Corporate ownership disposition options:

1) Sale of **stock** – transfer mechanics are easy to accomplish; LT capital gain treatment to the individual seller of stock; risk to the buyer about unknown corporate liabilities.

2) Sales of **assets** – more complicated transfer arrangements; concerns about non-assignable assets; various tax characterizations for transferred assets, dependent upon the allocation of the consideration from buyer.
Four Alternatives: Taxable Dispositions

Alternatives for the taxable disposition of a corporate business:

**Option One: Asset Sale By Corporation and Distribution of Proceeds**
- Shareholder
- Corporation
- Proceeds
- Buyer
- Assets

**Option Two: Asset Distribution By Corporation & Shareholder Asset Sale**
- Shareholder
- Corporation
- Proceeds
- Buyer
- Assets

**Option Three: Stock Sale By Shareholders**
- Shareholder
- Stock
- Corporation
- Proceeds

**Option Four: Asset Sale By Corporation and Proceeds Retained by Corporation**
- Shareholder
- Corporation
- Proceeds
- Buyer
- Assets
Sale of its assets by the target corporation to a purchaser for cash, notes, etc. (but not for Acquirer’s stock – which exchange could be eligible for tax-free corporate reorganization treatment (see Chapter 9)).

*Various types of consideration might be paid for these acquired T assets: cash, promissory notes, bonds and other property (e.g., stock of other than the purchaser corporate entity).
**Possible Structures for the Asset Acquisition**  p.357

**Structure One: Forward Cash Merger of Target into Acquirer**

- **Individual**
- **Target** → **Merger** → **Acquirer** → **Cash**

Equivalent to a sale of Target assets by Target and liquidation of Target. Rev. Rul. 69-6.

**Structure Two: Liquidation of Target followed by Shareholder Asset Sale**

- **Individual**
- **T Assets** → **Liquidation** → **Target** → **Proceeds** → **Buyer**

Target recognizes gain/loss on liquidation per §336(a). Shareholders recognize gain/loss on liquidation per §331. Shareholders have FMV basis in Target assets per §334 so no further gain/loss on Shareholder asset sale.

**Structure Three: Asset Sale By Target and Liquidating Distribution of Proceeds**

- **Individual**
- **Target** → **Assets** → **Cash** → **Proceeds** → **Target** → **Acquirer**

Target recognizes gain/loss on asset sale under §1001(a). Shareholders recognize gain/loss on liquidation per §331.

**Structure Four: Asset Sale By Target and Proceeds Retained by Target**

- **Individual**
- **Target** → **Assets** → **Cash** → **Proceeds** → **Target** → **Buyer**

Target recognizes gain/loss on asset sale under §1001(a).
"Lock-in" effect because of retention of stock until death to enable §1014 basis set-up.

Possible personal holding company status risk – requiring current distributions of income to the shareholders to avoid the PHC penalty tax. See §541.

Possible conversion of the corporation to S corporation status (but note S Corporation provision limitations, e.g., too much S. Corp investment income after having been a C Corp). See §1375.
§1060 requires an allocation of the purchase price paid for the assets acquired for cash.

Cf., William v. McGowan case (p. 353) re sale of separate assets and not the sale of the “business” enterprise as one unit.

This fragmentation approach requires a purchase price allocation & tax basis allocation among the various assets acquired by the purchaser.

Compare this result with a stock sale where gain/loss is with reference to Target stock only.
Seller:
1. Will want to sell Target stock, not assets.
2. If the Target corporation sells assets, then it would want to allocate proceeds to those capital assets producing long-term capital gain. For individuals, there is a tax rate differential for long-term capital gains, but for corporate sellers there is no tax rate differential but the selling corporation might need to consider possible capital loss carryover utilization.

Buyer:
1. Will want to purchase assets, not stock, so that Buyer can take a fair market value basis in all Target assets.
   - Cash value per $100 of Basis Step-Up: (Goodwill ~18%, Depreciable PP&E (~25%), Inventory (~35%). This assumes 35% tax rate and excludes state & local benefit.
2. Will want to allocate the purchase price to inventory and other short lived assets – to enable a prompt income tax deduction of these costs and minimize the allocation to goodwill (15 years) and land & buildings.
1) Proportionate methods, based on the relative fair market values of all assets.

