of a corporation because, under Sec. 1012, it will obtain a cost basis (usually a basis step-up) for the acquired assets. A basis step-up is also desirable to P, as it allows P to take increased depreciation and amortization deductions for the acquired assets. Sellers, on the other hand, usually prefer to sell stock, rather than assets; on transferring the stock to a buyer, all of T's liabilities (including contingent liabilities) will pass to the buyer. From a tax perspective, individual owners of a C corporation prefer a stock sale over an asset sale, because it produces only one level of tax (shareholder), not two (corporation and shareholder).

Is there a way for the parties to reconcile these divergent positions? An acquisition transaction can be structured as a stock sale, while still giving P the option to obtain a basis step-up in the acquired assets. The Code contains two elections to achieve this objective, the availability of which depends on whether T is a C corporation, an S corporation or a subsidiary of another corporation. If T is a C corporation, a Sec. 338 election is available; if T is an S corporation or a subsidiary of another corporation, a Sec. 338(h)(10) election is available. A Sec. 338 election is not usually made because of the added cost to the buyer. By contrast, the Sec. 338(h)(10) election is common, because the desired tax benefits can usually be obtained with minimal or no added cost to either the buyer or seller.

Sec. 338 Election

A corporate buyer of C corporation stock may, if it meets certain requirements, make a Sec. 338 election. If made, T is treated as having sold all of its assets on the acquisition date for fair market value (FMV) to a new corporation (new T), and thereafter immediately liquidated (Sec. 338(a)(1)). T recognizes gain or loss on the "deemed sale" just as if T had sold its assets to P. The deemed sale is treated as occurring after T's stock has been sold, and is included in a one-day deemed-sale return that P must file as owner of new T; see Sec. 338(h)(9) and Temp. Regs. Sec. 1.338-10T. T's Federal income tax liability (which would normally be paid by T in an actual asset sale) shifts to P.

The effect of the election is to require those C corporation acquirers that desire the tax benefits of an asset sale to pay for them. The deemed purchase price attributed to P includes the stock's purchase price, the liabilities that T assumed, and T's tax liability from the sale; see Temp. Regs. Sec. 1.338-4T. As a result of the rules, any stock sale in which T makes a Sec. 338 election would likely result in a double tax—a tax on the T shareholders to the extent of any gain on the sale of their T stock to P in the stock sale and a tax on T itself (paid by P) on any gain from the

deemed asset sale. In view of this unfavorable tax result, the Sec. 338 election is rarely made. The tax on P to achieve a basis step-up is viewed as tax inefficient.

Note: A Sec. 338 election may be feasible if P obtained a price concession from the seller for agreeing to engage in a stock sale. However, the price concession is frequently the present value of P's (future) lost tax benefits, which is usually less than the tax on the immediate gain P would have to recognize from assuming T's tax liability. Another potential exception is when T has net operating losses (NOLs) or credit carryovers that would otherwise expire, possibly being converted into recoverable asset basis as a result of the deemed sale.

The regular Sec. 338 election affects only P; thus, P can make it on Form 8023, Corporate Qualified Stock Purchase Elections, without the seller's consent. It must be filed no later than the 15th day of the ninth month beginning after the month in which the "acquisition date" occurs (Sec. 338(g)(1)). The general requirements for making a Sec. 338 election are:

1. The purchaser must be a corporation;

2. The purchaser must acquire at least 80% of the target's stock during a 12-month acquisition period; and

3. The acquisition of the target's stock must be in a taxable transaction from a person unrelated to the purchaser.

Sec. 338(h)(10) Election

Unlike a Sec. 338 election, a Sec. 338(h)(10) election is very common in acquisitions when T is a subsidiary of another corporation or is an S corporation, and the corporate acquirer is purchasing at least 80% of T's stock. The Sec. 338(h)(10) election mechanics are similar to a Sec. 338 election. Under Sec. 338(h)(10), the parent of T (or T itself, if T is an S corporation) and the buyer may elect to treat the stock sale as if T sold all of its assets at their FMV to new T and then liquidated. Contrary to the Sec. 338 election, however, in which the deemed asset sale is treated as occurring after the stock has been sold to the acquirer, under Sec. 338(h)(10), the deemed sale is treated as occurring while T *is still owned by the seller.*

As a consequence, when T is a subsidiary, the Sec. 338(h)(10) election may have two significant advantages over a Sec. 338 election. First, if T is a member of a consolidated group with NOLs, tax credits and other tax benefits available for use, the gain on the deemed asset sale may be partially or totally offset. Second, because T's parent is deemed to have received the sale proceeds in liquidation of T, it recognizes no gain on the sale of its T stock to the acquirer by virtue of Sec. 332 (tax-free liquidation of a subsidiary). Therefore, even if the consolidated group to which T belongs has no NOLs or other tax benefits with which to offset the gain on the deemed asset sale, the seller's gain would be taxed only at the corporate level. Thus, the Sec. 338(b)(10) election could achieve both the seller's and the buyer's objectives, because the buyer would obtain a basis step-up in T's assets, and the seller would be taxed at one level (if at all).

If T is an S corporation, the results may be similar. The deemed asset sale would not materially affect the sellers if it results in capital gain, because the corporate-level gain resulting from the sale would be passed through to the shareholders, giving them a corresponding basis increase in their T shares. The increased share basis will in turn reduce the capital gain (or increase the capital loss) they recognize on T's deemed liquidation. Like the deemed sale of the subsidiary, the result may be one level of tax on the sellers of T.

Caution: Two possible negative consequences of a Sec. 338(h)(10) election for an S corporation exist. They are the potential for depreciation recapture and the possible application of the built-in gain (BIG) tax. Depreciation recapture may occur as a result of the deemed asset sale if T's assets have been depreciated below their FMV. In such event, a portion of the corporate-level gain would be recharacterized as ordinary income and taxed at ordinary income rates to the extent of the depreciation recapture; see Secs. 1245 and 1250. The seller's marginal cost resulting from the additional tax may be resolved by an increase in the purchase price. The BIG tax may apply if T is an S corporation that, within the previous 10 years, was a C corporation. Sec. 1374 might impose a corporate-level tax on a sale, distribution or other disposition of appreciated assets occurring within 10 years from the date a C corporation's S election became effective. Consequently, if T makes a Sec. 338(h)(10) election within 10 years from the effective date of an election to switch from a C to an S corporation, the deemed asset sale caused by the Sec. 338(h)(10) election may result in an unexpected tax on T.

Because a Sec. 338(b)(10) election would affect the seller, it must be made jointly by both the buyer and the seller on Form 8023. Significantly, for S corporations, Temp. Regs. Sec. 1.338(h)(10)-IT(c)(2) specifically re-quires nonselling shareholders to also consent to the election.

Note: Not all states recognize Sec. 338(h)(10) elections (e.g., North Carolina and Pennsylvania); even where recognized, NOLs and tax credits that might shelter gain for Federal tax purposes might not be available for state tax purposes.

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