

Ch. 8 - Taxable Corporate Acquisitions/Dispositions

Corporate ownership & disposition options:

- 1) Sale of stock – transfer mechanics are easy to accomplish; LT capital gain treatment to the individual seller of the stock; risk to the buyer about unknown corporate liabilities.
- 2) Sale of assets – more complicated asset transfer arrangements; concerns about non-assignable assets; various income tax characterizations for the transferred assets; amounts are dependent upon allocation of the consideration provided by buyer.

Four Alternatives: Taxable Dispositions p.356

Possible transfer options for the taxable disposition of a corporate business (Target):

1. Sale by the corporation of its assets and then distribution of these proceeds in liquidation.
2. Distribution by the corporation of its assets “in kind” to the shareholders who then sell the assets.
3. Sale of the stock by the shareholders.
4. Sale of the assets at the corporate level and no liquidation distribution by the corporation.

Taxable Asset Acquisitions Consideration Paid p.357

Sale of its assets by the target corporation to a purchaser for cash, notes, etc., but not for the Acquirer's stock (which exchange could be eligible for tax-free corporate reorganization treatment).

See Chapter 9.

Various types of other consideration might be paid for these acquired assets: cash, promissory notes, bonds & other property (e.g., stock of other than the purchaser corporate entity).

Possible structures for the asset acquisition p.357

- 1) Forward cash merger of Target into Acquirer for cash (or merger into a subsidiary of Acquirer). Equivalent to a sale of assets and liquidation by the acquired corporation. Rev. Rul. 69-6 (p. 357).
- 2) Liquidation of the Target (into a D.E.?) followed by the shareholder's sale of assets to Acquirer.
- 3) Sale of the assets by the Target with subsequent distribution of the proceeds to the shareholders.
- 4) Sale of assets - with the proceeds retained (thereby avoiding shareholder level gain).

Issues Upon Corp Retention of Proceeds & Corp. Status

“Lock-in” effect because of retention of stock until shareholder death to enable §1014 basis step-up.

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

Possible conversion of the corporation to S corporation status (but note the S Corporation provision *limitations*, e.g., too much S Corp investment income after having been a C corp & having undistributed E&P).

Allocation of the Purchase Price for Tax Purposes

§1060 requires an allocation of the purchase price paid for the assets acquired for cash.

Cf., *William v. McGowan* case (p. 359) re the sale of separate assets and not the sale of the "business" enterprise as one unit. Cf., "sole proprietorship."

Cf., the sale of shares of a corporation (one asset).

This fragmentation approach requires for the purchaser (1) a purchase price allocation & (2) a tax basis allocation among the various assets acquired by that purchaser.

Tax Basis Allocation & Planning Objectives p.358

Seller: If an income tax rate differential exists, a tax planning objective will be to allocate proceeds to those capital assets producing LTCG; but, no income tax rate differential exists for the selling corporation (21% tax rate) But, consider possible NOL & capital loss carryover utilization.

Buyer: Wants to allocate the purchase price to inventory and other short lived assets - to enable a prompt income tax deduction of these costs. Avoid allocation to goodwill (15 years) and land & bldgs.

Allocating the Purchase Price? p.359 & 362

- 1) Should the buyer and seller agree on a purchase price allocation?
- 2) What is the binding nature of such a price allocation agreement on the IRS?
- 3) Can the taxpayer reject the agreement and report another purchase price allocation? See the Danielson case (p. 359).

§1060 specifies the binding nature of this agreement for the taxpayers.

See IRS Form 8594, “Asset Acquisition Statement.”

Approaches to Allocation of Buyer's Purchase Price

1. Proportionate methods, allocation based on the relative fair market values of all assets. P.360.

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 to be made to a "covenant not to compete," treated as an acquired asset.

Amortization of Intangibles

p.360

§197 amortization – Cost for intangible assets is amortizable over a 15 year period without regard to their actual “useful life.” Cf., “frozen assets.”

§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 require this 15 year allocation?

Allocation of Price - §1060

Asset Classes **p.361**

- Class 1 assets:** Cash & cash equivalents.
- Class 2 assets:** Marketable securities.
- Class 3 assets:** Accounts receivable; mortgages.
- Class 4 assets:** Inventory.
- Class 5 assets:** Tangible property (equipment).
- Class 6 assets:** Intangibles (§197), except Cl. 7.
- Class 7 assets:** Goodwill & “going concern value” (also §197 assets).

Stock Acquisitions p.363

Purchaser buys stock of a corporation from the shareholders. Structuring options are:

1. Direct purchase from the shareholders.

Similar to a Type “B” tax-free reorganization.

