

Wall Street Prep Webinar

Understanding
Asset / 338(h)(10)
vs. Stock Sales

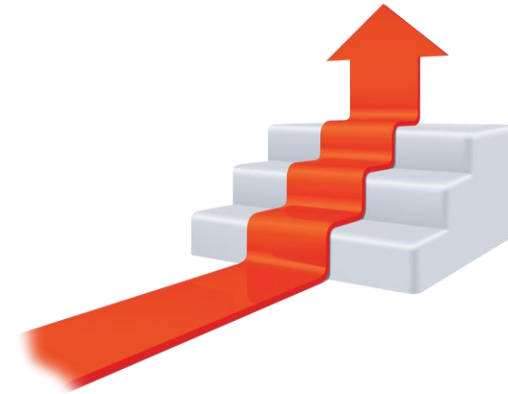
About the instructor

- Founder and CEO, Wall Street Prep
- Prior: Investment Banking and Equity Research, JP Morgan
- Trains new and experienced hires at world's leading IB/PE firms, corporations and business schools



Our goals

- Understand differences between
 1. Taxable stock sales
 2. Asset sales/338(h)(10)
 3. Nontaxable sales
- Understanding implications of structure when:
 - Target is a C corp, S corp or 80%+ owned sub
 - Target has substantial NOLs
- How deal structure decisions affect deal pricing



Caveats

- Framework introduced here to provide “rules of thumb”
- Tax rules can get quite complex - should always be conducted in consultation with qualified tax advisors
- We are not delving into GAAP accounting issues that emerge in acquisitions – focus purely on the value implications of prevailing deal structures
 - Purchase Price Allocation Webcast in October
 - M&A Modeling Online Course
- **Let’s begin!**

Stock sale vs. asset sale

- Suppose you want to buy a company with \$100m in assets (cash, PP&E, etc.) and \$20m in liabilities (A/P and loans)
- What is the legal mechanism for acquiring this business?
 1. Purchase all the assets and assume all the liabilities
 2. Alternatively, you could just buy the company's stock to gain ownership over the business
- Both approaches make you the owner
- BUT buying the assets is **treated quite differently** for tax purposes than buying stock

Stock sale vs. asset sale

- The big difference to the acquirer has to do with the **tax basis of the assets being acquired**
 1. Buying the assets: Creates a **basis step-up**
 2. Buying the stock: **No basis step up**

Stock sale vs. asset sale

- Say you acquire a company for \$140m with financials as illustrated.
- Assuming 50% of the \$60 excess of purchase price over book value is allocated to PP&E, with the remaining to Goodwill, what is the tax basis of assets & liabilities post-acquisition?

Cash	5.0
PP&E	80.0
Intangible Assets (Inc. GW)	15.0
Total Assets	100.0
A/P	5.0
Debt	15.0
Total Liabilities	20.0
Total Equity	80.0

	When buying the assets	When buying the stock
Cash	5.0	5.0
PP&E	110.0	80.0
Intangible Assets (Inc. GW)	45.0	15.0
A/P	5.0	5.0
Debt	15.0	15.0

Stock sale vs. asset sale

- **Buyers generally want to structure a deal in a way that achieves a tax basis step-up (i.e. asset sales)**

- Why? To reduce future tax liability, through the higher tax deductible D&A expense that the step-up affords

Quantifying acquirer tax savings in asset sales

- Assuming a 5 year useful life on our PP&E, the \$30m step-up increases tax-deductible D&A expense by an average of \$6m/year¹.
- At a 40% tax rate, that's an average annual savings of \$2.4m to the acquirer.
- Assuming a 10% discount rate and straight-line depreciation, the PV of this savings is \$9.1m
- Goodwill: In addition, goodwill is amortizable on a straight-line basis over 15 years for tax purposes (not for book), creating an additional \$0.8m in annual tax savings, with a PV of \$6.1m.

The total PV of savings for the acquirer is \$15.2m

¹We use straight line for simplicity in the example, although the IRS and most tax systems allow an accelerated depreciation method (IRS uses MACRS), enabling acquirers to realize the savings even sooner

So...buyers prefer asset sales. What about sellers?

