CHAPTER 17 TAX PLANNING FOR DIVESTITURES

After completing this chapter, you should be able to:

1. Understand the various types of taxable and tax-free divestiture methods.
2. Explain when a Section 338(h)(10) election should be made in the sale of a subsidiary.
3. Compute the price at which a divesting parent and an acquirer are indifferent between different subsidiary sale tax structures.
4. Explain the requirements under which a divestiture qualifies for tax-free treatment.
5. Understand the tax implications of tax-free divestitures for the distributing corporation and its shareholders.

Corporations seek to restructure through divestiture for a variety of reasons. Some conglomerates are unable to effectively and efficiently manage far-flung unrelated businesses. For this reason, they may choose to divest unrelated businesses or separate the conglomerate into distinct portions. However, firms often feel that the market doesn't appropriately price the various divergent portions of the company.[1] They therefore believe that separating it into several standalone businesses will result in appropriate, and presumably higher, prices for the separate underpriced businesses.

From a tax perspective, several structural divestiture alternatives are available. Several methods are tax-free while others are taxable. Tax-free divestiture methods include spin-offs, tax-free subsidiary sales (under Section 368), and equity carve-outs. Taxable divestiture methods include taxable asset sales and taxable stock sales.

In general, a tax-free divestiture method does not result in a taxable gain or loss at the divesting parent corporation level. It also does not usually result in the recognition of a financial accounting gain or loss, although certain balance sheet accounts are affected. Under certain tax-free divestiture structures, the historical shareholders of the parent retain ownership of the divested subsidiary.

[1]See for example, E. Nelson, "J. C. Penney, Amid Slumping Sales at Stores, May Be Better Off Dividing into Several Stocks," *The Wall Street Journal* (April 9, 1999), p. C2; and "Monsanto Feels Pressure from The Street," *The Wall Street Journal* (October 21, 1999), p. C1.

In a taxable divestiture, the divesting parent recognizes a taxable gain or loss and will also typically recognize a financial accounting gain or loss. Generally, a taxable divestiture results in a change in ownership of the divested business—that is, historical shareholders of the divesting parent do not retain control of the divested business. In this chapter, we introduce and analyze the tax and nontax implications of various divestiture methods.

17.1 SUBSIDIARY SALES[2]

In Chapters 14 and 16, we analyzed several ways to acquire freestanding C corporations using either taxable or tax-free structures. Some of the same principles apply to acquisitions of subsidiaries of freestanding companies, although several differences are notable. In particular, the seller of a subsidiary is a corporation and not an individual shareholder or a group of various types of shareholders. We focus on taxable subsidiary sales because they are most common, but we begin with a brief analysis of tax-free subsidiary sales. Table 17.1 provides a summary of the tax consequences of various subsidiary sale structures.

Tax-Free Subsidiary Sales

In a tax-free subsidiary sale, the divesting parent exchanges the stock or assets of the subsidiary for the stock of the acquiring firm. The same principles that applied in tax-free reorganizations of freestanding companies generally apply in nontaxable subsidiary sales as well. For ease of exposition, we illustrate with an example of a tax-free subsidiary stock sale. In this case, the divesting parent sells the stock of the subsidiary to an acquirer in exchange for the acquirer's stock.

Figure 17.1 illustrates this transaction. Assuming that the transaction is structured to qualify as a Section 368(a)(1)(B) reorganization, the divesting parent will not recognize a taxable gain or loss on the exchange. The selling parent will take a substituted basis in the acquiring-firm stock received equal to its basis in the sold subsidiary's stock. The sold subsidiary becomes a wholly owned subsidiary of the acquirer and the net asset basis of the sold subsidiary carries over. The sold subsidiary's tax attributes survive and remain with the sold subsidiary, but they are limited under **Section 382.** The acquirer takes a basis in the sold subsidiary's stock equal to the divesting parent's basis in the sold subsidiary's stock, a so-called carryover basis.

This structure is generally undesirable for several reasons. First, the seller holds a large block of acquirer stock after the transaction and therefore the seller has not truly divested its holding in the sold subsidiary. Furthermore, the seller will hold a relatively illiquid block of the acquirer. Finally, if the fair market value of the subsidiary is greater than the seller's tax basis in the subsidiary's stock, the acquirer and the seller will both hold financial positions with a built-in gain after consummation of the transaction.[3] For these reasons, tax-free subsidiary sales are fairly unusual.

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[2]This section is based on "The Effect of Transaction Structure on Price: Evidence from Subsidiary Sales," M. Erickson and S. Wang, *Journal of Accounting and Economics* (2000), v. 30.

[3]Essentially, the parent's built-in gain presale is duplicated in the acquirer's hands while being preserved in the divesting parent's hands, thereby leaving both parties facing a tax liability when they sell the acquirer or divested subsidiary's stock.

TABLE 17.1 Tax Implications of Various Subsidiary Sale Tax Structures

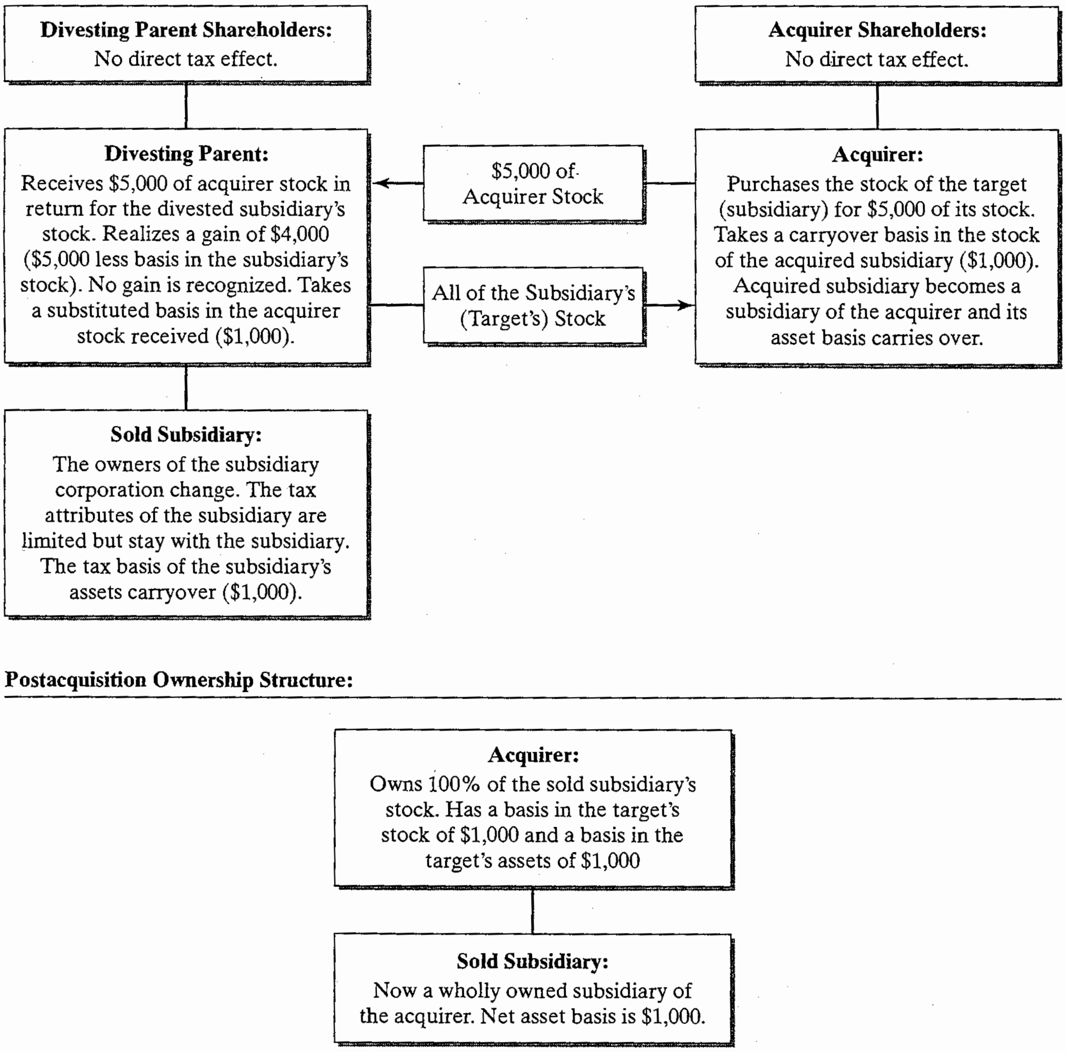
	Tax Structure			
Factors Influenced by Structure	***Tax-Free Stock Sale***	***Taxable Asset Sale***	***Taxable Stock Sale without an I.R.C. §338(h)(10) Election***	***Taxable Stock Sale with an I.R.C. §338(h)(10) Election***[1]
What is acquired?	Stock	Assets	Stock	Stock
Consideration used:	Acquirer stock	Usually cash[1]	Usually cash[1]	Usually cash[1]
Effect on the Divesting Parent:				
Gain or loss recognized:	No	Yes	Yes	Yes
Gain computed as:	No gain recognized	Price less basis in subsidiary's *net assets*	Price less basis in subsidiary's *stock*	Price less basis in subsidiary's *net assets*
Character of gain:	n/a	Ordinary income and capital gain[2]	Capital gain	Ordinary income and capital gain[2]
Sold Subsidiary's NOLs	Remain with subsidiary, but limited by §382	Remain with divesting parent, and can offset gain on sale; not limited by §382	Remain with subsidiary, but limited by §382	Remain with divesting parent, and can offset gain on sale; not limited by §382
Effect on the Acquirer:				
Basis in subsidiary's assets:	Carryover	Step-up to purchase price paid	Carryover	Step-up to purchase price paid
Basis in subsidiary's stock:	Carryover	n/a[3]	Purchase price	Purchase price
Tax benefits from additional depreciation and amortization deductions:	No	Yes	No	Yes

