Editorial | Kelly L. Frey & Amelia Lant

Having Your Cake and Eating It Too: Getting Asset Sale Tax Treatments in a Stock Sale

Transactional attorneys are taught early in their careers that there are two types of M&A (Merger and Acquisition) transactions: stock deals and asset deals. Unfortunately, that dichotomy is practically wrong and can cost mid-market, closely-held companies millions of dollars (and create potential malpractice claims by clients who become aware of the knowledge gap of their counsel after the transaction is completed).

Section 338(h)(10) of the Internal Revenue Code allows certain transactions to be structured as stock deals, but taxed as asset deals.[1]

Traditional Acquisition Considerations

In 99 out of 100 transactions, a buyer is going to prefer to acquire a target's assets.[1] Not only does an asset acquisition prevent residual liabilities of the target from creating massive headaches (and losses) after the acquisition, but an asset sale also allows a purchaser to both readjust the tax basis on the physical assets and depreciate the sales price (that is solely attributable to the basis in the assets) based upon the depreciable lifespan of the assets.

For example, take a simple acquisition of a $1M target with a $100K tax basis in its assets. In an asset sale, the acquirer can reallocate the tax basis in the assets (let's say to $1M)—a "step up" in basis—and conceivably depreciate the entire asset value/purchase price of the transaction post-closing (offsetting target income for years to come from the depreciation/loss carryover of the depreciation). In a stock sale, the acquirer merely receives a $1M basis in the stock of the target, with no offsetting depreciation/loss against future target earnings.[2] The practical, post-tax difference could be annual tax depreciation that could be used by the buyer to shelter income equal to the entire purchase price versus taxable recognition of the target's post-closing income from "dollar one" in a stock acquisition.[3]

From the seller's perspective, however, an asset sale can trigger (among other events) (1) significant tax obligations (based upon the excess of the purchase price above the basis of the assets of the company), (2) defaults in non-assignable contracts, and (3) repayment of debt obligations.

So, suggesting a 338 sale, where appropriate, can accommodate both seller and buyer in different ways.[4]

(continued on page 24)

Advantages of a 338 Sale

Specifically, Section 338(h)(10) provides a hybrid tax treatment that can accommodate target's (or seller's) desire to sell stock and acquirer's desire to purchase assets (and/or obtain contracts of target that are non-assignable in an asset sale).[5]

In a 338 transaction, seller and buyer explicitly "elect" under Section 338(h)(10) that the stock acquisition transaction is entirely disregarded for tax purposes by the selling shareholders, and instead, the transaction is reported as a deemed asset sale by the target followed by target's deemed liquidation. The seller and buyer allocate the purchase price against the physical assets (just as they would in an asset sale) by filing form 8023 with the IRS by the 15th day of the 9th month after the closing date.[6] And the target's final tax return must be filed within two and a half months of the transaction.[7]

A 338(h)(10) election is only available where the target is an S-corp (or member of an affiliated or consolidated group of corporations), and the buyer is a corporation making a qualified stock purchase of at least 80% of target's stock.[8] The buyer may want to immediately liquidate the target (tax free under Section 332) or perhaps continue the target/S-corp as a Qsub (if the buyer, itself, is a S-corp or a new S-corp is created specifically for the transaction).

A 338 election does not affect the buyer's responsibility for target's pre-closing liabilities, as the asset sale/deemed liquidation is a legal fiction—so sufficient indemnity provisions should be negotiated in a 338 transaction to adequately protect the buyer from pre-closing liabilities of the target (and escrow and insurance should remain in place sufficient to assure that there are proceeds to cover the indemnity obligations in the event of seller's inability to fully fund such obligations).

Additional Advantages Under New Tax Law

The advantages of a 338 sale became even greater under the new Tax Cuts and Jobs Act (TCJA) signed into law on December 22, 2017.

Under the TCJA, qualified property acquired after September 27, 2017, and placed into service on or before December 31, 2022, may be eligible for 100 percent bonus depreciation (i.e. the purchase price for this property will be immediately deductible).[9] Under the TCJA there is no "original use" requirement (such that both new and used property are now eligible for 100 percent expensing). Such 100 percent bonus depreciation to a potential purchaser, as well as the lower (21%) tax rate now imposed on corporate sellers, make stock sales subject to a Section 338(h)(10) election even more attractive to both parties (lowering taxes to seller for recognition as a stock sale and to purchaser for recognition as an asset purchase based upon higher/immediate depreciation of assets). In this regard, note that bonus depreciation is not available for goodwill and other intangible property, which remain amortizable under the straight-line method over 15 years (but "qualified property" for such accelerated treatment continues to include certain computer software and certain qualified film, television, and live theatrical productions). Accordingly, buyers generally will continue to have an incentive to allocate as much of the 338-purchase price as possible to tangible, depreciable property eligible for 100 percent bonus depreciation, whereas sellers will continue to have an incentive to allocate the purchase price to whichever assets have the highest tax basis and therefore produce the lowest taxable gain.

(continued on page 26)

Conclusion

Especially in the mid-market and closely-held sectors (where targets have traditionally adopted the S-corp status early in their history), a 338 election provides a mechanism to leverage post-tax advantages for a buyer and make a target more attractive as a stock acquisition without unduly/negatively affecting the tax consequences to seller/target. ■

Endnotes

1 Under 26 U.S.C. § 1060(a)(2), the purchaser can allocate the purchase price among the tangible assets of the target, as well as intangible assets such as goodwill, thus offering tax recognition and benefits of the entire purchase price.

2 Rather, the purchaser simply retains the tax basis in the stock until a subsequent sale of the stock, with the tax basis available to offset the proceeds.

3 *See id*. § 1012(a) (detailing the tax basis of property).

4 For instance, if an asset sale is not a viable option due to certain legal restrictions, the 338 transaction allows the target to maintain its corporate existence while still offering the tax benefits of an asset sale.

5 Thus, for legal purposes, the purchaser acquires the stock of the target, and for tax purposes, the purchaser acquires the assets. As a result, the purchaser can immediately realize the tax benefits of the total purchase price with yearly depreciation deductions that offset—or rather, shelter—taxable income.

6 *See id*. § 338(g)(1).

7 *See* 26 C.F.R. § 1.338-10(a)(6)(i) (outlining the due date for the target's tax return).

8 As set forth in 26 U.S.C. § 338(b)(6)(A), the qualified stock purchase can occur over a 12-month period, subject to certain limitations.

9 The bonus depreciation is scheduled to be phased out 20% a year over the five years beginning 2023.

***KELLY FREY** is a partner at Nelson Mullins Riley & Scarborough, LLP. He practices corporate law and was selected last year as "Best of the Bar" in Technology Law by the* Nashville Business Journal*, "Lawyer of the Year" in Nashville by Best Lawyers in America® in Technology Law, and the only attorney selected in Mid-South SuperLawyers in Technology Transactions. He is past-president of the Nashville Film Festival and current chair of the Board of Governors for the Franklin Theatre.*

***AMELIA LANT** is a business and technology attorney in the Nashville office of Nelson Mullins Riley & Scarborough, LLP. She focuses her practice in the areas of corporate venture capital and technology transactions.*