What about non-consenting shareholders?

Answer: Make no effective deal unless a super majority is obtained; then, can be followed by a “squeeze-out” merger to eliminate the remaining reluctant shareholders. *continued*

Stock Acquisitions cont.

p.363

2. Reverse triangular cash merger:

- a) Purchaser (P) forms a transitory subsidiary & that new Sub then merges into Target; and,
- b) Target shareholders receive cash (and notes) of the purchaser. Similar to the tax-free “Reverse Triangular Merger.” Shareholders are treated as selling their Target stock to P in a taxable sale.
- c) Purchaser acquires the Target stock with this merger. Target thereby becomes a subsidiary of P.

Stock Acquisitions - Income Tax Results

Results of either (a) a direct stock purchase or (b) a reverse subsidiary cash merger:

1. Selling shareholders - capital gain treatment upon their sales of shares (& §453 treatment?).
2. The purchaser takes a cost basis for the acquired shares in the acquired corporation.
3. Impact to the Target Corp.? Unaffected, except should this transaction actually be treated as a deemed asset acquisition (e.g., Kimball-Diamond)?

Kimbell-Diamond case

Asset Purchase? p.364

Corporation acquired stock of another corporation with involuntary conversion proceeds (§1033) & liquidated target. Objective was to acquire assets.

Issue re tax basis of the corporate assets acquired by the corporate transferee in the liquidation.

Tax basis for assets was higher than asset FMV.

Was this a tax-free liquidation of wholly owned subsidiary into parent corporation, under §332?

No, held: a deemed cash asset acquisition.

Sequel to Kimbell-Diamond

p.366

1) Enactment of (old) §334(b)(2) – if (1) stock acquisition made by corp. of an 80% subsidiary, and (2) liquidation within two years, then the stock acquisition was treated as an asset acquisition.

Objective to enable a tax basis step-up for the assets (and no gain recognition because of General Utilities) upon the actual corporate liquidation.

2) Further response: §338 enactment – no actual corporate liquidation required; treatment as an asset purchase. But, then, General Utilities repeal!

Code §338 - Elective Asset Purchase Tax Treatment

Can a corporate shareholder get a tax basis step-up for indirectly acquired assets without the actual liquidation of the acquired corporation?

If treated as a liquidation - therefore, gain recognition results as if the appreciated assets had been (i) distributed in kind to shareholder, and (ii) re-infused into a new corporation (§351).

But, old stock basis for the purchasing shareholder in the deemed liquidating corporation disappears.

Code §338 Objectives in a Stock Purchase

p.366

1. Same federal income tax effects as if:
 - (i) an actual sale by Target corporation of its assets, followed by
 - (ii) a corporate liquidation into a parent corp.
2. The buyer gets a cost basis in the assets acquired from Target.
3. Tax attributes of the Target disappear (e.g., the e&p account and the old holding periods for the various assets).

Share Purchases and Tax Planning Options p.367

- 1. No §338 election and the asset tax bases inside the corporation are unaffected.**
- 2. Do not elect §338, but liquidate under §332 – the historic asset tax bases (& E&P) move up to P.**
- 3. Elect §338 and treat the stock transaction as a taxable asset acquisition (keeping the sub.).**
- 4. Elect §338, treat the acquisition as an asset acquisition and, thereafter, liquidate the acquired corporation upstream into P (under §332).**

Qualification Requirements for the §338 Election p.367

1. Acquisition by the purchasing corporation of at least an 80% interest in another corporation (Target) during a 12 month acquisition period, i.e., a "qualified stock purchase" has then occurred.
2. Buyer must make an irrevocable §338 election.
3. Treated as a hypothetical sale by Target of assets for the fair market values of those assets as of the acquisition date.

Defining Sale Price - p.369

Deemed Fair Market Value

“Aggregate deemed sale price” (ADSP) - the price allocable to the assets *deemed sold* by Target.

Target treated as selling the 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.

Who Pays the Income Tax on this Deemed Sale?

The purchasing corporation has the indirect income tax payment obligation for tax recognized asset gain.

Why? For state law purposes the old corporation (for FIT purposes) and the new corporation (for FIT purposes) are the same corporation.

Therefore, nothing changes with the corporate charter as filed with the state Secretary of State.

The income tax liability for the recognized asset gain is that of the subsidiary corporation – now in the ownership of the purchasing corporation.

Adjusted Grossed-up Basis of Acquired Assets (AGUB)

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 as of deemed liquidation).
2. P's actual basis in non-recently purchased stock (more than 12 months holding period).
3. Target liabilities, including income tax liabilities resulting from the deemed asset sale.