(1)Consideration can be cash, debt securities, acquiring-firm stock, or some combination. Most often, however, the acquirer uses primarily cash in these transactions.

(2)Ordinary income arises from recaptured depreciation while capital gain is the difference between the purchase price and the historical cost of the assets. The top corporate statutory federal tax rate on ordinary income and capital gain income is currently 35%.

(3)The stock of the subsidiary is not acquired and therefore the acquirer does not have a basis in the acquired subsidiary's stock.

FIGURE 17.1 Tax-Free Subsidiary Stock Sale under I.R.C. §368(a)(1)(B)



Taxable Subsidiary Sales

The three basic taxable structures in which a corporation can sell a subsidiary are (1) a taxable asset sale, (2) a taxable stock sale, and (3) a taxable stock sale accompanied by a Section 338(h)(10) election. The latter results in the stock sale being taxed as if the divesting parent sold the assets of the subsidiary instead of the subsidiary's stock. As in the analyses presented in Chapter 14, we work through the mechanics of these structures with the help of a simple numerical example.

TAXABLE ASSET SALE

In a taxable subsidiary asset sale, the acquirer—typically, a corporation—purchases the assets of the target subsidiary corporation, usually for cash, from the divesting parent. The target corporation recognizes a gain or loss equal to the difference between the purchase price and the net tax basis of the assets. To the extent that the gain is recaptured depreciation (or arises from the sale of inventory), the gain will be ordinary. The difference between the purchase price of the target's assets and their historical cost will be a capital gain. Because the target is a subsidiary of the divesting parent, the taxable gain or loss passes through to the parent. The divesting parent corporation may or may not liquidate the sold subsidiary, but generally liquidation of the sold subsidiary occurs.

If the parent liquidates the target corporation, no gain or loss is recognized under **Section 332.**[4] The tax attributes of the subsidiary, such as its net operating losses or NOLs, survive and are available to the parent corporation without incurring the limitations under Section 382. If the target or parent has NOLs, these NOLs can be used to offset the gain on the subsidiary asset sale. The acquiring corporation will take a basis in the assets of the acquired subsidiary equal to the purchase price, and the step-up in basis of the target's assets will be equivalent to the amount of the gain—purchase price less net asset basis—recognized by the target corporation. The purchase price will be allocated to tangible and intangible assets, including goodwill,[5] as prescribed by the residual method, as discussed in Chapter 14.

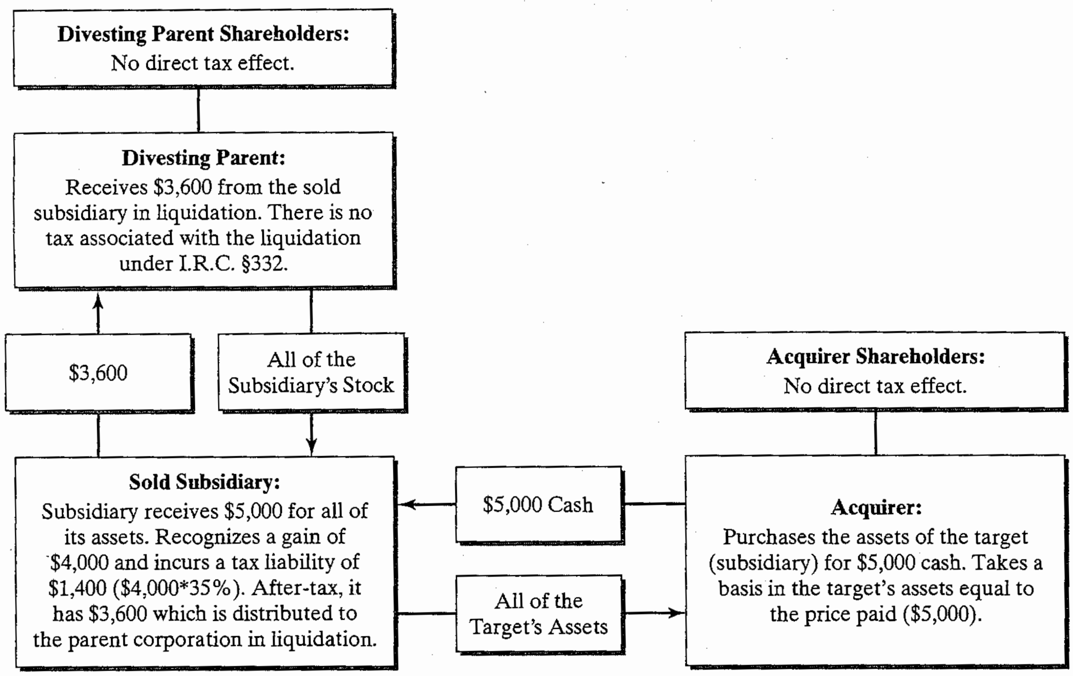
Figure 17.2 presents the structure of a taxable subsidiary asset acquisition followed by a liquidation of the target subsidiary. For purposes of illustration assume the following basic facts for our taxable subsidiary asset sale:

- The target corporation has assets with a net basis of $1,000 (historical cost equals $1,000 with $0 of accumulated depreciation) and no liabilities.
- The parent corporation has a basis in the stock of the target of $1,000 and the subsidiary is 100% owned by the parent.
- The subsidiary has no NOLs nor has the divesting parent.
- The acquirer pays the parent $5,000 for all the target's assets and the sold subsidiary is liquidated by the parent after the sale.

Given these facts, the target corporation recognizes a gain on the sale of its assets of $4,000 ($5,000 less $1,000 basis) and the character of the gain is capital in nature. A $4,000 capital gain taxed at 35% results in a tax liability of $1,400 for the target corporation. After tax, the target corporation has $3,600, which is distributed to the parent in exchange for all the target's stock in liquidation. Table 17.2 provides the details of these computations and those that follow. The parent corporation does not recognize a gain on the liquidation under Section 332. The shareholders of the parent corporation do not recognize a gain or loss unless the parent corporation distributes the proceeds of the asset sale, which is unusual.