- Sellers are primarily concerned with the level of tax incurred in the transaction, and prefer structures that can reduce and/or defer this tax.
- When deal consideration is primarily cash, the transaction is viewed as a taxable sale, with immediate tax on target shareholders and potentially on entity level.
- When deal consideration is primarily stock, the transaction can be structured as a “reorganization,” and tax can be largely deferred. These structures are called **section 368 nontaxable acquisitions**, somewhat misleadingly because tax is deferred.

Seller perspective

- In the prior example, had the seller received **\$140m in cash**, it would be taxed immediately:
 - If seller sells stock, then seller is taxed on gains at shareholder level (“outside basis”)
 - If seller sells assets, seller is taxed twice¹: first on asset gains (“inside basis”), then on shareholder level gains (“outside basis”)

Target entity - C-corporation	
Purchase price	140.0
Inside basis in net assets	80.0
Outside basis in stock	100.0
Corporate tax rate	40%
Capital gains rate	20%
Stock sale ✓	
Taxable gain to company	0.0
Corporate level tax	0.0
Dividend to shareholders	140.0
Taxable gain to shareholders	40.0
Tax on shareholders	8.0
Proceeds to shareholders	132.0
Asset sale	
Taxable gain to company	60.0
Corporate level tax	24.0
Dividend to shareholders	116.0
Taxable gain to shareholders	16.0
Tax on shareholders	3.2
Proceeds to shareholders	112.8
<i>Memo: Future tax savings to acquirer</i>	<i>15.2</i>

¹If seller is S-Corp, only one level of tax at shareholder level but at ordinary income tax rate, more on this shortly

Seller perspective

- Had seller received **\$140m in acquirer shares in a nontaxable 368**, no corporate level tax applies regardless of whether target sells assets or stock, while shareholder level tax is deferred

Wrinkles that change the calculation for buyer and seller

- If target is an S-corporation or 80%+ owned subsidiary: Double tax on asset sale can be avoided
- Substantial target and target-parent NOLs: Reduces gain for target in asset sales

Review

- **To determine basis**, the question to ask is “what is being purchased?” If assets, then step up; if target stock then no step up
- **To determine taxability**, the question to ask is “what is the form of consideration? Broadly speaking, if acquirer stock, then nontaxable; if cash then taxable.

Now let's dig deeper...

Taxable stock sales

- Acquirer does not get an inside basis step up (gets “carryover basis”) so no future tax savings from D&A
- Acquirer does get an outside basis step up in target’s stock
- Seller only one level of tax:
 - Avoids taxable gain on sale on corporate level
 - Only recognizes a taxable gain on shareholder level

Taxable sale		Section 368 non-taxable sale	
Stock Sale	Asset Sale/ 338 election	Stock Sale	Asset Sale

Taxable asset sales – acquirer perspective

- Acquirer purchases assets and assumes liabilities of target.
- Higher D&A from inside basis step-up shields acquirer from taxes; PV of savings factored into deal pricing
- Acquirer also gets an outside basis step-up in target's stock assuming target shareholders liquidate proceeds
- If acquirer sells target down the road the higher outside basis will lower taxable gain

Taxable sale		Section 368 non-taxable sale	
Stock Sale	Asset Sale/ 338 election	Stock Sale	Asset Sale

Goodwill: Unlike GAAP accounting, tax rules allow goodwill to be amortized over 15 years, along with other intangible assets that fall under IRC section 197.

NOLs (DTAs) : In an asset sale, the target tax attributes (NOLs) can be used by the target to offset the gain on sale, but any excess does not transfer to the acquirer

Taxable asset sales – target perspective

- Potentially two levels of tax:
 1. Corporate level gain on sale
 2. If proceeds are then distributed to shareholders, those dividends are taxed again at capital gains rate¹
- While acquirer may increase the purchase price to entice the target to agree to asset sale; tax savings to acquirer are usually not sufficient to make asset sales favorable
- Asset sales more costly and legally complex

Taxable sale		Section 368 non-taxable sale	
Stock Sale	Asset Sale/ 338 election	Stock Sale	Asset Sale