2) Residual method – allocation (in order) to: (1) liquid assets, (2) tangible assets, (3) intangible assets and, (4) goodwill (i.e., based on the increasing difficulty of valuation).

§1060 implements the residual method.

Also, an allocation is made to a “covenant not to compete”, treated as an acquired asset.
§197 amortization – cost for intangible assets is amortizable over a 15 year period without regard to their actual “useful life”.

§197 assets defined: customer lists, patents, know-how, licenses, franchises, etc., including goodwill and going concern value; also, “covenants not to compete” (even though the period of the non-compete covenant is actually much shorter than 15 years).

Why this 15 year allocation?
1) Should the buyer and seller agree on a purchase price allocation?
   a) Issue One: Form 8594 (Asset Acquisition Statement) requires reporting whether or not agreed. If you report that an allocation is not agreed, then this is a “red flag.”
   b) Issue Two: If agreed, then binding on the parties unless fraud. See Danielson case (p.363, note 26).
   c) Issue Three: Never contractually give away your right to take the tax positions you believe are appropriate.

2) Purchase Price allocation is not binding on IRS. But, an allocation where two parties have divergent interests is strong evidence of fair value.
Purchaser buys stock of a corporation from the shareholders.

**Option One: Stock Sale By Shareholders**

**Problem:** We have no deal certainty unless super majority of shareholders is obtained and after the sale then Buyer must do a “squeeze-out” merger to eliminate non-consenting shareholders.

**Option Two: Reverse Subsidiary Merger**

**Benefit:** If a deal is approved by Target shareholders, then non-consenting shareholders are cashed out as part of the acquisition.
Stock Acquisitions – Income Tax Results

Results of a direct stock purchase or a reverse subsidiary cash merger:

1) Selling shareholders – capital gain treatment upon sale of shares under §1001(a), but this capital gain may be subject to installment sale treatment under §453

2) The Buyer takes a cost basis in the acquired Target stock per §1012.

3) General Rule: Target has no gain or loss as the sale is a shareholder event but the ownership change may limit Target’s ability to use its loss attributes (see Chapter 12). Exception: the parties can elect to treat this stock acquisition as a deemed asset acquisition under §338 (see page 361).
Transaction Steps:

1. Kimbell-Diamond acquired Whaley stock with involuntary conversion proceeds (per §1033) with objective to acquire assets.

2. Kimbell-Diamond immediately liquidated Whaley to acquire its corporate assets.

Issue: What did Kimbell-Diamond acquire, assets or stock?

HELD: Kimbell-Diamond is deemed to have purchased assets. The asset acquisition doctrine was born.
Transaction Form: Acquirer purchases Target Stock.

Tax Form: §338 transaction deems that asset acquisition has occurred with the following fictional steps: (i) a sale by “Old” Target of its assets to “New” Target (buyer of “New” Target gets cost basis in assets) followed by (ii) a liquidation of “Old” Target to its shareholders. Tax attributes of the “Old” Target disappear (e.g., E&P, tax attributes, & holding period).
Share Purchase and Tax Planning Structural Options

1) No §338 election and the asset tax bases inside the corporation are unaffected.

2) No §338 election and liquidate Target under §332 – historic asset tax bases move upstream.

3) Elect §338 and treat the stock transaction as a taxable asset acquisition (keeping the corp).

4) Elect §338, thus treating the stock transaction as a taxable asset acquisition, and thereafter liquidate Target upstream (under §332). Assets move upstream with stepped up basis.
Qualification Requirements
For the §338 Election

1) Acquisition by purchase by a corporation of at least an 80% interest in another corporation during a 12 month acquisition period, i.e., a “qualified stock purchase” has then occurred.

2) Purchasing corporation acting alone (see §338(g)(2)) makes the regular §338(g) election and once made is irrevocable. The election must be made by 15th day of the ninth month after the month of acquisition.