[4]Section 332 allows a corporation to liquidate wholly owned subsidiaries in a tax-free manner. Such corporate liquidations are common in various types of acquisitions.
[5]The amortization associated with these intangible assets is tax deductible under Section 197.

FIGURE 17.2 Taxable Subsidiary Asset Sale



The acquiring corporation takes a basis in the assets of the target equal to the purchase price ($5,000), so the step-up in the tax basis of the target's assets is $4,000. A portion of the $4,000 step-up may be allocated to goodwill and other intangibles. For financial accounting purposes, the acquirer would account for this transaction using the purchase method. As in the case of asset acquisitions of freestanding companies, some of the target subsidiary's liabilities may remain with it. This treatment is a potential benefit for the acquirer, but a divesting parent should price the costs of liability retention. As we noted in Chapter 14, asset acquisitions are potentially costly in terms of transaction costs, such as title transfer, and some assets may not be transferable. On the other hand, this structure may be particularly useful when selling pieces of a business or selected assets rather than an entire incorporated subsidiary.

TAXABLE STOCK SALE WITHOUT A SECTION 338(H)(10) ELECTION

The divesting parent may sell the stock of the subsidiary rather than the assets. Under this structure, the acquirer purchases the stock of the target corporation from the parent for cash.[6] The parent corporation recognizes a

[6]In some cases, acquirers use their stock in a taxable stock acquisition. The transaction is typically structured to fail to qualify for tax-free treatment under Section 368(a)(1)(B) making the transaction a taxable stock acquisition. See WorldCom's acquisition of CompuServe from H&R Block, for example.

TABLE 17.2 Tax Implications of Various Taxable Subsidiary Sale Structures

Fact Pattern:

Purchase price	$5,000.00
Target's tax net asset basis	1,000.00
Divesting parent's tax basis in target's stock	1,000.00
t_c =	35%
r =	10%
Amortization period (n) =	10

	Subsidiary Sale Structure		
	Taxable Asset Sale	***Taxable Stock Sale without a §338(h)(10) Election***	***Taxable Stock Sale with a §338(h)(10) Election***
Purchase price	$5,000.00	$5,000.00	$5,000.00
Tax Effect for Divesting Parent:			
Gain on sale(1)	$4,000.00	$4,000.00	$4,000.00
Cash received	$5,000.00	$5,000.00	$5,000.00
Tax on gain(2)	1,400.00	1,400.00	1,400.00
After-tax cash	$3,600.00	$3,600.00	$3,600.00
Acquirer Cost:			
Purchase price	$5,000.00	$5,000.00	$5,000.00
Less: incremental tax savings(3)	860.24	0.00	860.24
Net after-tax cost	$4,139.76	$5,000.00	$4,139.76
Acquirer's Tax Basis in Target's:			
Stock	n/a	5,000.00	5,000.00
Net assets	$5,000.00	$1,000.00	$5,000.00
Step-up in the tax basis of the target's assets	4,000.00	0.00	4,000.00

(1)Computed as the purchase price less the divesting parent's basis in the sold subsidiary's stock or net assets, depending on the transaction's structure.

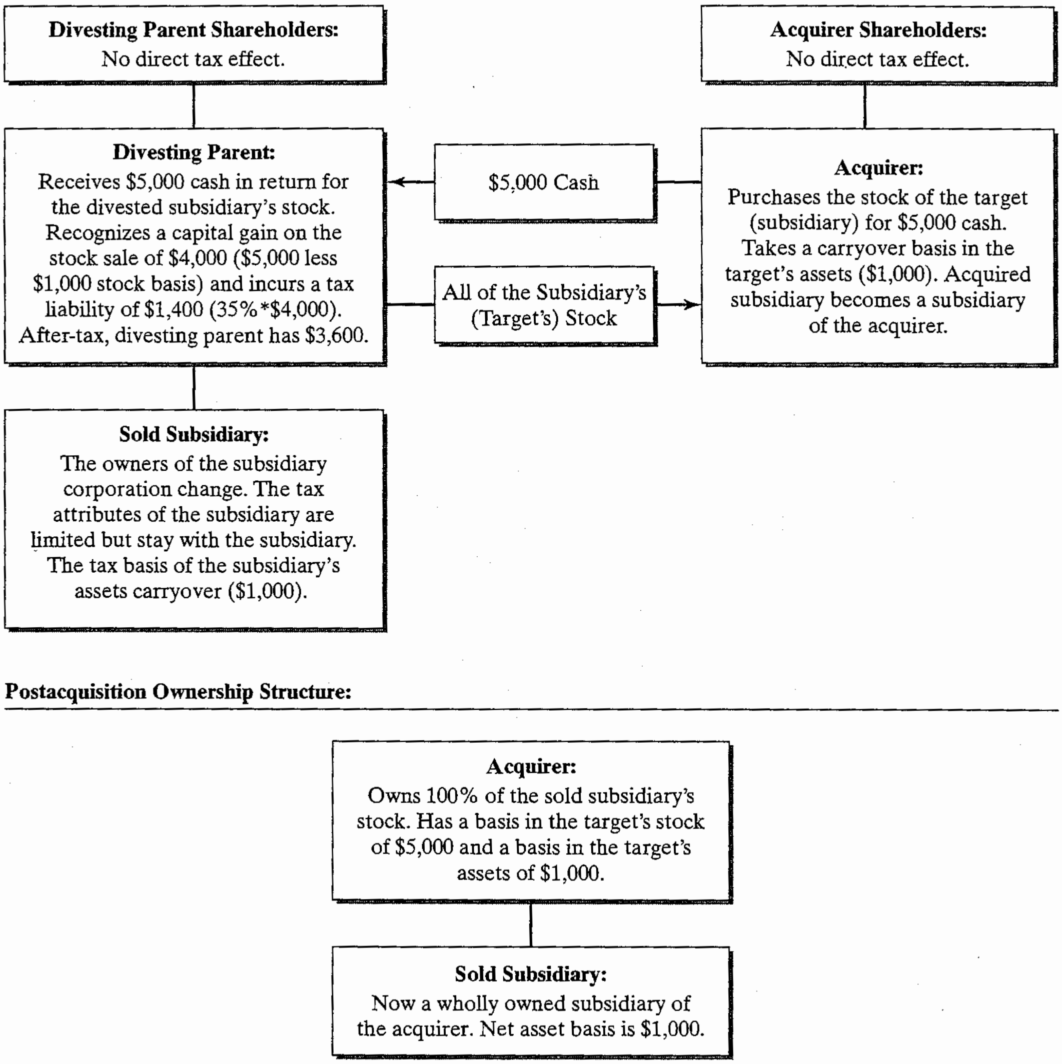
(2)Corporate tax liability on the subsidiary sale. The tax is computed based on the nature of the gain (capital or ordinary) and the appropriate tax rate. We assume here that ordinary and capital gains rates are identical for divesting parents.

(3)The present value of the tax savings resulting from stepping-up the tax basis of the target's assets assuming that the step-up is amortized/depreciated straight-line over a 10-year period, the applicable tax rate is 35% and the after-tax discount rate is 10%.

gain or loss on the sale of the subsidiary's stock equal to the difference between the purchase price and its basis in the subsidiary's stock. The gain or loss will be capital in nature because *stock* is a capital asset.

The acquiring firm will take a basis in the target subsidiary's stock equal to the purchase price, and it will take a carryover basis in the assets of the target. The acquirer obtains all the assets and liabilities of the target, and the target becomes a subsidiary of the acquirer postacquisition. Figure 17.3

FIGURE 17.3 Taxable Subsidiary Stock Sale without a §338(h)(10) Election



illustrates the mechanics of a taxable subsidiary stock sale without a Section 338(h)(10) election.

