Session 23 - Divestitures

- Divestitures
  - 338(h)(10) Elections
- Equity carve-outs
- Spin-offs
- Liquidations

Divestitures

- A sale of a group of operating assets for cash, securities or some other property (a subsidiary, a division, a business segment)
- Divestiture motivations:
  - eliminating unwanted assets (earning lower than required rates of return)
  - regulatory considerations (antitrust)
  - reversals of “mistakes” (reducing scope of activities)
  - cash for debt reduction (LBOs)

Tax treatment of divestitures

- Almost nothing new here
- For unincorporated divisions or business segments, treatment is identical to any other taxable asset sale
- For subsidiaries, treatment depends on the type of transaction chosen
  - taxable asset acquisitions
  - taxable stock acquisitions
  - tax-free asset acquisitions
  - tax-free stock acquisitions

Taxable Stock Acquisitions Section 338 (h)(10) Election

- If A makes a regular Section 338 election 2 levels of tax occur on the sale of T stock
  - a tax on the seller's gain on the sale of T stock and
  - a corporate-level tax on T's deemed sale of assets to New T
- If a Section 338 (h)(10) election is made, A's purchase of T stock is ignored and new T is treated as purchasing old T's assets (only 1 level of tax)

Section 338 (h)(10) Elections

- A **and** the selling T shareholders can make a 338 (h)(10) election only if T satisfies one of the following conditions:
  - T was a member of a group that filed a consolidated return
  - T was a member of an "affiliated" group (a group that could elect to file a consolidated return)
  - T was an S Corporation

T Purchased from PCo (Consolidated Group)

- If A and the selling T shareholders make a Section 338(h)(10) election:
  - "Old T" is treated as selling its assets in a single transaction to "New T"
  - "Old T" is treated as then having liquidated into PCo (parent owning 80% or more) in a tax free 332 liquidation
    - PCo recognizes no gain or loss
    - PCo inherits old T's tax attributes (NOLs, etc.)
  - "New T" is treated as purchasing the assets on the day after the acquisition date

T Purchased from PCo (Consolidated Group)

- When will PCo be willing to join A in making a 338(h)(10) election?
- PCo's decision depends on the relative magnitude of its outside basis in its T stock compared to T's inside basis in its assets
  - If T's inside basis is > PCo's outside basis, a 338 (h)(10) election will reduce PCo's gain
  - If T's inside basis is < PCo's outside basis, a stock sale without a 338(h)(10) election will be more preferable (produces less gain)

Example

- PCo's outside basis in its T shares is $200.
- T has assets with a FMV of $225 and:
  - Case A -- an inside basis of $190.
  - Case B -- an inside basis of $210.
- A pays PCo $225 for T shares.

Will PCo be willing to make the 338(h)(10) election?

Example (continued)

- Case A -- an inside basis of $190
  - 338(h)(10) ⇒ PCo's gain $35 (225 - 190) on deemed asset sale and $0 on liquidation.
  - No 338(h)(10) ⇒ PCo's gain $25 (225 - 200) on stock sale.
- Case B -- an inside basis of $210
  - 338(h)(10) ⇒ PCo's gain $15 (225 - 210) on deemed asset sale and $0 on liquidation.
  - No 338(h)(10) ⇒ PCo's gain $25 (225 - 200) on stock sale.

Calculating Old T's Gain

To calculate old T's gain we need to determine the modified aggregate deemed sales price (MADSP):

$$MADSP = G + L +/- Other$$

G= grossed-up basis of A's recently purchased T stock

(Basis of A's recently purchased stock divided by percentage of T Purchased)

L= liabilities new T inherits from old T

Other (-) = subtraction of A's acquisition costs that are capitalized in A's basis and PCo's selling costs incurred in its disposition of T

Old T's Gains -- Who pays?

- Tax liabilities from the deemed asset sale are the responsibility of PCo
- New T is "contingently" liable for the taxes if PCo does not pay

New T's Basis

- New T's basis is equal to the MADSP plus A's costs for acquiring T
- New T's basis is allocated among its various assets in the same manner as under the regular 338 election
  - residual method (see notes for taxable stock acquisitions)

Equity Carve-Outs

- The sale by a company of a portion of one of its subsidiaries' stock through an IPO.
  - interest sold generally less than 20% (why?)
- Subsidiary has its own board, CEO, and financial statements
- In addition to raising cash, benefits include:
  - improved investor understanding of operations
  - improved corporate governance (executive compensation)

Equity Carve-Outs -- Tax Treatment

- Two options are available when executing an equity carve-out:

  1. parent company sells some of its subsidiary stock directly

     parent recognizes gain (loss) = cash received - basis

  2. subsidiary offers the stock to the public directly

     no gain or loss is recognized (Section 1032)

     cash can still go to parent as a dividend (100% dividend exclusion)

Spin-Offs

- The distribution by a company of the stock of a subsidiary (80%+) as a dividend
- Subsidiary has its own board, CEO, and financial statements
- Possible motivations:
  - avoid regulatory restrictions (antitrust)
  - focusing managerial talents on core business
  - improved corporate governance (executive compensation)
  - expropriating bondholder collateral

Spin-Offs -- Tax Treatment

- Section 355 provides tax-free treatment if:
  - only stock distributed to shareholders
  - shares constituting control are distributed (80%)
  - meets the active business requirement
  - PCo must not have acquired subsidiary in previous 5 years in a taxable transaction
  - PCo and spun-off subsidiary can not be acquired within 2 years of or 2 years after the spin-off
  - spin-off must not be a device for distributing E&P
- If 355 does not apply
  - Shareholders treat shares received as a dividend
  - PCo pays tax on (FMV subsidiary – basis)

Liquidations

- A corporation is in liquidation status when it ceases to be a “going concern” and it's merely “winding up”
- Why liquidate?
  - “Game over”
  - assets are loss producing -- pass through entity may allow deductions at shareholder level
  - elimination of double taxation

Tax Consequences of Liquidation to Shareholders

	Amount of Gain or Loss Recognized	Basis	Holding Period
General rule	(Cash + FMV of property) - basis of stock = capital gain (or loss)	FMV of property	Day after liquidation
Controlled Subsidiary	No gain or loss is recognized when an 80% controlled subsidiary is liquidated into its parent (332)	Carryover basis	Includes subsidiary's holding period

Tax Consequences of Liquidation to Corporation

	Amount of Gain or Loss Recognized	Tax Attributes
General rule	Gain or loss is recognized when corporation distributes property as part of liquidation	Tax attributes disappear
Controlled Subsidiary	No gain or loss is recognized when a subsidiary's property is distributed to its parent (80%+) corporation (332)	Tax attributes assumed by parent
Related party / Tax avoidance	Loss recognition may be limited	