See p. 364.

Allocation of the “Adjusted Grossed-up Basis” p.371

The objective of determining the AGUB tax basis is to determine the amount to be allocated to the Target’s various assets after the deemed asset purchase. §338(b)(5) regulations.

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 the purchase price in a taxable asset acquisition.

Subsidiary Sale - Possible §338(h)(10) Election p.374

Acquisition of the stock of a corp. subsidiary (rather than a precedent §332 liquidation).

The Parent corporation is the seller of the stock of target subsidiary corp. (keeping the sub alive).

Possible §338(h)(10) election - Treat the transaction as (1) if it were a sale of T's assets while a member of the seller's consolidated group, and, (2) S then liquidated tax-free into Acquiring Parent under §332. Objective: To avoid two corporate level gain tax events.

When Use the §338(h)(10) Election? p.374

- 1) Large potential gain on the stock, but limited gain on the assets - as if (a) an actual §332 liquidation into parent corporation, and, then, (b) a sale of the subsidiary's assets. E.g., Kimbell-Diamond.**
- 2) Consolidated group has losses from other operations which can be used to offset the gain realized on the deemed asset sale for the subsidiary being sold.**

§336(e) Regulations

p.376

Regs. authorize that, a (seller) corporation that owns 80% of stock of another corporation may elect to treat stock sale as if an asset sale.

Old Target is treated as selling all assets to New Target for aggregate deemed disposition price.

This provision applies to the distribution of T stock as well as sales & exchanges.

Comparison of Acquisition Methods for Stock p.378

Probable alternatives:

- 1) Sell stock with no §338 election (one level of tax).**
- 2) Make §338 election if Target corp. has net operating losses which can offset recognized gains.**
- 3) Special treatment where Target corp. is a subsidiary of another corporation – & Code §338(h)(10) election is a possibility with gain reported on the Seller's consolidated tax return.**

Problem (a)

p.380

Asset Sale and Liquidation

T: (1) adopts a plan of complete liquidation;
(2) sells (at the corporate level) its 1.1 mil. non-cash assets (subject to 300x liabilities) to P for 800x cash (corporate level tax of \$175,000 on gain); and,
(3) distributes the after-tax proceeds (next slide) to the three shareholders in proportion to their stockholdings (A&B have LTCG but C has loss).

Problem (a), cont. p.380

Asset Sale and Liquidation

Proceeds to the three shareholders in proportion to their stockholdings (A&B have LT CG but C has loss). T's proceeds as distributed:

800 net + 200 cash = 1.0 mil less 175 tax = 825,000

A – 412,500 (50%) less stock basis of 50 = 362,500

times 20% LT CG tax = 72,500 tax = 340,000 net.

B – 334,000 (40%) less stock basis of 50 = 284,000

times 20% LT CG tax = 56,800 tax = 277,200 net.

C – 82,500 (10%) , but 57,500 LTCL for stock.

Problem (a), cont. p.380

Asset Sale and Liquidation

Tax basis to P for the acquired assets?

**Cost basis of \$1.1 mil.: 800x for assets of 1.1 mil.
(after eliminating 200x cash),**

plus 300x liability equals \$1.1 mil.

**Then: §1060 (and applicability of the multi-tier tax
basis allocation process mandated by the Section
1060 regulations).**

Problem (b)

p.381

Asset Liquidating Distribution

T (i) adopts plan of liquidation; (ii) transfers all business assets (& liabilities) to shareholders; and, (iii) shareholders sell the assets to P.

Tax effects of the asset distribution to:

(i) corporation – gain treatment under §336(a) (reserve 175,000 for corporate level tax); and,

(ii) Shareholders – treatment under §331.

Also, income tax basis effects to P? Tax basis of assets is \$1.1 million (allocated per §1060).

Problem (c)

p.381

Installment Note Distribution

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.

Issues re the availability of installment sale treatment to corp. when: (i) T's assets sold (inventory, but bulk sale?; not for recapture), and, (ii) T's distribution of notes. Gain is entirely recognized to the corp. on the note transfer to the shareholders. §453B(a).

continued

Problem (c), cont. p.381

Installment Note Distribution

Corporation's status: 400 cash (200 + 200) less 175 tax (upon distribution) = 225 cash remaining for distribution, plus the 600 promissory note.

Tax of 175 @ 35% on the 500 income (350 + 150).

Shareholder treatment: May A and B (C having a loss) report their §331(a) gain on the installment method upon the liquidation of Target (assuming T is not publically traded)? See §453(h)(1)(A).

A to receive 112,500 cash & 300x notes = 412,500.

