IRS Regulations Now Give Certainty On Multistep M&A Transactions

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Qualified stock purchases and the 338 election. When an acquiror buys at least 80% of a target for consideration within 12 months, whether through stock or cash in exchange for the target's stock, the acquiror is deemed to have made a qualifying stock purchase (QSP). Under the Internal Revenue Code, tax attorney Richard Morris explains, the acquiring company (and usually the target as well) is entitled to make a Section 338 election. Doing so allows the buyer to record the assets at market value, as if the target's assets had been acquired rather than its stock. Such a choice provides the buyer with a stepped-up basis for assets that have appreciated in the target's hands. One catch is that the acquiror can make this election only if the target is either at least an 80%-owned subsidiary from a consolidated group of companies or is an S corporation.

The step transaction moves forward. Problems with the 338 election emerged in 1990, when the IRS issued a ruling in a case that negated an election. The acquiror had merged a subsidiary into a target, paying cash to its shareholders in the process, and the entity subsequently merged into the acquiror. Rather than recognizing the substance of the deal (i.e., that the target had been acquired), the IRS viewed the transaction in steps and ruled that the second merger was tantamount to the sub's liquidation. This recognized the company's payment to the target's shareholders as a QSP, notes the author, but the liquidation treatment of the subsidiary eliminated any chance for the 338 election. This resulted in the acquiror recording the sub's assets at their previous book value rather than at market value, not the acquiror's hoped-for outcome. The ruling sent M&A planners into a tizzy and caused considerable confusion for tax practitioners.

New rulings help the cause. The IRS further muddied the waters in 2001 when it negated QSPs in two multistep deals that the parties had assumed would qualify for 338 election. Realizing the frustration among dealmakers, the IRS finally issued proposed regulations in 2003, which became final in mid-2006. The new rules allow the acquiror a choice: either view the deal in steps, as the IRS had ruled in the earlier cases, or apply the 338 election. Startlingly, the IRS provides some examples in the regulation materials establishing that taxpayers can make a choice in a situation which, prior to the regulatory change, would have not been favorable to the acquiror. As a result of the ruling, the author indicates, dealmakers can now feel confident that the IRS will respect their Code Sec. 338(h)(10) elections.

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