1. Tax Planning for Divestitures: A corporate divesture is the disposition of a controlled C corporation by its corporate parent. Divestures can be accomplished in various taxable and tax-free ways. Note that we are assuming in this chapter that the parent corporation and the subsidiary corporation are part of an affiliated group that has elected to file a consolidated return and that the acquiring corporation is not part of the affiliated group. An affiliated group requires a parent that directly owns at least 80% of a subsidiary, and it then includes all “includable” corporations in which a controlling interest is owned directly or indirectly by the parent.
	1. Subsidiary Sales: Table 15.1 (p. 15-2) summarizes the various ways in which a divesture can be accomplished by a transfer of the subsidiary’s stock or assets. We already are familiar with three of these: a taxable sale of the subsidiary’s assets, a taxable sale of the subsidiary’s stock without an election under §338(h)(10), and a taxable sale of the subsidiary’s stock with an election under §338(h)(10). Recall that a §338(h)(10) affects the taxes of both the seller and buyer and so must be made jointly. Further, recall that unlike a regular §338 election, an election under §338(h)(10) often can generate significant tax savings while imposing minor tax costs. Note: the textbook tacitly assumes that the parent and the subsidiary file a consolidated return. As a result, earnings of the subsidiary are reported on the parent’s tax return and generate a dollar-for-dollar increase in the parent’s basis in the subsidiary’s stock. Thus, the taxation of the parent/subsidiary pair largely is the same as taxation of an S corporation and its shareholders.
		1. Tax-Free Subsidiary Sales: In a tax-free subsidiary sale, the parent exchanges its stock of the subsidiary for stock of the acquiring corporation. This is a “B” reorganization so that there is no tax to the selling parent, to the sold subsidiary, or to the acquiring corporation. Note that the consideration received by the selling parent must be *voting* stock of the acquiring corporation. This really is not a sale of the subsidiary because the parent retains an indirect interest in the subsidiary through its voting stock of the acquiring corporation. And recall that the parent’s basis in the subsidiary’s stock carries over both into the voting stock of the acquiring corporation that is received by the selling corporation and also is carried over in the stock of the subsidiary acquired on the exchange.
		2. Taxable Subsidiary Sales
			1. Taxable Asset Sale: In a taxable asset sale, the acquirer purchases the assets of the subsidiary. Thus, the subsidiary remains in existence (unless the parent corporation elects to liquidate it). The target corporation recognizes a gain or loss on the sale that will be ordinary to the extent of depreciation recapture or inventory items and will be capital otherwise. (Recall that there is no capital gain preference for C Corporations.) Because the target corporation remains in existence, its tax items (including NOLs) remain available. Section 382 does not apply because there has been no change of ownership of the target. See figure 15.2 (p. 15-5) for a numerical example. The acquiring corporation takes a cost basis in the purchased assets.
			2. Taxable Stock Sale without a Section 338 Election: In a taxable stock sale, the acquiring corporation takes a cost basis in the purchased stock. The acquiring corporation can liquidate the subsidiary, but if it does that, its cost basis disappears (because the buyer and the Target are affiliated, so the liquidating distribution is a t6ax-free subsidiary liquidation under §332) and the distributed assets retain their subsidiary basis unchanged. If the acquiring corporation does not liquidate the subsidiary, §382 applies to the subsidiary’s NOLs. While there is no requirement that the parent owns 100% of the subsidiary, it is unusual to have outside shareholders in lower-tier affiliated corporations. Note that the gain or loss recognized to the parent corporation is based on its stock basis in the subsidiary rather than the subsidiary’s basis in its assets.
			3. Taxable Stock Sale with a Regular Section 338 Election: In addition to the actual stock sale, the election adds a deemed sale of the corporation’s assets to itself (from Old Target to New Target) at fair market value. Gain from this deemed transaction burdens the purchaser because it burdens the Target, and the purchaser owns the Target. Gain from this deemed transaction equals the deemed sale price (P + L + T) less asset basis. New Target takes a cost (fair market value) basis in the assets, and its existing NOLs can be used against the gain arising from the deemed transaction, but they then disappear.
			4. Taxable Stock Sale of an S Corporation with a Section 338(h)(10) Election: The actual stock sale is replaced by two deemed transactions: an asset sale from Old Target to New Target followed by a taxable distribution to the Target shareholders. The deemed sale price equals P + L (note that there is no corporate-level tax on the deemed asset sale). The purchase price (“P”) less any subsidiary liabilities is then deemed distributed in complete liquidation of the subsidiary. As a result, there is a pass-thru gain to the subsidiary shareholders equal to the deemed sale price less asset basis. This gain is includible to the Target shareholders and increases basis in Target stock. Capital gain or loss is then recognized on the deemed liquidation of Target; and the combined effect of these transactions is that the Target shareholders recognize gain on the excess of P – Stock Basis. However, to the extent the deemed asset sale generates ordinary income, the election converts Target shareholder capital gain into ordinary income. An S Corporation has no NOLs.