Returning to our numerical example, we make the same assumptions here. The acquirer is willing to pay $5,000 for the stock of the target. The selling parent will recognize a capital gain on the stock sale equal to $4,000, which is $5,000 purchase price less stock basis of $1,000, and faces a tax liability of $1,400. After tax, the divesting parent will have $3,600. The acquirer will take a basis in the target's stock of $5,000 and will have a basis in the target's assets of $1,000 (carryover).

Notice that, with this structure, the acquirer does not obtain a step-up in the tax basis of the target's assets. To the extent that the acquirer records financial accounting goodwill on this transaction, it will be goodwill that is not tax deductible, because the tax basis of the target's assets is not stepped-up. The tax attributes of the target survive with this structure and remain with the target subsidiary corporation. However, the target's tax attributes will be limited by Section 382.

From a nontax perspective, a stock sale is often cheaper than an asset sale in terms of transaction costs. In most cases, the divesting parent will hold a minimal number of shares (e.g., 100) that possess 100% of the voting control of the divested subsidiary. As a result, the cost of transferring these shares is typically much lower than the cost of transferring title in the subsidiary's numerous assets. A stock sale preserves the identity of the target with it all its liabilities—recorded and unrecorded. However, the acquirer does obtain some degree of liability protection, because the target corporation becomes a wholly owned subsidiary of the acquirer. On the other hand, if the target has assets that are difficult to transfer, a stock sale facilitates ownership transfer of these assets to the acquirer.

TAXABLE STOCK SALE WITH A SECTION 338(H)(10) ELECTION

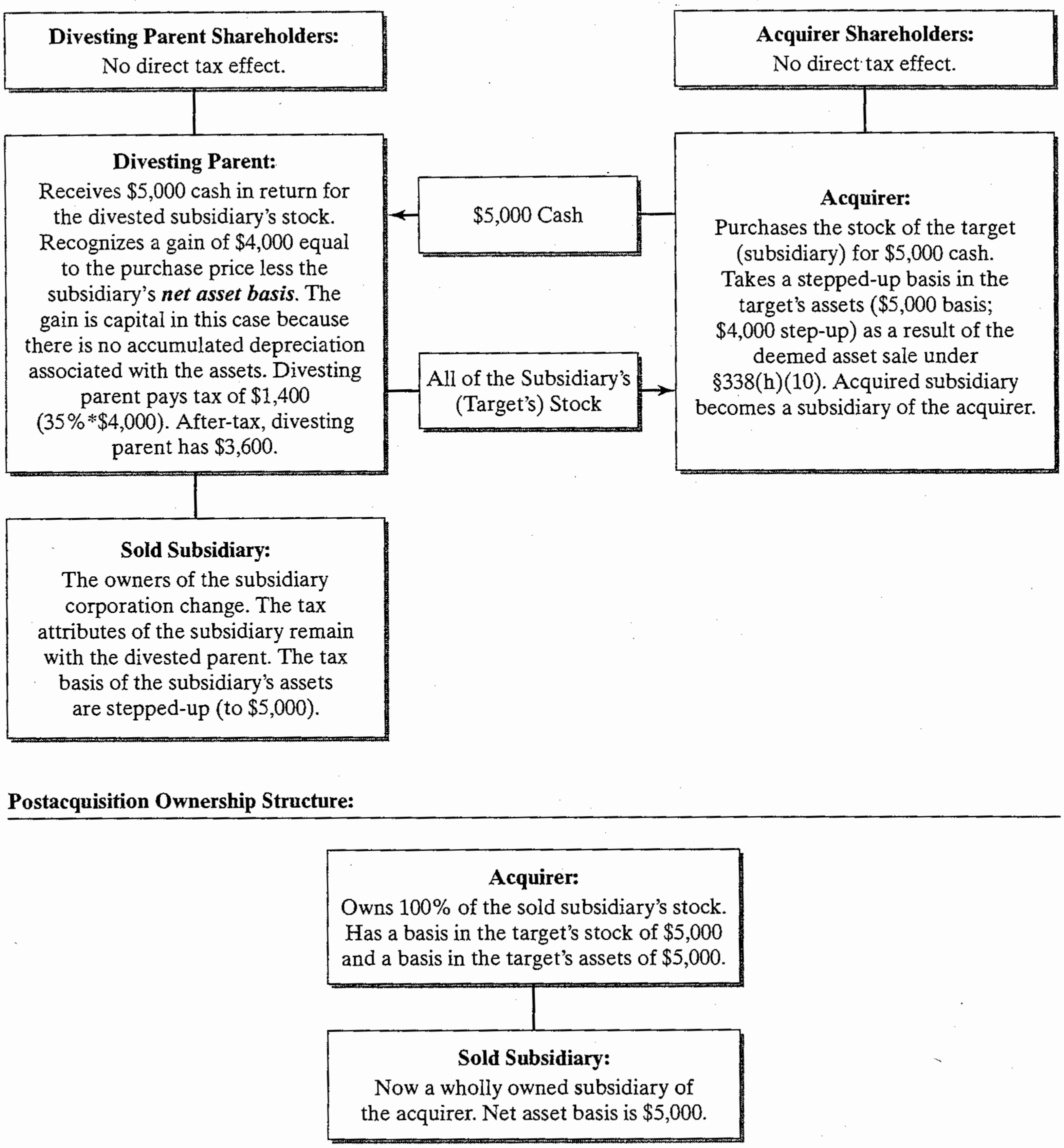
An acquirer and divesting parent can structure the divestiture to be completed as a stock sale, while being taxed like an asset sale. The acquirer may prefer to obtain a stepped-up basis in the target's assets, but the nontax costs of an asset sale may be prohibitive. In Section 338(h)(10), the tax law provides a vehicle to facilitate the potentially favorable tax treatment of an asset sale without incurring the nontax costs of an asset sale.

Under Section 338(h)(10), a subsidiary stock sale can be taxed as an asset sale if both the buyer and seller agree to such tax treatment. In a qualifying stock purchase with at least 80% of the target's stock obtained during a 12-month period, the acquirer and divesting parent can jointly agree to make a Section 338(h)(10) election. This election will cause a taxable subsidiary stock sale to be taxed as if the divesting parent had sold the subsidiary's assets to the acquirer rather than the subsidiary's stock. The taxable gain or loss on the transaction is computed as the purchase price less the divesting parent's basis in the *net assets* of the target. No tax is assessed on the stock sale.

Returning to our hypothetical numbers, we illustrate the case in Figure 17.4. With this structure, the stock sale is taxed as if the target sold its assets for \$5,000. Hence the parent corporation recognizes a gain on the sale of \$4,000 equal to the difference between the purchase price (\$5,000) and its basis in the target's *net assets* (\$1,000). The gain is capital in nature because the target has no accumulated depreciation. The divesting parent faces a tax liability of \$1,400 on the sale and has \$3,600 after tax. If the divesting parent or the target subsidiary had NOLs, they could serve to offset the gain on the deemed asset sale. The divesting parent retains the tax attributes of the target.

The acquiring firm takes a basis in the stock of the target equal to the purchase price paid (\$5,000) and takes a basis in the net assets of the target also equal to \$5,000. The acquirer obtains a stepped-up basis in the target's assets

FIGURE 17.4 Taxable Subsidiary Stock Sale with a §338(h)(10) Election



because the transaction was taxed like an asset sale (a gain at the target *corporation* level was triggered). The step-up in the target's assets is $4,000, and purchase price will be allocated to the sold subsidiary's assets under Tax Code Section 1060 (residual method).

It is important to note that a valid Section 338(h)(10) election can occur only when both the acquirer and the divesting parent jointly make the election. Without the seller's explicit cooperation, the acquirer cannot obtain a step-up in the tax basis of the target's assets in a stock sale. Recall that in a taxable stock acquisition of a freestanding company, the acquirer unilaterally makes a so-called regular Section 338 election.