See next slide

Problem (c), cont. p.381

Installment Note Distribution

A's installment reporting:

A to receive 112,500 cash & 300x notes = 412,500.

Gross profit is 362,500 (412,500 less 50x basis).

§453 gross profit fraction is 87.878%.

A's payments:

1) 112,500 times 87.878% = \$98,864

**2) 300,000 (five years later) times 87.878%
equals \$263,636.**

Problem (d)

p.381

Asset Sale & No Liquidation

T sells all its assets to P; T recognizes \$150,000 of ordinary income and \$350,000 net LTCG.

However, T does not liquidate but invests the (\$825,000) total after-tax (\$175,000) cash proceeds in publicly traded securities. Increase occurs to T's E&P by \$325,000 (\$500,000 gain less the \$175,000 tax liability on sale) & equals \$725,000.

No distribution of the proceeds and the §331 tax is avoided at the shareholder level. What tax risks?

Personal holding co.? Redeem C's stock (loss)?

Problem (e)

p.380

Stock Purchase- §338 Election

P purchases all the stock of T for \$800 per share and P makes a Code §338 election. Why purchase for \$800?

Shareholders recognize capital gain (or loss) on their share sales.

A has 400 proceeds less 50 tax basis = 350 LT CG.

B has 320 proceeds less 40 tax basis = 280 LT CG.

C has 140 tax basis less 80 proceeds = 60 LT CL.

Problem (e)

p.380

Stock Purchase- §338 Election

2) Corporate level results:

P is now eligible to make a §338 election since a “qualified stock purchase” has occurred (since a purchase of 100 percent of the stock).

T is then treated as having sold all its assets as of the acquisition date at FMV.

Result: New T is treated as a new corp. which purchased all the old T assets on the day after acquisition date.

Problem (e), continued

p. 380

New T's basis in its acquired assets:

- 1) \$800,000 grossed up basis (sales amount here)**
- 2) \$300,000 bank loan**
- 3) \$175,000 tax paid**

Total “aggregate deemed sales price” is \$1,275,000.

This \$1,275,000 is then allocated among T's assets under Code §338(b)(5) (& Code § 1060).

Stock sale & §338 election are the same as an asset sale.

Problem (f)

p.380

Stock Purchase & No §338

P purchases all the stock of T for cash but does not make the Code §338 election. Gains tax to sellers.

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

T's has the same asset bases and other T tax attributes remain in T as prior to the sale.

A knowledgeable buyer would not pay \$1 million for the stock – why? Future income tax liability upon T's asset sales. But, pay more than 825x?

Problem (g)

p.380

Choice of Sales Method?

(1) Method of choice is a purchase of stock *without* a §338 election.

(2) If either (a) Target sells assets and is liquidated, or (b) Target shareholders sell stock and a Code §338 election is made, the transaction generates income tax at both the shareholder and the corporation level.

(3): Do not make §338 election & do not pay current income tax merely to get tax basis step-up!

Problem (h)

p.380

Target With NOL Carryover

If T had a NOL carryover of \$600,000:

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 the assets without any income tax cost resulting from the election.

Could P otherwise use the NOL? Unlikely.

Possible §382 limit on P's future NOL utilization?

Problem (i)

p.380

Target is the Subsidiary

Assume T is a wholly owned subsidiary of S, Inc. and S has 200x adjusted basis in its T stock.

1) T distributes all of its assets (subject to the liability) to S in complete liquidation. This liquidation of T is tax-free to S (under §332) and to T (under §337). S's T stock gain is eliminated.

2) S then sells the assets to P. On the sale of assets S recognizes \$150,000 of ordinary income and \$350,000 net LTCG. P has a §1012 cost basis for the various acquired assets.

3) No S, Inc. shareholder effect.

Problem (j)

p.380

Acquisition of Target Stock

P insists that the transaction must be structured as an acquisition of T stock. T is the subsidiary of Seller (S) and a member of P's consolidated group.

§338(h)(10) permits S and P to jointly elect to treat transaction as deemed sale of T's assets in a single transaction, rather than a sale by S of the T stock.

A lesser gain amount is then realized (& any NOL is available to S to protect gain?).

S recognizes no gain (or loss) on the stock sale – here a larger stock gain (800x) than asset sale gain.

Prob. 2 -Tax Policy – Stock vs. Asset Purchases p.380

Should the repeal of the General Utilities doctrine remain in corporate liquidation/takeover context?
Does a double tax (both corporate and shareholder levels) encourage a “lock-in effect”?
Is this a detriment only to closely held businesses?
How provide any relief? At the shareholder or corporate level? Integrated treatment?
What is impact of the 20% tax rate on the individual shareholders’ capital gain?