			5. Taxable Stock Sale of an Affiliated Subsidiary Corporation with a Section 338(h)(10) Election: If a taxable stock sale of an affiliated subsidiary includes an election under §338(h)(10), the transaction is recast as a deemed asset sale followed by a deemed liquidation of the Target corporation. Gain (or loss) from the deemed asset sale is treated as taking place immediately prior to the deemed liquidation of the Target. As a result, any tax arising from the deemed asset sale burdens the affiliated Parent corporation. Any liabilities of the subsidiary are treated as assumed by the acquiring corporation and so add to the deemed sale price. Neither subsidiary liabilities nor subsidiary tax on the deemed asset sale add to the ADSP (just like in §338(h)(10)/S Corporation context). The Target corporation is then deemed to distribute the cash received on the deemed asset sale to its affiliated parent, and this distribution is tax-free to both Target and Parent as a subsidiary liquidation under §332. Because the deemed liquidation consists only of cash, there is no issue regarding the parent’s basis in assets deemed distributed. Thus, the only gain recognized is based on the excess of the ADSP over the subsidiary’s asset basis. Because there is no corporate preference for net capital gain, *if aggregate stock basis equals aggregate asset basis plus debt, there is no cost to the §338(h)(10) election in this scenario.* But if asset basis and stock basis are not equal, the election can create gain or loss to Target in excess of the gain or loss that would be recognized on the actual stock sale. NOLs of Target can be used against gain arising from the deemed asset sale but then disappear. NOLs of the subsidiary are not transferred to the purchaser but are shifted to affiliated parent.
		3. Comparison of Taxable Acquisition Structures: Table 15.3 (p. 15-9) compares a taxable sale without a §338(h)(10) election, a taxable sale with a §338(h)(10) election at the acquirer-indifferent price, and a taxable sale with a §338(h)(10) election at the midpoint between the non-election price and the acquirer-indifferent price.
			1. When Should the Section 338(h)(10) Election Be Made? An election under §338(h)(10) is tax-efficient when the left side of **equation 15.2** (p. 15-10) exceeds the right side. Why is this equation 15.2 not identical to the simplified version of **equation 13.3** (p. 13-9)? The assumption that stock basis equals asset basis is removed and the differential taxation on depreciation recapture vs capital gain is gone. Note that the value computed in **equation 15.3** (p. 15-11) is the *maximum* price the acquiring corporation will be willing to pay.
		4. Additional Complexities: Subsidiary Sale: the example of page 15-12 shows that an election under §338(h)(10) is suboptimal when the subsidiary’s asset basis (in the example, it is $1,000) is low as compared with the parent’s basis in the subsidiary stock (in the example, it is $4,000). The complete analysis of this example is set forth in Table 15.4 (p. 15-13).
		5. Difference between Subsidiary Sales and Sales of Freestanding C Corporations: In the acquisition of a free-standing C Corporation, the cost of a basis step-up is corporate-level recognition of gain equal to the step-up (assuming the acquired corporation does not have NOLs and is fully subject to US taxation). But the cost of a basis step-up given an election under §338(h)(10) is the excess, if any, of the parent’s basis in the subsidiary stock as compared with the subsidiary’s basis in its assets.
			1. When Is a Section 338(h)(10) Election Optimal? If the parent’s basis in the subsidiary’s stock is equal to or less than the subsidiary’s asset basis, then an election under §338(h)(10) is tax-efficient. But if the reverse is true, the tax cost (to the parent corporation) must be compared with the anticipated to the tax benefit (to the acquiring corporation).
			2. When Is a Section 338(h)(10) Suboptimal? Why might a subsidiary corporation have an asset basis significantly below the parent’s stock basis? If the parent acquired the subsidiary in a taxable acquisition, a significant variation between stock basis and asset basis can arise.
		6. Valuation Effects:
			1. This section of the book (pages 15-14 through 15-17) provide examples of the net realized benefit of an election under §338(h)(10). Note that the rule of thumb in the indented paragraph on page 15-5 says that the usual benefit is about 20% and that in the Bristol Myers, UIL, Catalyst Health Solutions and Express Scripts transaction, the net benefit *to the acquiring corporation* was between 10% and 20%, suggesting that the acquiring corporation generally benefits from at least half of the total tax benefit.
			2. The Fairness Opinion: Please note the various parts of the fairness opinion: (1) The transaction is briefly described; (2) the documents relied upon are identified with specificity; (3) facts provided by others are identified and explicitly treated as *accurate and complete;* and (4) conversations with involved parties are described. Why are each of these provisions necessary?