3) Treated as a hypothetical sale for asset fair market values as of the acquisition date.

Note: The purchasing corporation has the income tax payment obligation for the recognized gain. The corporate tax liability on the deemed sale from “Old” Target to “New” Target stays with Target which the stock purchaser has acquired. See Reg. §1.338-1(b)(3)(i).
“Aggregate deemed sale price” (ADSP) – the price allocable to the assets deemed sold by Target.

Target treated as selling assets for the ADSP.

This deemed sale price includes:

1) Price of acquired stock (as grossed-up, to approximate the real price if not all the stock is then held by the purchaser); and

2) The acquired liabilities (Crane case), including the income tax liability incurred in the asset sale.

Consider the similarity to an asset sale/purchase.
Tax basis to **new Target** (owned by Purchaser) for assets deemed acquired by Purchaser consists of:

1) Grossed-up price of P’s **recently purchased** stock (need to gross-up where not all shares have been acquired).

2) P’s actual basis in non-recently purchased stock (more than 12 months holding period).

3) Target liabilities, including tax liabilities resulting from the deemed asset sale.
The objective of determining this tax basis is to determine the amount to be allocated to the Target’s various assets after the deemed asset purchase.

This tax basis is allocated to the various assets, as specified in the §338(b)(5) income tax regulations, similar to the §1060 approach to allocating purchase price in a taxable asset acquisition.
Acquisition of the stock of a corp. subsidiary.

Parent corporation is the seller of the target subsidiary corp. stock (keeping the sub alive). So, deemed sale happens on Parent’s watch. Unlike a §338(g) election the §338(h)(10) election treats the transaction as (1) if it were a sale of T’s assets while Target is a member of the Parent’s consolidated group, and (2) “Old” Target then liquidates tax-free into Parent under §332. Objective: to avoid two corporate level gain tax events.
When Use the §338(h)(10) Election?

Generally advisable because it avoids double-taxation while providing a step-up in inside asset basis to the Acquirer. With this said, it is extremely beneficial in the following two further factual variations:

1) Seller has a potential gain on the stock (low outside stock basis) but the inside asset basis is higher so that the gain is smaller from an asset sale. In this scenario, a §338(h)(10) election provides the same result as if there were an actual §332 liquidation of Target into Parent and then a sale of Target’s assets by Parent.

2) The Seller consolidated group has losses from other operations which can be used to offset the gain realized on the deemed asset sale.

3) Requires a joint election between Buyer and Seller. See Reg. §1.338(h)(10)-1(c)(2).
Probable alternatives:

1) Sale stock with **no** §338 election (one level of tax).
2) Make Section 338 election if Target corp. has net operating losses to offset recognized gains.

Special treatment where Target corp. is a subsidiary of another corporation –
Code §338(h)(10) election possibility with gain reported on Seller’s consolidated tax return.
§336(e) allows Parent to treat a disposition of Subsidiary stock as a deemed asset disposal.

1) §336(e) gives similar treatment to that of §338(h)(10).
2) §336(e) is potentially broader as it applies to any disposition of Subsidiary stock including dispositions to individuals whereas §338 only applies to purchases of stock by a corporation. Also, it can also apply to any disposition of stock including liquidations and distributions of stock whereas §338 applies only to stock purchases. Finally, §336(e) permits the seller-only to make an election whereas §338(h)(10) requires a joint election and §338(g) is a Purchaser-only election.

Thus, Purchasers who acquire Target stock should be aware of §336(e) and contract for what they want. A Purchasers might want to forbid the Seller from making a §336(e) election if the Purchaser wants Target’s tax history. Or, if Purchaser might want Seller to make a §336(e) election to gain an asset basis step-up.
Transaction: Target sells non-cash assets subject to bank note for cash and distributes after-tax proceeds to shareholders.

