

IRC Section 338(h)(10) Elections

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§338(h)(10) Election Overview

- If a §338(h)(10) election is made for a target, old target generally is deemed to have sold all of its assets to new target and to have distributed the proceeds to the old target shareholders immediately before the target ceases to exist (generally in a deemed liquidation).
 - In effect, the sale of target stock is ignored for federal income tax purposes, which generally allows for the single level of federal income tax that is the hallmark of the §338(h)(10) election.
- The principal effect of a §338 election on Target (“T”) is that T’s aggregate basis in its assets is “stepped up” under §1012 to the price that Purchaser (“P”) paid for T’s stock (adjusted for assumed liabilities and other items).

§338(h)(10) Eligibility

- A §338(h)(10) election can be made only if a qualified stock purchase is accomplished (80% vote and value via 1504(a)(2)) and the target is
 - (i) a domestic corporation that is a subsidiary member of a consolidated group,
 - (ii) a domestic corporation that is a subsidiary member of an affiliated group not filing a consolidated return, or
 - (iii) an S corporation.
 - For an S corporation to qualify as a target for purposes of a §338(h)(10) election, the purchasing corporation cannot purchase any target stock before the acquisition date.
 - Such a purchase terminates the S election for the target.

§338(h)(10) Motivations

- If an acquiring corporation purchases stock of a target corporation from the target's parent, the §338(h)(10) election is often desirable.
- The parent will not recognize gain or loss on the sale of the target's stock, and the target will recognize gain or loss as if it sold its assets.
 - The treatment of the parent's stock sale as an asset sale allows the parent to dispose of the sub with only one tax at the corporate level, even though the purchaser obtains a stepped-up basis in the assets.
 - A §338(h)(10) election is advantageous if
 - i) the purchase price is allocable to depreciable assets or amortizable §197 intangibles or
 - ii) the unrealized appreciation in T's assets is less than the unrealized appreciation in Parent's stock in T.

§338(h)(10) Mechanics

- If a §338(h)(10) election is made old target is deemed to transfer all of its assets to an unrelated person (i.e., new target) in exchange for consideration that includes the discharge of old target's liabilities in a single transaction at the close of the acquisition date (but before the deemed "liquidation" of old target).
 - Old target recognizes all of the gain realized on the deemed transfer of its assets in consideration for the "aggregate deemed sale price" (ADSP). Old target realizes the deemed sale tax consequences before the close of the acquisition date.
 - Gain or loss from the deemed asset sale for a consolidated target is included in the consolidated return filed by the selling consolidated group for the tax year that includes the acquisition date.
 - An S corporation target for which a §338(h)(10) election is made files a final return for the entire short S corporation year.
 - The purchasing corporation takes a cost basis in recently purchased target stock under §1012, and is automatically deemed to have made a gain recognition election for any nonrecently purchased target stock.

§338(h)(10) S Corp Mechanics

- Any direct or indirect subsidiary of an S corporation target that the target has elected to treat as a QSub remains a QSub through the close of the acquisition date.
 - The regulations provide no specific guidance on §338(h)(10) elections in cases in which a QSub itself is the target.
- The sale by an S corporation of all of the stock of a QSub generally is treated as an asset sale by the S corporation to the purchaser of the QSub stock.

§338(h)(10) Tiered Mechanics

- If old target is the parent of a chain of subsidiaries for which §338(h)(10) elections are made, the deemed asset sale of old target is deemed to precede that of its subsidiary.
- As a consequence of this “top-down” cascade, each deemed sale and purchase of the stock of a target subsidiary may result in a qualified stock purchase (assuming the requisite stock ownership).
- No deemed §338(h)(10) election is made for lower tier target subsidiaries, but an affirmative election is possible on a subsidiary by subsidiary basis.

§338(h)(10) Election Filing

- The §338(h)(10) election must be made
 - i) jointly by the Purchaser and Seller on Form 8023
 - ii) not later than the 15th day of the 9th month beginning after the month that includes the acquisition date, and
 - iii) is irrevocable

§338(h)(10) – New York State

- Since 1991, New York State has adhered to the federal treatment of IRC §338(h)(10) elections, regardless of the composition of the New York group.
 - Federal consolidated return effects of IRC §338(h)(10) elections are irrelevant for purposes of New York reporting.
- Effective for tax years beginning on or after January 1, 2007, if a N.Y. nonresident is a shareholder in an S corp that has made the election to be a N.Y. S corp, and the S corp has made an election under IRC section 338(h)(10), then any gain recognized on the deemed asset sale for federal income tax purposes will be treated as N.Y. source income. The amount of the gain to be included in N.Y. source income is determined using the applicable allocation percentage in effect for the year that the section 338(h)(10) election was made.
 - TSB-M-10(10)I, 8/31/10

§338(h)(10) – New York State (cont)

- In addition, when a nonresident shareholder exchanges his or her S corp stock as part of the deemed liquidation, any gain or loss recognized on the stock sale for federal income purposes will be treated as the disposition of an intangible asset for N.Y. State purposes and will not increase or offset any gain recognized on the deemed asset sale as a result of the section 338(h)(10) election. Therefore, the gain or loss from the deemed liquidation of S corp stock is not included in N.Y. source income.
 - New York Technical Service Bureau Memorandum TSB-M-10(10)I, 08/31/2010

§338(h)(10) – New York City

- Amendments to the general corporation tax rules provide that the Department of Finance will recognize IRC §338(h)(10) elections for purposes of entire net income (ENI) calculations and return filing, unless the target corporation is an S corporation for federal income tax purposes.
 - These amendments apply to all open years. RCNY §11-27(h)-(j)
- The federal taxable income of the target corporation, for purposes of computing ENI, will include any gain or loss on the deemed asset sale by the target corporation recognized by virtue of the election.
- The federal taxable income of a member of the selling consolidated group, for purposes of computing ENI, does not include the gain or loss on the target corporation's sale or exchange of stock not recognized by virtue of the election.

§338(h)(10) – New York City (cont)

- Because the starting point for determining the entire net income of an S corporation is the taxable income that the corporation would have been required to report for Federal tax purposes had no S election been made, any 338(h)(10) election made with respect to a target corporation that is an S corporation for Federal tax purposes will be deemed to be an invalid election and will not be recognized.
- If a section 338(h)(10) election of an S corporation is not recognized, the corresponding election pursuant to section 338(g) will be deemed invalid and will not be recognized
 - As a consequence of the nonrecognition of the section 338(g) election, the basis of the assets of the target corporation will be determined without regard to any adjustments made pursuant to section 338(b).



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