Problem 3(a)

§336 Issue

p.381

X disposes of at least 80 % of the T stock, i.e., a “qualified stock disposition” has occurred.

Sold 85 shares (of 98) within 12 months, i.e., more than 80%: $30 + 50 + 5 = 85$ (but not the 10 to a related person).

Therefore, X and T may (alone) make the §336(e) election.

Problem 3(b)

p.381

Tax consequences of the §336(e) election:

- 1) No gain or loss on the distribution of shares.**
- 2) Old T recognizes all the gain on the deemed disposition of its assets.**

What about loss assets? Only a portion of the loss may be recognized – equal to the loss attributed to the (30) shares sold before the disposition date.

New T determines adjusted grossed-up basis similar to §338(h)(10).

Tax Treatment of Acquisition Expenses p.382

Choices for the buyer:

- 1) Immediate tax deduction (ordinarily preferred).
- 2) Amortization (e.g., debt financing/buyer).
- 3) Frozen in the buyer's tax basis until the disposition of the asset (e.g., stock cost).

Tax treatment depends on the specific acquired assets & the financing arrangements. E.g., deal costs; new sub. stock (§248); executive retention payment arrangements.

Target's Treatment of Acquisition Expenses

Target's expenses – deal costs (e.g., a “fair value opinion” from Target’s investment banker).

Not deductible to the target corporation but required to be capitalized?

What if a benefit is provided to the shareholder but the cost is paid by the corporation? (Constructive dividend?)

Relevance of either (1) a hostile or (2) a friendly acquisition transaction?

Possible Application of INDOPCO Decision p.383

Holding that takeover costs in a friendly takeover were nondeductible capital expenses – since the cost produced a “future benefit.” Cf., advertising.

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 Mfg. Co. (7th Cir) case, p. 384, permits deduction.

Acquisitions & Cost Recovery

p.385

Failed acquisitions: Costs are incurred in investigating an acquisition and the transaction fails or is abandoned – §165 enables an (ordinary?) loss deduction.

The §263 (Indopco) regulations - 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 to fight hostile takeover attempts.

LBOs – Types of Transactions

p.386

Objectives: Reduce the equity amount and increase the debt amount - which then facilitates:

- 1) deductible interest expense, and**
- 2) greater net income per share (and, then, greater share value based on “earnings per share” times probable multiple).**

Recall: Chap. 3 re debt-equity considerations.

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

Types of Arrangements to Achieve Equity Reduction

Possible options for buyout/buyback transactions:

- Redemption of shares (to change ownership).
- Facilitate a “going private” transaction.
- Facilitate a “bootstrap acquisition” of another enterprise (using internal cash).
 - Facilitate a stock tender offer (first from externally sourced cash).

Possible objective: “going private” transaction.

Important result & ultimate objective: Eliminate income tax as a “cost of doing business.”

LBOs & Tax Limitations on Excessive Debt

p.389

“Junk bond” - Applicable high yield discount (AHYDO) obligations - §163(e)(5).

Junk bond is defined as having:

- a) high yield (5% + above AFR),**
- b) significant OID in the instrument; &**
- c) greater than five year maturity.**

**Result: No current cash cost for borrowing.
Interest expense deduction is limited & only when interest is actually paid.**

continued

LBOs & Tax Limitations on Excessive Debt **p.390**

Payment in kind (PIK) bonds – interest payments are made in stock of the issuer (or a related party).

Current interest expense deduction is limited, since no actual cash cost to the obligor. §163(l).

Holder of the debt instrument still recognizes interest income as accruing to the lender.

continued

LBOs & Tax Limitations on Excessive Debt **p.390**

Limit the use of an NOL attributable to the debt leveraging interest expense from an LBO.

§172(g) limits ability to carry back NOLs when deductions attributable to debt financing arrangements.

Types of transactions which trigger this NOL limitation include “CERTs” (or “corporate equity reduction transactions”), i.e., stock acquisitions and “excess distributions.”

See Code § 172(b)(1)(D) & (g).

continued

LBOs & Tax Limitations on Debt, cont. p.392

“Earnings stripping” limitation - deductible interest is paid to foreign lender (who is related and is exempt from U.S. income tax). Prior Code 163(j). Deduction was limited for payor for interest expense deduction where:

- 1) debt exceeds a 1.5 to 1 debt-equity ratio, and**
- 2) the proportion (more than 50 percent) of income reduced by interest is exceeded.**

Possible carryover of any excess interest expense deduction for future use.