Deemed asset sales - 338(h)(10) elections

- Allows stock sales to be treated as an asset sale for tax purposes, although in actuality stock is exchanged
- Acquirer and target tax treatment identical to asset sale
- Avoids legal costs and complications of straight asset sale

Taxable sale		Section 368 non-taxable sale	
Stock Sale	Asset Sale/ 338 election	Stock Sale	Asset Sale

Deemed asset sales - 338(h)(10) elections

Requirements to qualify for 338(h)(10) election

- ☑ Target must be a subsidiary or S-corporation¹
- ☑ Election must be made jointly by buyer and seller, before deal is consummated
- ☑ Buyer must be a C corp (not an LLC or partnership. PE buyers, who are typically structured as LLCs, bypass this by creating a new C-corp that buys the target)
- ☑ Must purchase >80% of target stock within 12 months of the first purchase of stock
- ☑ Foreign targets are not eligible for a 338 election
- ☑ Cannot be made in a non-taxable stock sale

NOLs are when asset sales/338s start looking good

- Target NOLs can be used without limit to offset the corporate level gain. Any excess NOLs are lost

Taxable sale		Section 368 non-taxable sale	
Stock Sale	Asset Sale/ 338 election	Stock Sale	Asset Sale

- Can substantially reduce the corporate level tax
- Makes an asset sale attractive compared to stock sales

NOLs in stock sales

- While target does not get to use its NOLs in stock sales, NOLs do carry over to the acquirer¹
- Creating a future tax savings for acquirer
- Subject to annual limitations under IRC section 382
 - 382 annual limit = Purchase price x % IRC 382 LT Rate¹

Taxable sale		Section 368 non-taxable sale	
Stock Sale	Asset Sale/ 338 election	Stock Sale	Asset Sale

¹The current rate is 2.3%. Good updated source for LT tax exempt rate is <http://www.pmstax.com/>

NOLs exercise

- Let's revisit our example, but assume the target has \$55m NOLs with 10 years remaining (they can be carried forward 20 years from when created)

So which approach is optimal?

NOLs create several new competing forces:

- Lower taxable gain to company makes asset sale more favorable, offset by the acquirer benefit of future NOLs if deal is structured as a stock sale
- To quantify PV benefit to acquirer, let's assume a LT exempt rate of 2.3% and a discount rate of 10%

Target entity - C-corporation

Purchase price	140.0
Inside basis in net assets	80.0
Outside basis in stock	100.0
Corporate tax rate	40%
Capital gains rate	20%
Target NOLs	55.0

Stock sale

Taxable gain to company	0.0
Corporate level tax	0.0
Dividend to shareholders	140.0
Taxable gain to shareholders	40.0
Tax on shareholders	8.0
Proceeds to shareholders	132.0

Memo: Future NOL tax savings to acquirer 7.9

✓ Asset sale

Taxable gain to company	5.0
Corporate level tax	2.0
Dividend to shareholders	138.0
Taxable gain to shareholders	38.0
Tax on shareholders	7.6
Proceeds to shareholders	130.4

Memo: Future tax savings to acquirer 15.2

NOLs for 80%+ owned subsidiaries

NOLs when target is an 80+ owned subsidiary by a parent company

In an asset sale the parent can use both NOLs directly attributed to target and parent NOLs to reduce the corporate gain on sale

In a stock sale while NOLs directly attributable to the target can't be used to offset target's shareholder level gains, the parent can use its own NOLs to offset the shareholder level gain at the corporate tax rate, any remaining parent NOLs remain with parent.

Selling S-corporations and subsidiaries

- S-corporations are pass-through entities; one level of tax, all at shareholder level
 - Profits and gains at ordinary income rate, capital gains at capital gains rate
- When target is 80%+ owned subsidiary of parent
 - No double tax on asset sale: Tax on gain on sale of assets but after-tax liquidation proceeds can be distributed to the parent tax-free (IRC section 332) ¹

Taxable sale		Section 368 non-taxable sale	
Stock Sale	Asset Sale/ 338 election	Stock Sale	Asset Sale

¹But if parent distributes proceeds as a dividend, they will be subject to a second tax on dividends

Aggregate deemed sale price (ADSP)

