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Client Memo

Stepping Up Tax Basis in Equity Acquisitions

Deal makers who regularly seek the advice of tax advisors may come to expect that conventional pieces of tax advice will apply in all circumstances. This may not be the case. One conventional piece of tax advice is to acquire assets, rather than equity, in order to "step up" the tax basis of the acquired business. While extremely helpful, this directive is somewhat naive in today's world. In many situations, acquisitions of equity can also result in a stepped up asset basis.

First, many businesses are held in limited liability companies (LLCs). LLCs are hybrid entities for income tax purposes, in that they can elect to be treated as corporations, partnerships or disregarded entities for income tax purposes. Absent any election, a domestic LLC with only one member is treated as a disregarded entity for income tax purposes. Businesses are sometimes held through such LLCs to shield the member from liability for non-tax purposes. If the membership interest of a tax-disregarded LLC is acquired, then the transaction is treated as an asset acquisition for income tax purposes. Thus, an acquisition of certain LLC equity can result in a stepped up asset basis for the acquirer.

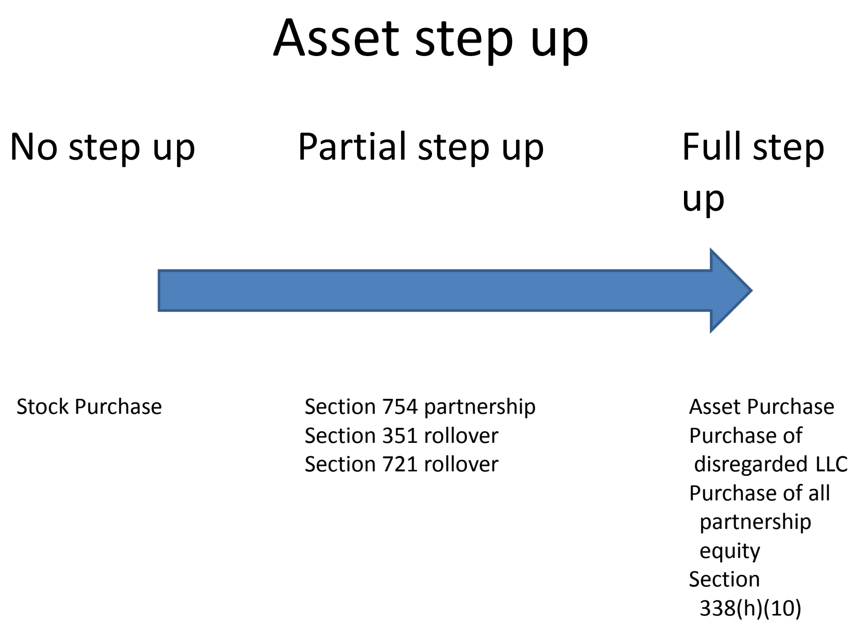
Second, many businesses are held in partnership form. Partnerships are not disregarded entities for tax purposes, but are generally not taxpayers. Under Revenue Ruling 99-6, an acquisition by a third party of all the equity of a partnership (or an LLC taxed as a partnership) will be treated as an asset acquisition from the perspective of the acquirer. Thus, an acquisition of all the equity of a partnership can also result in a stepped up asset basis for the acquirer.

Third, if a target corporation is a Subchapter S corporation or a corporate subsidiary in a consolidated tax group, the acquisition of stock of that entity may qualify for a Section 338(h)(10) election. The effect of that election is to treat the stock acquisition as an asset acquisition from the perspective of the acquirer. Thus, a Section 338(h)(10) election can result in a stepped up asset basis for the acquirer.

These three cases all involve acquisitions in which the sellers retain no interest. But many acquirers prefer that sellers keep some "skin in the game" by continuing to own an interest in the acquired business. Of course, sellers would prefer not to pay tax on the portion retained. Even in such partial acquisitions, some asset step up may be available. For example, if an acquirer is setting up a new entity to make an acquisition, then the seller may be able to receive as part of its consideration some equity of that newly formed entity, tax free. Special provisions apply to contributions of property to partnerships (section 721) and corporations (Section 351) in exchange for equity. Under certain circumstances, the equity may be received tax free and the acquirer will get a step up in basis only with respect to the taxable portion of the consideration.

Another example involves the acquisition of a portion of an existing partnership. With a Section 754 election, the acquirer can get a partial step up with respect to the assets of the partnership even if it acquires only a portion of the equity of the partnership. Meanwhile, the sellers retain equity and do not trigger any gain with respect to that retained equity. This particular approach is used frequently when the acquired business has been conducted for several decades and falls within the much maligned “anti-churning” rules (which limit the use of goodwill amortization deductions).

The bottom line is that “rules of thumb” are helpful, but they cannot replace the deal-specific attentions of a good tax advisor.



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