	2. Tax-Free Divesture Methods: Tax-free divestures can be accomplished I two distinct ways: (1) by issuing new shares to a buyer or to the general public; or (2) distributing shares of the subsidiary to shareholders of the parent. This last structure can involve a pro rata distribution (so that the subsidiary becomes a sibling of its former parent) or it can be distributed to a group of parent shareholders in exchange for their stock of parent (so that the owners of the former parent and the former subsidiary do not overlap).
		1. Equity Carve-Outs: In an equity care-out, the subsidiary issues new shares to one or more new buyers, often in an initial public offering. Because the parent retains shares of the subsidiary, it is not a true divesture but rather a mere reduction in the parent’s parent ownership interest in the subsidiary. If new purchasers acquire more than 20% of the subsidiary, the subsidiary is no longer part of the parent’s affiliated group. Deconsolidation can impose tax costs on the subsidiary corporation as well as on the remaining members of the affiliated group including the parent corporation. Note that this form of quasi-divesture does not yield any cash to the parent unless a dividend is paid from the subsidiary prior to the equity carve-out.
		2. Tax-Free Spin-Offs:
			1. In a tax-free spin-off, the parent corporation distributes its ownership stake to its shareholders. In one variation of this, the distribution is made pro rata to the shareholders of the parent, turning the former parent/subsidiary pair into a brother/sister pair. In the second variation, the distribution is made to a group of parent shareholders who turn in their parent corporation shares (technically, this is called a “redemption” of their shares) in exchange for control of the subsidiary corporation. In either event, the transaction is tax-free to the parent corporation, to the subsidiary corporation, and to the distributee shareholders so long as certain requirements are satisfied.
				1. The parent must own at least 80% of the subsidiary corporation immediately prior to the distribution (80% ownership constitutes “control”). We are assuming 100% ownership.
				2. The parent corporation must distribute at least 80% of the subsidiary’s stock and, unless the IRS agrees otherwise, it must distribute all of its stock of the subsidiary.
				3. Immediately after the distribution, both the parent corporation and the former subsidiary corporation must be engaged in the active conduct of a trade or business that was not acquired by the parent in a taxable transaction within the prior 5 years.
				4. The transaction cannot be used as a “device” for the distribution of the earnings and profits of the parent corporation. When dividends were taxed as ordinary income, this requirement played a much more significant role.
				5. There must be a corporate-level business purpose for the transaction; and (if the transaction is to remain entirely tax-free)
				6. Neither the parent corporation nor the subsidiary corporation may undergo a change of ownership within two years of the transaction, either before or after.
			2. If the distribution is made pro rata to the parent’s shareholders, the shareholders allocate their pre-distribution basis in the parent stock between the parent stock and the former subsidiary stock in proportion to relative fair market value.
			3. If the distribution is made in complete redemption of some of the parent shareholder’s stock in parent, then those shareholders move their basis from their former shares in parent to their new shares in the former subsidiary.
			4. This divesture technique can be used to spin-off a trade or business operated by the parent by first moving the trade or business into a new subsidiary, and then spinning-off the new subsidiary.
		3. Factors that Influence Divesture Method Choice: Table 15.5 (p. 15-20) summarizes the non-tax aspects of the various divesture structures. Relevant factors include (1) does the parent need cash from the transaction, (2) does the parent have a built-in loss in the subsidiary’s stock, and (3) whether the parent is looking to smooth its earnings statement.
	3. Questions (p. 15-21)
		1. Question 1: A taxable sale of assets (followed by a dividend distribution), a taxable sale of shares with or without an election under §338(h)(10), and an equity carve-out with a pre-transaction dividend, and a debt-financed dividend prior to a spin-off.
		2. Question 2: A pro rata spin-off.
		3. Question 3: An election under §338(h)(10) always should be made unless the parent’s basis in the subsidiary’s stock is significantly above the subsidiary’s asset basis. See **equation 15.5** (p. 15-11).
	4. Problems (p. 15-21)
		1. Problem 7:
			1. Part (a): $800 million (no change).
			2. Part (b): Gain equals $1.9 billion less stock basis of $1 billion, so gain equals 900 million, generating a tax liability of $189 million. Accordingly, net cash equals $1.9 billion less 189 million, or $1.711 billion.
			3. Part (c): Cost of $1.9 billion.
			4. Part (d): Gain equals $1.9 billion less asset basis of 800 million, so gain equals $1.1 billion, generating a tax liability of $231 million, so that net cash equals $1.9 billion less $231 million, or $1.669 billion.