Comparison of Taxable Acquisition Structures

Table 17.2 compares the tax implications of the three taxable acquisition structures using the numerical examples we just described. Notice that, in each case, the divesting parent's after-tax wealth is $3,600. In the first and third column of the table, the acquirer obtains a step-up in the tax basis of the divested subsidiary's assets while, in the middle column, the tax basis of the target's assets carry over.

It is important to note that, in step-up basis transactions under a fact pattern like this one *only,* the incremental cost of the step-up in the tax basis of the target's assets is $0. The reason is that the tax basis of the target's net assets is exactly equal to the divesting parent's tax basis in the target's stock. Therefore, whether the parent sells the stock or assets of the target, the gain on the sale will be the same, because the basis in the property sold is identical whether the property is assets or stock. Recall that the incremental cost of obtaining a step-up in the assets of a freestanding C corporation was not $0. This point is a major difference between subsidiary sales and sales of free-standing C corporations.

Returning to the numerical example illustrated in Table 17.2, we see that the optimal structure is either a taxable asset sale or a taxable stock sale with a Section 338(h)(10) election. Those structures result in the lowest after-tax cost to the acquirer ($4,139.76), while the seller is indifferent between structures. From the acquirer's perspective, making the Section 338(h)(10) election is worth $860.24.[7] That is, the acquirer is better off after taxes by $860.24 when the election is made. Because the election cannot be made without the seller's cooperation, the acquirer should be willing to pay the seller up to $860.24 more than $5,000 in order to get the seller to join in making the Section 338(h)(10) election. Actually, the acquirer is willing to pay up to $6,095.93 as illustrated in Table 17.3.

The acquirer is willing to pay more than $860.24 because as the purchase price rises so does the tax benefit from a step-up in the tax basis of the target's assets. Any price between $5,000 and $6,095.93 when the election is made leaves both the buyer and the seller better off after tax than a taxable stock acquisition at $5,000 with no election. The step-up election generates a net tax benefit that increases the wealth of both the divesting parent and the acquirer.

As the price of the sale approaches $5,000 ($6,095.93), the acquirer (divesting parent) captures relatively more of the tax benefits. For example, at a purchase price of $5,547.97 (midpoint between $5,000 and $6,095.93), the acquirer's net after-tax cost is $430.12 lower than it is if the election is not made and the deal is priced at $5,000. Similarly, the divesting parent's after-tax wealth is $356.18 higher if the election is made and the deal is priced at $5,547.97. Table 17.3 contains these computations. You should now see a pattern developing. Note once again how important it is to consider the tax implications of a transaction to both parties.

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[7]The same is true of the taxable asset sale structure, but we focus on the stock sale with the election here for ease of exposition and because the nontax costs of the stock sale with the election are the same as those without the election.

TABLE 17.3 Tax Implications of Various Taxable Subsidiary Sale Structures

Fact Pattern:

Purchase price—without the §338(h)(10) election	$5,000.00
Purchase price—with the §338(h)(10) election	$6,095.93
Target's tax net asset basis	1,000
Divesting parent's tax basis in target's stock	1,000
t_c =	35%
r =	10%
Amortization period (n) =	10

	Subsidiary Sale Structure		***Tax Benefit Split***(1)	
	Taxable Stock Sale without a §338(h)(10) Election	***Taxable Stock Sale with a §338(h)(10) Election***	***Midpoint Price with a §338(h)(10) Election***	***Incremental Difference***
Purchase price—base case	$5,000.00			
Acquirer indifference price(2)		$6,095.93		
Purchase price—tax benefit split(1)			$5,547.97	
Tax Effect for Divesting Parent:				
Gain on sale(3)	$4,000.00	$5,095.93	$4,547.97	
Cash received	$5,000.00	$6,095.93	$5,547.97	
Tax on gain(4)	1,400.00	1,783.58	1,591.79	
After-tax cash	$3,600.00	$4,312.35	$3,956.18	$356.18
Acquirer Cost:				
Purchase price	$5,000.00	$6,095.93	$5,547.97	
Less: incremental tax savings(5)	0.00	1,095.93	978.08	
Net after-tax cost	$5,000.00	$5,000.00	$4,569.88	$430.12
Acquirer's Tax Basis in Target's:				
Stock	$5,000.00	$6,095.93	$5,547.97	
Net assets	$1,000.00	$6,095.93	$5,547.97	
Step-up in the tax basis of the target's assets	$0.00	$5,095.93	$4,547.97	

(1)This column presents the split in the net tax benefits from the step-up election assuming a price that is between the divesting parent's and acquirer's indifference price in a step-up transaction [relative to a taxable stock sale without a §338(10)(h) election at a price of $5,000].

(2)Price at which the acquirer is indifferent between making the §338(h)(10) election and a purchase without the election at a price of $5,000.

(3)Computed as the purchase price less the divesting parent's basis in the sold subsidiary's stock or net assets, depending on the transaction's tax structure.

(4)Corporate tax liability on the subsidiary sale. The tax is computed based on the nature of the gain (capital or ordinary) and the appropriate tax rate. We assume here that ordinary and capital gains rates are identical for divesting parents.

(5)The present value of the tax savings resulting from stepping-up the tax basis of the target's assets assuming that the step-up is amortized/depreciated straight-line over a 10-year period, the applicable tax rate is 35% and the after-tax discount rate is 10%.

When Should the Section 338(h)(10) Election Be Made?

Assuming that a divesting parent has decided to sell a subsidiary in a taxable transaction, what structure should be employed? We restrict our analysis to taxable subsidiary stock sales for ease of illustration.

Because the seller and the buyer jointly make a Section 338(h)(10) election, the buyer cannot unilaterally determine the structure of the transaction but requires the seller's cooperation in defining the transaction's tax structure. Consequently, the differential tax effects of the Section 338(h)(10) election on the seller influence the election decision. The seller's tax cost in the absence of a Section 338(h)(10) election is computed as the difference between the sale price and the seller's basis in the sold subsidiary's stock multiplied by the tax rate. On the other hand, the seller's tax cost when a Section 338(h)(10) election is made is the difference between the purchase price and the seller's basis in the net assets of the sold subsidiary, multiplied by the corporate tax rate. The seller will be indifferent between a Section 338(h)(10) election and no election when both choices leave it equally well off. More formally, the seller is indifferent if the price with an election meets the following condition,

$$\text{Price}_{338h10} - t_c(\text{Price}_{338h10} - \text{Asset}) = \text{Price}_{NO338h10} - t_c(\text{Price}_{NO338h10} - \text{Stock}) \quad \textbf{(17.1)}$$

where

$$\begin{aligned}
\text{Price}_{338h10} &= \text{the price when a Section 338(h)(10) election is made}\\
\text{Price}_{NO338h10} &= \text{the purchase price if the election is not made}\\
t_c &= \text{the corporate tax rate}\\
\text{Stock} &= \text{seller's basis is the sold subsidiary's stock}\\
\text{Asset} &= \text{seller's basis in the sold subsidiary's net assets}
\end{aligned}$$

Assume that $\text{Price}_{NO338h10}$ is the price of the subsidiary, ignoring any change in its asset basis, and that the seller and the acquirer agree on this price. The *minimum* price demanded by the seller to make the Section 338(h)(10) election can be expressed by simplifying equation (17.1) as:

$$\text{Price}_{338h10} = \text{Price}_{NO338h10} + [t_c/(1 - t_c)](\text{Stock} - \text{Asset}) \quad \textbf{(17.2)}$$

As equation (17.2) indicates, the minimum price demanded by the seller in a Section 338(h)(10) transaction can be greater or less than the price without the election. The relationship between the price under the differing structures is a function of the seller's basis in the subsidiary's stock and net assets. If the seller has an equivalent basis in the stock and the assets of the subsidiary, then it will be equally well off after tax, at any price, whether or not the election is made.[8] If the seller's basis in the subsidiary's stock is greater than its basis in the subsidiary's net assets, as is often the case, then the seller will have the same wealth after tax only when Price_{338h10} exceeds $\text{Price}_{NO338h10}$.[9]

If the parties make the Section 338(h)(10) election and the purchase price exceeds the subsidiary's net asset basis, the acquirer will obtain tax benefits from a step-up in

[8]This point was illustrated numerically in Table 17.2.
[9]Net asset basis exceeds stock basis relatively infrequently.

the tax basis of the acquired subsidiary's assets. Like a seller, an acquirer is indifferent between tax structures when it is equally well off after tax, as when the after-tax *cost* of the acquisition is the same. Because the acquirer obtains incremental tax benefits with the Section 338(h)(10) election, it is equally well or better off after tax with the election even if the *pretax* purchase price of the subsidiary is higher.