Results:
1. Target has $450 of long-term capital gain and $100 long-term capital loss for a net long-term capital gain of $350. Target has $150 of ordinary income.
2. Corporate tax of $175 ($500*35%).
3. Net cash of $825 ($1,000 -$175 tax) distributed to A ($412.5), B ($330), and C ($82.5).
4. A’s gain is $362.5 (tax of $72.5). B’s gain is $290 (tax of $58). C’s loss is $57.5 (tax benefit of $11.5).
5. Total Tax Cost $294 ($175 corporate + $119 shareholder)
6. P takes $1.1 million basis per §1060.
Problem (b)  
Asset Liquidating Distribution

Transaction: Target transfers all assets and liabilities to shareholders who then sell assets to P.

1) Target has corporate level gain under §336(a) in exactly same amount as in (a) (i.e., $175 of corporate tax).

2) Shareholders have same gain/loss treatment under §331 (i.e., $119 of net shareholder tax).

3) P takes tax basis of assets if $1.1 million (allocated per §1060).
Problem (c)  
Installment Note Distribution

Transaction: P paid T $200,000 in cash and $600,000 in notes with market rate of interest payable annually and the entire principal payable in five years. T distributes cash and note pro-ratably to shareholders.

Results:
1. No change for Target as distribution of the note causes the gain to be triggered.
2. A & B can report §331(a) gain on the installment method upon the liquidation of Target. Compute A & B gross profit percentage and then report gain as cash received. See §453(h)(1)(A).
3. No change for P.
Problem (d)
Asset Sale & No Liquidation

Transaction: Target sells all its assets to P but T does not liquidate. Instead, T invests the $825,000 after-tax cash proceeds in publicly traded securities.

1. Increase to T’s E&P by $325,000 ($500,000 gain less the 175,000 tax liability triggered on the sale).

2. No distribution of proceeds creates risk that Target would be considered a “personal holding company” as defined in §543. Personal holding companies are required to distribute their net ordinary investment income annually or pay a penalty tax. Faced with this distribution requirement, dividend and interest income earned by T will be subject to double tax.
P purchases all T for $800 per share & makes a §338 election. Results:
1. Shareholders recognize capital gain (or loss) on their share sales.
2. P is eligible to make a §338 election since a “qualified stock purchase” has occurred. New T is treated as a new corporation which purchased all the old T assets on the day after the acquisition date.
3. New T’s basis in its acquired assets: $800,000 grossed-up basis (sales amount here); $300,000 bank loan; $175,000 tax paid. Total “adjusted grossed-up basis” $1,275,000. This $1,275,000 is then allocable among T’s assets under §338(b)(5) (& Code §1060).
P purchases all the stock of T for cash but does not make the §338 election. Results:

1. T is not deemed to have sold the assets and, therefore, T recognizes no current gain or loss.

2. T has the same asset bases and other T tax attributes remain as prior to the sale. A knowledgeable buyer not pay $1 million for the stock because of the future income tax liability upon T’s asset sales. But more than 825x?
Method of choice is a purchase of **stock without a §338 election**.

Reasoning: If (1) Target sells assets and is liquidated, or (2) Target shareholders sell stock and a Code §338 election is made, the transaction generates tax at both the shareholder and the corporation level. The T assets are not stepped-up with a stock sale, but this disadvantage is more than offset by the avoidance of an immediate corporate level tax on the asset gain. So, do **not** make §338 election and do **not** pay current tax merely to get a tax basis step-up!

A savvy buyer would want to reduce the purchase price for the lost in the step-up in basis for depreciation.
If T had a NOL carryover of $600,000, then a §338 election makes good sense. Reason: T could shelter the $500,000 of gain on the deemed sale by using the NOL to offset the sales gain. A §338 election then enables new T to take a stepped up basis to fair market value for assets without any income tax cost resulting from the election. As discussed in Chapter 12, the P-T group may not be able to use the NOL after the ownership change. More later.
Assume T is a wholly owned subsidiary of S, Inc., and S has 200x adjusted basis in T stock. T distributes all of its assets (subject to the liability) to S in complete liquidation. The liquidation of T is tax-free to both S (under 332) and T (under § 337). S takes a transferred basis in T’s assets under § 334(b), and S's gain on its T stock is eliminated. S recognizes $150,000 ordinary income and $350,000 net long-term capital gain on the sale of the assets to P, which takes the assets with a cost basis under § 1012. The result would be identical if T first sold its assets and then liquidated. P has a §1012 cost basis for the various acquired assets.
P insists that the transaction must be structured as an acquisition of T stock. T is the subsidiary of corporate Seller (S) and a member of a consolidated group.