			5. Part (e): Using **equation 15.2** (p. 15-10) with PriceNO338h10 of $1.9 billion, tc = 21%, Stock = $1 billion, and Asset = $800 million, so that Price338h10 = $1.9 billion + [0.21/(1 – 0.21)]($1 billion - $800 million) = $1.9 billion + [0.21/0.79](200 million) = $1.953 billion.
			6. Part (f): Using equation 15.4 (p. 15-11) with PriceNO338h10 = $1.9 billion, tc = 21%, factor = PVANN/n = 0.70236, and Asset = $1 billion, we get Acqprice338h10 = $2.09 billion.
			7. Part (g): Yes: because the seller will demand at least $1.953 billion and the buyer is willing to pay up to $2.09 billion, the election is tax-efficient.
			8. Part (h): If Sunglass Hut paid the least amount the seller would accept, it’s cost would be $1.953 billion, giving rise to a step-up of $1.153 billion in basis. The after-tax value of that step-up is about $170 million, so that the net after-tax cost = $1.953 billion - $170 million, or $1.783 billion. (The tax benefit of the step-up equals tc\*(value of step-up) \* factor, or 0.21\*$1.153\*0.70236, or about $170 million.
			9. Part (i): If Sunglass Hut paid its tax-indifferent price of $2.09 billion, the taxable gain to the seller would equal $2.09 billion - $800 million, or $1.29 billion, generating a tax liability of about 271 million, leaving net cash at $2.09 billion – 271 million, or $1.819 billion. This is about a $108 million improvement.
		2. Problem 8:
			1. Part (a): (1) If asset basis = stock basis, (2) if asset basis is greater than stock basis, (3) if the parent has significant NIOLs that otherwise cannot be used efficiently, or (4) stock basis > asset basis by less than the tax benefit from the step-up.
			2. Part (b): When stock basis > asset basis by a large amount, or when forgoing the election will generate a taxable loss and making the election will generate a taxable gain. **Equation 15.5** (p. 15-11) provides a more definitive indication of when the election should and should not be made.
		3. Problem 9 – In exam format (computations in parentheses):
			1. Part (a): No change, so asset basis remains at $300 million.
			2. Part (b): Gross proceeds equal $900 million. Gain equals $900 million - $600 million (or $300,000 million). This generates a tax liability of 21% of the gain (or $63 million), leaving net proceeds of $900 million less the tax liability (or net of $837 million).
			3. Part (c): Cost of $900 million.
			4. Part (d): Gain equals $900 million less $300 million (or $600 million). The after-tax net proceeds total $900 million less the tax due on the gain at a tax rate of 21% (or $900 million less 0.21\*600 million, which is $900 million less $126 million, or $774 million). [If we use 40% as the corporate tax rate, the tax becomes $240 million, reducing the net proceeds to $660 million.]
			5. Part (e): Ontario, the seller, will be indifferent between a price of $900 with no 338(h)(10) election and a price defined by **equation 15.2** (p. 15-10), with the premium equal to [tc/1-tc)](STOCK – ASSET), where tc = 21%, STOCK = stock basis of 600 million, ASSET = asset basis of $300 million (so that the answer is 0.266\*(300 million), or 79.7 million, for a total purchase price of about $980 million).
			6. Part (f): The acquiring company will prefer the price described in (e) only if the tax benefit to it exceeds the premium it must pay. That tax benefit equals the present value of the depreciation, and that equals tc\*PVANN\*STEP/n, where tc = 21%, PVANN = the present value of an annuity paying $1 per year for n years with a discount rate of 7%, STEP equals the increase in basis from the election, and n = 7. The increase in basis equals the amount determined in part (e) above less the target’s historical asset basis of $300 million. (PVANN = 5.39, so that the tax benefit equals 0.21\*5.39\*680 million/7, or about $110 million. Accordingly, the net after-tax cost = $980 million less about $110 million, or about $870 million, and because that is less than $900 million, the §338(h)(10) election is preferred.)
			7. Part (g): If the answer to part (f) is that the net cost to the acquiring company with an election is lower than the after-tax cost without an election, then yes. Otherwise, no. (Here, it is yes.)
			8. Part (h): We determined the after-tax cost to Parker in part (f) above (it was $870 million). Without the election, the after-tax cost equals $900 million. The difference is the after-tax savings to Parker (Here, that is $900 million - $870 million, or about $30 million).
			9. Part (i): If Ontario captures all the tax benefit from the transaction, then the purchase price can be determined from equation **15.3** or **15.4**. Call this value $B. ($B is about $1015). The after-tax proceeds with the election at this price equals $B minus 0.21 times [$B – 300 million]. (Here, $B = $1015 million so that the taxable gain equals $715 million, generating a tax liability of about $150 million. Thus, the net proceeds equal about $865 million). The net benefit from the election is a comparison of this number with the value determined in part (b) above (or $837 million, for an improvement of about $28 million).