As a result of the tax benefits from the basis step-up, the acquirer should be willing to pay a higher purchase price if the Section 338(h)(10) election is made. Assuming that the acquirer uses straight-line depreciation and amortization after purchasing the subsidiary, we can express the maximum price that the acquiring firm will pay in a Section 338(h)(10) transaction as:

$$\text{Acqprice}_{338\text{h}10} = \text{Price}_{\text{NO338h10}} + t_c \times PVANN[(\text{Acqprice}_{338\text{h}10} - \text{Asset})/n] \qquad \textbf{(17.3)}$$

where

$\text{Acqprice}_{338\text{h}10}$ = the maximum purchase price that the acquiring company is willing to pay in a Section 338(h)(10) transaction

$PVANN$ = the present value of an annuity

n = the average useful life of the acquired subsidiary's assets

$\text{Price}_{\text{NO338h10}}$, Asset, and t_c are defined above.

The second term on the right-side of equation (17.3) is the present value of the tax benefits from stepping up the tax basis of the acquired subsidiary's assets. Rearranging, substituting, and simplifying equation (17.3) yields:

$$\text{Acqprice}_{338\text{h}10} = (\text{Price}_{\text{NO338h10}} - t_c\text{Factor} \times \text{Asset})/(1 - t_c\text{Factor}) \qquad \textbf{(17.4)}$$

where Factor is $PVANN/n$, and all other terms are as previously defined. In general, equation (17.3) shows that the acquirer is willing to pay a higher price in order to persuade the seller to make the Section 338(h)(10) election if the subsidiary's net asset basis is less than the purchase price without the election ($\text{Price}_{\text{NO338h10}}$).[10] If the purchase price is less than the net tax basis of the subsidiary's assets, equation (17.4) indicates that the price paid by the acquirer in a Section 338(h)(10) election would be lower than if the election were not made. The election would therefore result in a step-down in the asset basis of the subsidiary.

A Section 338(h)(10) election will be made in a subsidiary sale when the maximum price that the acquirer is willing to pay in a Section 338(h)(10) transaction ($\text{Acqprice}_{338\text{h}10}$) is greater than or equal to the minimum price that the seller is willing to accept ($\text{Price}_{338\text{h}10}$) in a transaction with the election, or when $\text{Acqprice}_{338\text{h}10}$ − $\text{Price}_{338\text{h}1070}$. The difference between $\text{Acqprice}_{338\text{h}10}$ and $\text{Price}_{338\text{h}10}$ is the difference between equations (17.2) and (17.4). After rearrangement and substitution,

$$\begin{aligned}\text{Acqprice}_{338\text{h}10} - \text{Price}_{338\text{h}10} &= \left[t_c \Big/ \left(\frac{1}{\text{Factor}} - t_c\right)\right](\text{Price}_{\text{NO338h10}} - \text{Asset}) \\ &\quad - [t_c/(1 - t_c)](\text{Stock} - \text{Asset}) \qquad \textbf{(17.5)}\end{aligned}$$

If the right-hand side of equation (17.5) is greater (less) than zero, a Section 338(h)(10) election will (will not) be made. Therefore, the Section 338(h)(10)

[10] This point was illustrated numerically in Table 17.3.

election decision depends in large part on the difference between the seller's basis in the subsidiary's stock (Stock) and the seller's basis in the subsidiary's net assets (Asset). Specifically, a Section 338(h)(10) election becomes less likely as the difference between the tax basis of the subsidiary's net assets and stock increases.[11]

What Determines a Parent's Basis in a Subsidiary's Stock and Net Assets?

A divesting parent's tax basis in a subsidiary's stock and net assets is determined by the manner in which the subsidiary was created or acquired.

- If the divesting parent internally generated the subsidiary, the parent's tax basis in the stock and net assets of the subsidiary will be the same.
- If the sold subsidiary was previously acquired by the divesting parent, that is, the divested subsidiary was previously a freestanding target that was acquired by the divesting parent, then the parent's tax basis in the subsidiary's stock and assets will be determined by the tax structure used to acquire the target.
- If the target, now the sold subsidiary, was acquired in a taxable stock acquisition, the parent's tax basis in the stock of the sold subsidiary will likely be much higher than its basis in the sold subsidiary's assets. Most taxable stock acquisitions of freestanding C corporations are structured in a manner that results in a carryover basis in the target's assets. At the same time, acquirers take a basis in the stock acquired equal to the purchase price, which usually exceeds the net asset basis of the acquired target by a substantial amount.
- If the target, now the sold subsidiary, was acquired using a tax-free structure, then the divesting parent's basis in the stock and net assets of the sold subsidiary are also not likely to be equal. The parent's basis in the stock of the sold subsidiary is likely to be greater than the net asset basis of the sold subsidiary in this scenario as well.

Additional Complexities: Subsidiary Sale

Let's consider a more complex subsidiary sale example that illustrates the concepts laid out in equations (17.1) through (17.5). Our objective is to determine whether the hypothetical subsidiary stock sale should be accompanied by a Section 338(h)(10) election. Assume the following facts relating to the pending sale of Richard Stevens, Inc.

- Richard Stevens, Inc., an investment bank, is a subsidiary of York Securities, and the net tax basis of Richard Steven's assets is $1,500 (historical cost equals basis).
- York's tax basis in the stock of Richard Stevens is $3,500.[12]
- Chicago Bank wants to purchase Richard Stevens and believes that the value of Richard Stevens is $5,000, if the tax basis of Richard Steven's assets carryover.

[11] This conclusion ignores a divesting parent's tax status. For example, if the divesting parent had large capital loss carryforwards, its relative preference for a stock sale without the election would be much greater.
[12] York acquired Richard Stevens in a taxable stock acquisition 3 years ago.

- Chicago Bank wants to pay cash to acquire Richard Stevens.
- The corporate tax rate is 35%, any step-up in the tax basis of Richard Steven's assets will be amortized straight-line over a 10-year period, and the appropriate after-tax discount rate is 10%.

Table 17.4 provides the particulars of the following computations. In a taxable stock sale without the election, York Securities would have $4,475 after tax, which is $5,000 price less $525 tax, or $5,000 minus $3,500 times 35%. Therefore, York would need to receive a pretax price in a Section 338(h)(10) transaction that left it with $4,475 after tax.