- Because a 338 is actually a purchase of stock that is just treated as a purchase of assets, the new inside basis of assets must be calculated:

Taxable sale		Section 368 non-taxable sale	
Stock Sale	Asset Sale/ 338 election	Stock Sale	Asset Sale

- $ADSP = \text{Stock purchase price}^1 + \text{target liabilities}$
- The gain from which tax is calculated = $ADSP - \text{inside basis of assets (not net assets)}$
- In our example, $ADSP = \$140m + 20m = \$160m$, and the gain = $\$160 - \$100 = \$60$

¹For simplicity, we assume 1) No selling costs, that acquirer purchases 100% of target and 3) that Seller assumes the tax liability. When the acquirer purchases less than 100% of target stock, the equity purchase price is grossed up to reflect a 100% acquisition for purposes of calculating the new inside basis (ADSP). ADSP also subtracts selling costs. Additionally, if the buyer (instead of the seller) pays the tax, the $ADSP = \text{Stock purchase price} + \text{target liabilities} - \text{selling costs} + (\text{tax rate} \times ADSP \text{ gain})$

Putting it all together

Purchase price - Stock Sale/Asset Sale	\$140.0
Target liabilities	20.0
ADSP for 338(h)(10)	160.0
Target inside tax basis on net assets:	80.0
Target outside stock basis:	100.0
Ordinary income tax rate:	40%
Capital gains tax rate:	20%
D&A period	10
Discount rate	10.0%
NOLs - Directly attributed to Target	55.0
NOLs - Parent (excl. direct target NOLs)	35.0
Long term tax exempt rate	2.3%
382 NOL annual limit	3.2
Years NOLs will be carried forward	17.1

Target/Parent Perspective

Taxable gain on sale of assets (pre-NOL)
Taxable gain on sale of assets (post-NOL)
Taxes on gain on sale:
Proceeds to shareholders/parent
Taxable capital gains of:
Capital gains tax:

Net proceeds to target/parent

Acquirer perspective

Annual D&A from step-up
Annual tax benefit
Present value of tax savings from basis step up
Annual 382 limitation on NOLs
Annual tax savings from NOLs
Present value of tax savings from NOLs

Taxable sale

C corp

	<u>Stock sale</u>	<u>Asset Sale</u>
Taxable gain on sale of assets (pre-NOL)	0.0	60.0
Taxable gain on sale of assets (post-NOL)	0.0	5.0
Taxes on gain on sale:	0.0	2.0
Proceeds to shareholders/parent	140.0	138.0
Taxable capital gains of:	40.0	38.0
Capital gains tax:	8.0	7.6
Net proceeds to target/parent	132.0	130.4

Proceeds to target + PV of tax benefits to acquirer

142.4 145.1

Putting it all together

Purchase price - Stock Sale/Asset Sale	\$140.0
Target liabilities	20.0
ADSP for 338(h)(10)	160.0
Target inside tax basis on net assets:	80.0
Target outside stock basis:	100.0
Ordinary income tax rate:	40%
Capital gains tax rate:	20%
D&A period	10
Discount rate	10.0%
NOLs - Directly attributed to Target	55.0
NOLs - Parent (excl. direct target NOLs)	35.0
Long term tax exempt rate	2.3%
382 NOL annual limit	3.2
Years NOLs will be carried forward	17.1

Target/Parent Perspective

Taxable gain on sale of assets (pre-NOL)	0.0	60.0
Taxable gain on sale of assets (post-NOL)	0.0	5.0
Taxes on gain on sale:	0.0	2.0
Proceeds to shareholders/parent	140.0	138.0
Taxable capital gains of:	40.0	0.0
Capital gains tax:	8.0	0.0

Net proceeds to target/parent

Acquirer perspective

Present value of tax savings from basis step up		14.7
Present value of tax savings from NOLs	10.4	
Proceeds to target + PV of tax benefits to acquirer	142.4	152.7

Taxable sale

S-Corp

<u>Stock sale</u>	<u>338(h)(10)</u>
0.0	60.0
0.0	5.0
0.0	2.0
140.0	138.0
40.0	0.0
8.0	0.0
132.0	138.0

