

Business Transaction Marketplace

Information about Business Valuations, M&A and Corporate Finance December 2011

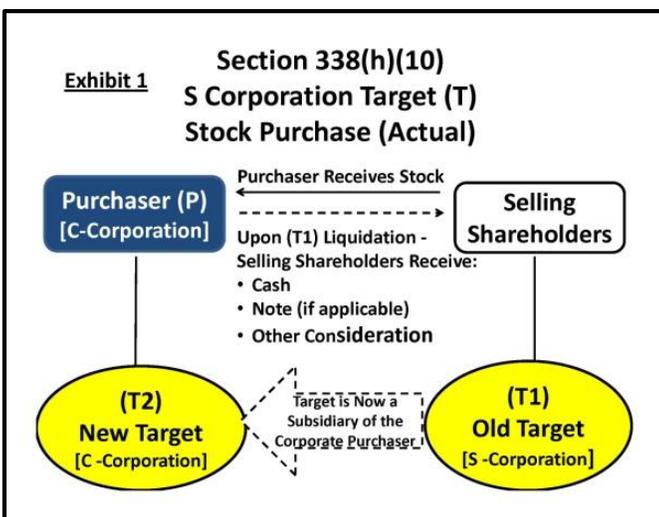
Section 338(h)(10) Election – Both a Stock and an Asset Purchase

Purchasers in a business transaction generally prefer an asset purchase in order to step up the basis of acquired assets. Yet, a stock purchase may be preferable for a variety of non tax reasons. Normally in a stock purchase, the consideration paid becomes the tax basis of the stock from the purchaser's standpoint.



However, in certain circumstances, the Internal Revenue Code gives the purchaser and the seller the ability to make a joint election where the actual transaction is a stock purchase, but for tax purposes it is treated as an asset purchase. This is accomplished by making a Section 338(h)(10) Election (H-10 Election) – the subject of this article.

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H-10 Election – Requirements

Qualified Stock Purchase (QSP)

To qualify for the H-10 Election, the transaction must meet the following QSP requirements:

- The Purchaser (P) of Target's (T's) stock must be either a C Corp or an S Corp.
- P cannot be an individual, partnership, or LLC treated as a partnership.
- P must purchase at least 80% (vote and value) of T's stock over a 12-month period.

Target (T) Eligibility

To be eligible for the H-10 Election, T must be a domestic corporation under one of the following:

- A member of a consolidated group that files a consolidated return.
- A member of an affiliated group that does not

file a consolidated return.

- An S Corp (**the focus of this article**).

Exhibit 1: S Corp Target – Stock Purchase (Actual)

P may want to purchase T's stock for the following non tax reasons:

- T has several assets that require title transfer that would be burdensome in an asset purchase.
- T has contracts that are difficult to transfer.
- T has favorable workers compensation and/or unemployment ratings that P wants to preserve.
- T has historical preferences with governing bodies that would be lost in an asset sale.
- T (a C Corp) has tax attributes that will survive (e.g. net operating loss carryovers).
- T's corporate name is retained.
- **Caution:** As with any stock purchase comes the responsibility for disclosed and undisclosed liabilities along with unwanted assets.

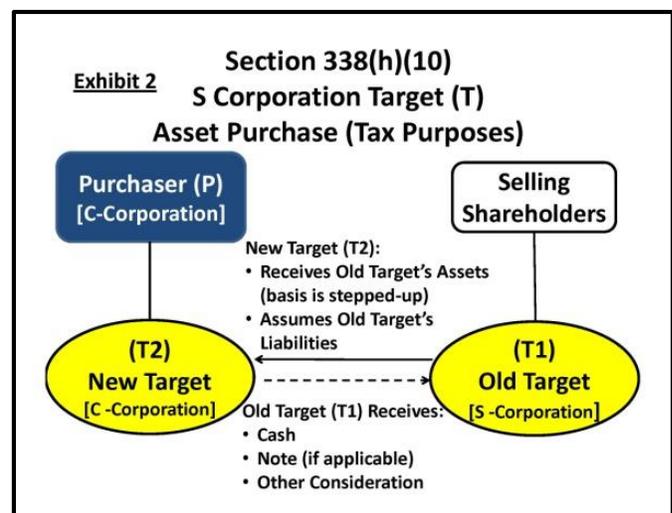


Exhibit 2: S Corp Target – Asset Purchase (Tax Purposes)

If the transaction is deemed to be a QSP and T is one of the three eligible corporations, the transaction can be treated for tax purposes as an asset purchase by doing the following:

- P and T make a joint H-10 Election by filing [IRS Form 8023](#) by the 15th day of the ninth month after the acquisition.
- All of Old Target's (T1's) S Corp shareholders must agree to the election – even though up to 20% (vote and value) may not be selling their stock.
- New Target (T2) obtains an adjusted grossed-up basis (AGUB) in the acquired assets.
- T2's AGUB is based upon the consideration paid for T1 stock, plus T1 liabilities that were assumed.
- The AGUB asset allocation is reported by T1 and T2 on [IRS Form 8883](#).
- T1 files a final S Corp tax return as of the acquisition date and liquidates for tax purposes.
- Now the subsidiary of P (a C Corp), T2 becomes a C Corp since an S Corp cannot be owned by a C Corp (see QSub discussion below).

H-10 Election – Tips and Traps

- As stated above, a C Corp cannot own an S Corp. But if P is an S Corp and acquires 100% of T's stock, it can make a Qualified Subchapter S Subsidiary (QSub) Election. The QSub Election is done by filing [IRS Form 8869](#). Both P and T then become pass through entities thereby eliminating tax at the corporate level.
- Because of potential ordinary income recapture in a deemed asset purchase, T's S Corp sellers – who agree to the H-10 Election – are likely to pay more taxes than they would have paid in a stock purchase (for tax purposes). The parties will often negotiate a higher price to compensate for this additional tax cost borne by the seller.
- If T was not an S Corp for its entire existence, there may be a recapture of a built-in gain (BIG) upon the deemed asset purchase. The definitive purchase & sale agreement should specifically identify the party (P or T) responsible for paying the BIG tax liability.
- The treatment of the H-10 election for state income tax purposes is less certain because most states do not have statutes or regulations addressing this issue. Appropriate steps should be taken by P and T to determine their respective state income tax treatment.
- Lastly. The H-10 Election is complex. Parties to the transaction should seek legal and tax advice from professionals well versed in the H-10 Election.



Marketplace Alert – New 70% Write-off Safe Harbor

In early 2011, the Internal Revenue Service issued Revenue Procedure 2011-29. The Revenue Procedure provides taxpayers a safe harbor election in expensing success-based fees paid in business acquisitions or reorganizations. In lieu of maintaining mandatory required documentation, the safer harbor allows taxpayers the write-off 70% of success-based fees paid. The balance of the fee must be capitalized as an amount that facilitates the transaction.

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