Equation (17.2) provided the minimum price demanded by York Securities to make the election ($\text{PRICE}_{338\text{h}10}$).

$$\begin{aligned} \text{Price}_{338\text{h}10} &= \text{Price}_{\text{NO}338\text{h}10} + [t_c/(1-t_c)](\text{Stock} - \text{Asset}) \\ &= \$5{,}000 + (.35/.65)(\$3{,}500 - \$1{,}500) \\ &= \$6{,}076.93 \end{aligned} \tag{17.2}$$

Would Chicago Bank be willing to pay $6,076.93 in a transaction that results in a Section 338(h)(10) election if it will pay $5,000 (and York will accept) in a non-Section 338(h)(10) transaction? The acquirer's net after-tax cost in a transaction in which the election is not made, at a price of $5,000, is $5,000. At a pretax price of $6,076.93 in a Section 338(h)(10) transaction, the present value of tax benefits from stepping up the target's assets is $984.11.[13] The acquirer's net after-tax cost is therefore $5,091.83 if the election is made, which is greater than the acquirer's net after-tax cost if the election was not made. Equation (17.4) provided the maximum price that Chicago Bank will pay ($\text{Acqprice}_{338\text{h}10}$) to purchase Richard Stevens if the election is made.

$$\text{Acqprice}_{338\text{h}10} = (\text{Price}_{\text{NO}338\text{h}10} - t_c\text{Factor} \times \text{Asset})/(1 - t_c\text{Factor}) \tag{17.4}$$

Factor is equal to $.6145(n = 10, r = 10\%)$.

$$\begin{aligned} \text{Aprice}_{338\text{h}10} &= [\$5{,}000 - .35(.6145) \times 1{,}500]/[1 - .35(.6145)] \\ &= \$5{,}959.03 \end{aligned}$$

Given these numbers, the election should not be made, because $\text{Acqprice}_{338\text{h}10}$ is less than $\text{Price}_{338\text{h}10}$. That is, the *maximum* price that the acquirer will pay if the election is made is less than the *minimum* price that the seller will accept if the election is made. The incremental cost of making the election is more than the incremental tax benefits associated with the election.[14] Stated another way, the acquirer's net after-tax cost in a Section 338(h)(10) transaction is higher than its net after-tax cost if the election is not made and the deal is priced at $5,000.

[13] Assuming that the step-up is amortized straight-line over a 10-year period, the tax rate is 35%, and the appropriate after-tax discount rate is 10%.

[14] The incremental tax benefit of the election at a price of $5,000 is equal to $752. The incremental tax cost to the seller at a price of $5,000 is $700, or $3,500 stock basis less $1,500 asset basis multiplied by 35%. In order to compensate the seller for this additional $700 of taxes, the buyer must pay the seller an additional $1,076.92 pretax, or $1,076.92(1 – t) = $700, where $t = 35\%$. A buyer is unwilling to pay an additional $1,076.92 to obtain $752 of tax benefits, as illustrated by equations (17.2) and (17.4).

TABLE 17.4 Tax Implications of Various Taxable Subsidiary Sale Structures

Fact Pattern:	
Purchase price—without a §338(h)(10) election	$5,000.00
Target's tax net asset basis	1,500
Divesting parent's tax basis in target's stock	3,500
t_c =	35%
r =	10%
Amortization/depreciation period (n) =	10

	Subsidiary Sale Structure		
	Taxable Stock Sale without a §338(h)(10) Election	***Taxable Stock Sale with a §338(h)(10) Election***	***Taxable Stock Sale with a §338(h)(10) Election***
Purchase price	$5,000.00		
Divesting parent indifference price(1)		$6,076.92	
Acquirer indifference price(2)			$5,958.94
Tax Effect for Divesting Parent:			
Gain on sale(3)	1,500.00	4,576.92	4,458.94
Cash received	$5,000.00	$6,076.92	$5,958.94
Tax on gain(4)	525.00	1,601.92	1,560.63
After-tax cash	$4,475.00	$4,475.00	$4,398.31
Acquirer Cost:			
Purchase price	$5,000.00	$6,076.92	$5,958.94
Less: incremental tax savings(5)	0.00	984.31	958.94
Net after-tax cost	$5,000.00	$5,092.61	$5,000.00
Acquirer's Basis in Target's:			
Stock	5,000.00	6,076.92	5,958.94
Net assets	$1,500.00	$6,076.92	$5,958.94
Step-up in the target's assets	0.00	4,576.92	4,458.94

(1)Price at which the divesting parent is indifferent between making the §338(h)(10) election and a purchase without the election at a price of $5,000.

(2)Price at which the acquirer is indifferent between making the §338(h)(10) election and a purchase without the election at a price of $5,000.

(3)Computed as the purchase price less the divesting parent's basis in the sold subsidiary's stock or net assets, depending on the transaction's structure.

(4)Corporate tax liability on the subsidiary sale. The tax is computed based on the nature of the gain (capital or ordinary) and the appropriate tax rate. We assume here that ordinary and capital gains rates are identical for divesting parents.

(5)The present value of the tax savings resulting from stepping-up the target's assets assuming that the step-up is amortized/depreciated straight-line over a 10-year period, the applicable tax rate is 35% and the after-tax discount rate is 10%.

Difference between Subsidiary Sales and Sales of Freestanding C Corporations

Subsidiary sales are often structured to result in a step-up in the tax basis of the target subsidiary's assets, while in acquisitions of freestanding C corporations, the target's assets almost always carry over. Why the disparity between the two transaction types? In the sale of a subsidiary, the incremental cost of the step-up is a function of the difference between the divesting parent's basis in the stock and assets of the sold subsidiary. In many but not all cases, the incremental cost of the step-up in a subsidiary sale is less than the incremental tax benefits from the step-up.

On the other hand, in an acquisition of a freestanding company, the incremental tax cost of obtaining $.35 of tax benefits in the future is $.35. With a nonzero discount rate, the incremental cost of the step-up is therefore always greater than the incremental tax benefits from the step-up. The only exception occurs when the freestanding target has large NOLs. As we illustrated in Chapter 16 (see Table 16.3), in some cases, even when the target has NOLs, a carryover basis transaction is still optimal.

When Is a Section 338(h)(10) Election Optimal?

Assuming that tax rates are constant, a Section 338(h)(10) election is wealth maximizing when the stock and asset basis of the target subsidiary are identical and the purchase price exceeds the net asset basis. In such a case, the incremental cost of the step-up election is $0, as we discussed and illustrated in Table 17.2. The election also makes sense when the tax basis of the target's assets exceeds the tax basis of the target's stock. Although such a circumstance is unusual, in this situation, the tax costs associated with the election are actually *less than* the tax costs if the election is not made. With changing tax rates, these generalizations can change. Equation (17.5) presented formally the case in which the step-up decision is optimal from a tax perspective.

When Is a Section 338(h)(10) Election Suboptimal?

Again, assuming that tax rates are constant, the step-up election doesn't make sense when the divesting parent's tax basis in the sold subsidiary's stock substantially exceeds the net tax basis of the subsidiary's assets. Readers may wonder when such a circumstance is likely to arise. Recall the analyses in Chapters 14 and 16. If the divested subsidiary was previously acquired in a taxable stock acquisition, the divesting parent's basis in the stock of the sold subsidiary is likely to exceed the tax basis of the sold subsidiary's net assets. Because carryover basis transactions are the most common structure used to acquire freestanding companies, in a significant number of situations, the Section 338(h)(10) election will not be viable.

Valuation Effects

The computations and illustrations in the preceding section and in Tables 17.2, 17.3, and 17.4 indicate that a subsidiary's *pretax* selling price varies with the tax bases of the sold subsidiary.[15] As a result, when performing valuations, we must account for the incremental tax costs and tax benefits associated with the tax structure of a subsidiary

[15] M. Erickson, and S. Wang, (2000), "The Effect of Transaction Structure on Price: Evidence from Subsidiary Sales," *Journal of Accounting and Economics* provide evidence that pretax prices are higher in subsidiary sales that include a Section 338(h)(10) election.

sale. For example, in comparable **company analyses,** controlling for the tax structure used in the acquisition of comparable companies is critical (see Figure 16.6). Perhaps more importantly, those involved in the purchase (sale) of subsidiaries should consider the ramifications of tax structure on the minimum (maximum) price at which a subsidiary can be acquired (sold). Clever planning on this dimension can have significant wealth effects.

17.2 TAX-FREE DIVESTITURE METHODS

Although taxable subsidiary sales are the most common form of divestiture, in many cases a tax-free divestiture method may be preferable. We focus on two tax-free divestiture methods: equity carve-outs and spin-offs. An equity carve-out is essentially a subsidiary IPO that is tax-free to the divesting parent and its shareholders. The divesting parent gets cash from its sale of the subsidiary's shares. A spin-off on the other hand is much like a large stock dividend. Shareholders of the divesting parent receive stock of the spun-off subsidiary, tax-free, in proportion to their ownership of the divesting parent. In a spin-off, the divesting parent does not obtain cash as part of the transaction, although it is common for the spun-off division to pay a debt-financed dividend to the divesting parent prior to the spin-off.