Putting it all together

Purchase price - Stock Sale/Asset Sale	\$140.0
Target liabilities	20.0
ADSP for 338(h)(10)	160.0
Target inside tax basis on net assets:	80.0
Target outside stock basis:	100.0
Ordinary income tax rate:	40%
Capital gains tax rate:	20%
D&A period	10
Discount rate	10.0%
NOLs - Directly attributed to Target	55.0
NOLs - Parent (excl. direct target NOLs)	35.0
Long term tax exempt rate	2.3%
382 NOL annual limit	3.2
Years NOLs will be carried forward	17.1

Target/Parent Perspective

Taxable gain on sale of assets (pre-NOL)	0.0	60.0
Taxable gain on sale of assets (post-NOL)	0.0	0.0
Taxes on gain on sale:	0.0	0.0
Proceeds to shareholders/parent	140.0	140.0
Taxable capital gains of:	5.0	40.0
Capital gains tax:	2.0	0.0

Net proceeds to target/parent

Acquirer perspective

Present value of tax savings from basis step up		14.7
Present value of tax savings from NOLs	10.4	
Proceeds to target + PV of tax benefits to acquirer	148.4	154.7

	Taxable sale	
	80%+ Sub	
	<u>Stock sale</u>	<u>338(h)(10)</u>
	0.0	60.0
	0.0	0.0
	0.0	0.0
	140.0	140.0
	5.0	40.0
	2.0	0.0
	138.0	140.0

Nontaxable sale

- Up until now we have been talking about transactions that the IRS views as taxable

Taxable sale		Section 368 non-taxable sale	
Stock Sale	Asset Sale/ 338 election	Stock Sale	Asset Sale

- If a sufficient portion of the consideration provided to the target is in acquirer stock (roughly at least 50%), a transaction can be considered a nontaxable reorganization under IRC section 368

Additional requirements for nontaxable treatment:

- Acquirer must continue the target's line of business
- There must be a valid business purpose for acquisition (beyond tax avoidance)
- Transaction cannot be part of a larger plan that would constitute a taxable acquisition

Nontaxable sale

- Acquirer perspective

- No inside or outside basis step up
- Target NOLs transfer (still subject to the 382 limitation)

- Target perspective

- No corporate level tax or shareholder level tax on qualifying consideration (i.e. acquirer stock)¹
- Selling shareholders receive carryover basis in their new shares, and a taxable gain will be triggered when they sell those shares.

Taxable sale		Section 368 non-taxable sale	
Stock Sale	Asset Sale/ 338 election	Stock Sale	Asset Sale

Taxable versus non taxable transactions

Taxable versus non taxable transactions summary				
	Taxable		Non taxable	
	Asset sale or 338(h)(10) election	Stock sale	Asset sale <i>A or C reorganization</i>	Stock sale <i>B reorganization</i>
Generally preferred by	BUYER	SELLER	SELLER	SELLER
Tax paid by target	Taxed on gain on sale as ordinary income	No	No	No
Tax paid by target shareholders	Yes, if there is liquidating dividend	Capital gains tax (short term or long term)	Only on portion received in cash ("boot")	No (generally no boot allowed)
Acquirer gets inside basis step up?	Yes	No	No	No
Acquirer gets outside basis step up?	Yes, if there is liquidating dividend	Yes	No	No

Wall Street Prep Webinar

Q&A

Bring us in house

- M&A, Subsidiary and Deferred Tax Accounting
- Advanced M&A Modeling
- LBO Modeling
- Contact us
 - Matan Feldman
 - 617-314-7685 ext. 703
 - mfeldman@wallstreetprep.com

Appendix: 338(g)

- C-corporation targets can also be acquired in a deemed asset sale under a 338(g)
- Under a 338(g), the selling shareholders are not impacted.
- Instead, the acquirer make this election after deal completion and a tax on the gain on sale of assets is borne by the acquirer.
- Why would an acquirer take on this liability? If the target NOLs (which can be used to offset the gain) along with the PV of future tax savings from write-ups are sufficient to compensate the acquirer for the additional tax burden. This is a more rare election than the 338(h)(10)