1. §338(h)(10) permits S and P to jointly elect to treat the transaction as a **deemed sale** of T’s assets in a single transaction, rather than as a sale by S of the T stock. A lesser gain amount is realized then.

2. S recognizes **no** gain (or loss) on the stock sale – here a larger stock gain than asset sale gain.
Choices for the buyer:

1) Immediate deduction until “whether and which date.” Then capitalized costs of acquisition into buyer’s tax basis until disposition of the asset (e.g., stock cost).

2) Financing Costs: Capitalized into debt

Tax treatment depends on the specific acquired assets & financing arrangements.

Failed acquisitions: §165 enables an immediate deduction for costs incurred in investigating an acquisition where the transaction fails or is abandoned.
Indopco holding was that takeover costs in a friendly takeover were non-deductible capital expenses since the cost produced a “future benefit”. Cost need not be related to a specific asset. Different treatment for fees to prevent a hostile tender offer – only seeking to preserve the entity – until changing to a friendly transaction. Staley (7th Cir) case, p. 389.

Post-Indopco: the §263 (Indopco) regulations now provide that costs incurred to complete a transaction must be capitalized and amortized. But, a current deduction is permitted for costs to find a White Knight and hostile takeover defense costs.

Failed acquisitions: §165 enables an immediate deduction for costs incurred in investigating an acquisition where the transaction fails or is abandoned.
Objectives: Reduce equity and increase debt which facilitates (1) deductible interest and (2) greater income per share (and greater share value based on the “earnings per share” probable multiple).

- To facilitate a “going private” transaction.
- To facilitate a “bootstrap acquisition” of another enterprise.
- To facilitate a stock tender offer.

Recall: Chap. 3 re debt-equity considerations.

Further benefit available: dividends taxed at low 20% rate (to individuals) & DRD; cf., interest.

2) Payment in kind (PIK) bonds - when it applies, §163(l) denies deduction.

3) Limit use of an NOL attributable to debt leveraging interest expense. §172(h).


5) Classification issues (See Chapter 3) – debt for tax & equity for GAAP?
Deal Structure: Acquisition structure & post-closing integration.
A. Asset Sale. Provides Buyer with the ability to leave behind income tax exposures (but may have transferee liability) and provides Buyer with step-up in basis for assets.
B. Stock Sale. Buyer takes-over the prior income tax exposures and generally does not get a basis step-up.
   1. Buyer’s purchase price should be adjusted to reflect the lost value due to unrecorded tax exposures or tax benefits.
   2. Buyer’s purchase price should be adjusted to reflect the lost value due to lack of tax basis step-up in assets.

Goals of Buyer’s Counsel: Structure decisions and ensure that any material tax exposures are known and quantified.

Goals of Seller’s Counsel: Structure decisions, advocate for client’s pre-closing tax positions, and minimize risk of post-closing litigation over diligence process.
Tax Due Diligence

Generally, once Buyer & Seller agree on a price target and have tentatively agreed on deal structure, the next key issue will be whether contingent tax exposures (or tax benefits) exist that are not recorded on the Target’s balance sheet.

1. Document Request (Data Room): Issue identification that can involve deal value. If there is a tax exposure, the Seller should have adequate reserves on the balance sheet for that exposure.

2. Representations & Warranties. May or may not survive closing but if done well facilitate due diligence process.

3. Tax Covenants: Generally survive closing

4. Tax Indemnity. Allocates tax benefits and risks pre-closing and post-closing between Buyer & Seller. Often will have a materiality threshold and have baskets/caps and notice requirements.