

Insight

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Purchase Price Allocations Support Section 338 Elections

“We allocated the purchase price to the different acquired legal entities and then allocated the legal entity value to the various asset categories...”

An Internal Revenue Code (IRC) Section 338 election may offer advantages for buyers in corporate acquisitions. In general, the impact of a Sec. 338 election is that a stock acquisition is treated as an asset acquisition and therefore the tax basis of the assets held by the target company is stepped up to the purchase price. Sec. 338 elections generally take one of two forms: the Sec. 338(g) election which is most useful in the case of foreign acquisitions, and the Sec. 338(h)(10) election which is commonly used in the case of a domestic acquisition. Both types of Sec. 338 elections require that a purchaser acquire 80% of the vote and value of the target company's stock.

SECTION 338(g) ELECTION

In the case of a Sec. 338(g) election, the target recognizes gain on the deemed sale of its assets. This tax impact of this gain is borne by the acquirer. The target is then considered a new corporation with a stepped-up basis in the assets. In addition, the seller recognizes gain or loss on the sale of the target company shares. Accordingly, the Sec. 338(g) election results in two levels of tax and thus is generally not beneficial in the case of a domestic acquisition since the acquirer pays tax on the gain immediately and realizes the benefit of the stepped-up basis over time. In the case of an acquisition of a foreign target, a Sec. 338(g) election may be beneficial. The deemed sale of assets by a foreign corporation without U.S. operations has no impact as the foreign corporation is not subject to U.S. tax. The election results in the elimination of any accumulated earnings and profits of the foreign corporation. Also, the assets of the foreign target would be stepped up for U.S. tax purposes which would result in lower future earnings and profits due to higher depreciation and amortization.

SECTION 338(h)(10) ELECTION

The Sec. 338(h)(10) election, in contrast to the Sec. 338(g) election results generally in a single level of tax. The target is deemed to have sold all its assets to the new target and to have distributed the proceeds to the old target shareholders. The sale of the shares is in essence ignored. The acquirer receives a stepped-up basis in the assets and thus obtains the benefit of future increased depreciation and amortization deductions. Thus, the buyer can have the benefit of the step-up without being required to pay a tax on the full amount of the gain up front, at the time of the election. The buyer also receives the benefit of the increased cash flow.

SECTION 338(h)(10) REQUIREMENTS

The requirements for a Sec. 338(h)(10) election are as follows:

- The acquisition must be at least 80% of the target stock
- The target must be a corporation that is either a) a subsidiary that filed with a consolidated group; b) a corporation that is 80% controlled without filing consolidated; or c) an S corporation
- Both parties (buyer and seller) need to agree to the election
- Joint tax reporting, i.e. both the buyer and seller need to complete Form 8594

SECTION 1060 ALLOCATION RULES

Section 1060 provides special allocation rules for certain asset acquisitions. Under Sec. 1060, the

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“Our valuation was used to provide a supportable basis of value for allocation of the purchase price for tax reporting purposes to the tangible and intangible assets acquired and to the respective legal entities.”

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purchase price must be allocated to the assets under the residual method per IRC Section 338 (b)(5). Assets must be placed in one of seven asset categories:

Class I: Cash and cash equivalents

Class II: Actively traded personal property (or Sec. 1092(d)), certificates of deposit, and foreign currency

Class III: Accounts Receivables, mortgages, and credit card receivables

Class IV: Inventory

Class V: All assets not in classes I – IV, VI and VII (equipment, land, building)

Class VI: Sec. 197 intangibles, except goodwill and going concern

Class VII: Goodwill and going concern

CASE STUDIES

1) Our client, a multinational food and beverage company, made a Sec. 338(g) election on an international acquisition. From the acquirer’s perspective, the Sec. 338(g) election potentially provided significant tax benefits without the upfront gain required from the deemed asset sale since the target was a non-U.S. entity. Making the Sec. 338(g) election afforded the acquirer the opportunity to start fresh with zero earnings and profits, potentially minimizing future taxability of distributions and simplifying the future determination of the tax impact of distributions. Additionally, future earnings and profits would be lowered due to the impact of higher depreciation and amortization deductions for U.S. tax purposes which result from the stepped-up basis in the assets. We allocated the purchase price to the different acquired legal entities and then allocated the legal entity value to the various asset categories (i.e. working capital, PP&E, intangible assets and goodwill). Our analysis provided the acquirer with a tax basis in the acquired assets by legal entity and also provided the acquirer with value estimates (for the various assets).

2) In support of a major food processor’s 338(h)(10) election, we valued both tangible and intangible assets. Our valuation was used to provide a supportable basis of value for allocation of the purchase price for tax reporting purposes to the tangible and intangible assets acquired and to the respective legal entities. The tangible assets consisted of land, land improvements, buildings, machinery and equipment, office furniture and equipment, computers, laboratory equipment, vehicles and storage facilities. The intangible assets included patents, trademarks, service marks, and software. The assets were allocated to the seven asset classes as required under Sec. 338(b)(5).

RELY ON THE EXPERTS

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