Equity Carve-Outs

Figure 17.5 illustrates an equity carve-out. The divesting parent firm issues shares in the subsidiary to investors for cash. If the shares are held by the subsidiary, no gain or loss is recognized on the stock issue. This tax treatment is associated with any stock issue by a corporation.

On the other hand, if the shares sold to the public are the parent's shares of the subsidiary, then the sale gives rise to a taxable gain or loss because the parent's stock ownership of the subsidiary constitutes a capital asset in the parent's hands. When this asset is sold, a gain or loss on the sale of the capital asset occurs. If the parent firm wants or needs cash, the subsidiary can pay cash to the divesting parent in the form of a tax-free dividend prior to the stock issue.[16]

For this reason, an equity carve-out can be a tax-free source of cash for the divesting parent. As an empirical fact, equity carve-outs typically involve the issue of a small portion, or less than 20%, of the stock of the subsidiary. Divesting parents are believed to complete these relatively small stock issues because it allows them to ascertain the fair market value of the subsidiary with a complete divestiture likely subsequent to the carve-out. By issuing less than 20% of the subsidiary's stock, the parent retains the ability to either complete a tax-free spin-off or sell the entire subsidiary in a qualifying taxable stock acquisition that can be followed by a Section 338(h)(10) election.[17] For

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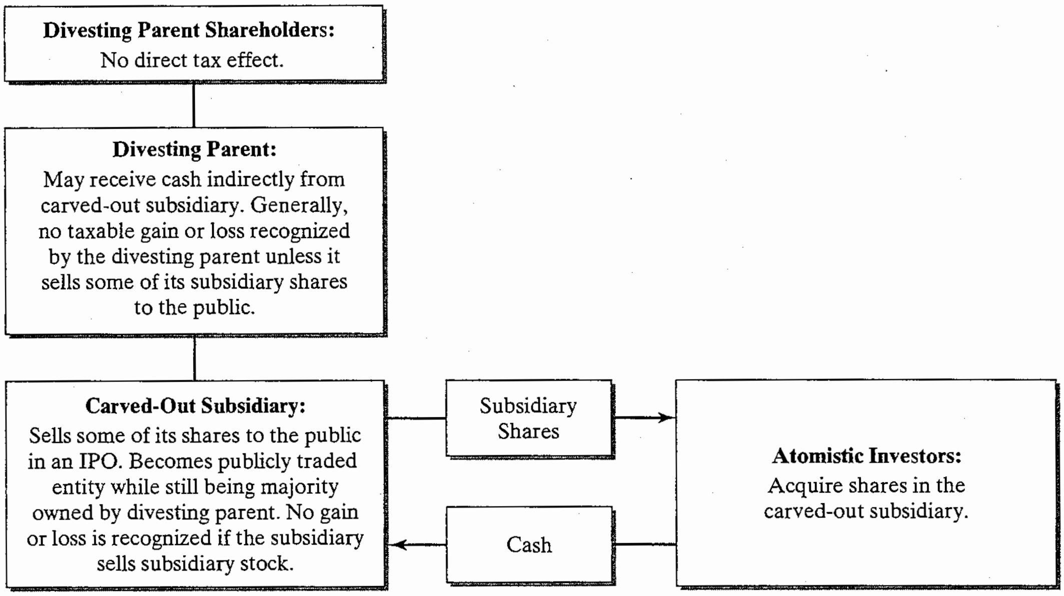
[16]This point is only true if the parent's ownership of the subsidiary is greater than 80%. Ownership of greater than 80% results in a dividends received deduction of 100%.

[17]A qualifying stock purchase is one that results in acquisition of 80% of the voting power of the target. A tax-free spin-off must involve the distribution of at least 80% of the divested subsidiary's stock. In some instances, divesting parents have carved out more than 20% of a subsidiary, but still qualified subsequently for tax-free spin-off treatment. The desired tax treatment was accomplished by the clever use of different classes of stock with different voting rights. See R. Willens, "DuPont's Enlightened Divestiture Plan," Lehman Brothers (October 23, 1998.)

FIGURE 17.5 Equity Carve-Out



accounting purposes, the divesting parent does not recognize any gain or loss on the equity carve-out.[18]

Tax-Free Spin-Offs

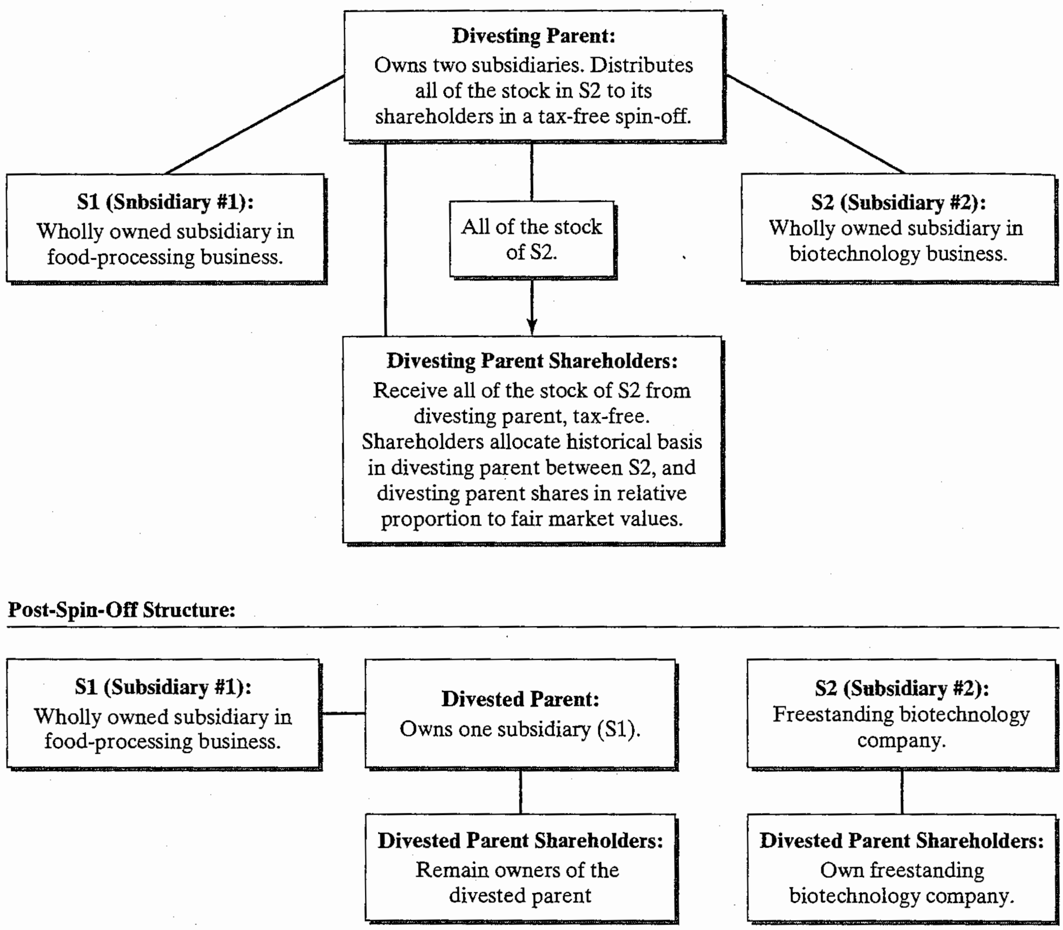
In a spin-off, the divesting parent divides its operations into two (or more) distinct corporate entities. If the parent's business is operated as two subsidiaries, restructuring prior to the spin-off is unnecessary. In either case, the parent firm distributes the stock of the divested subsidiary to its shareholders pro rata. Figure 17.6 illustrates the structure of a spin-off. Essentially, the parent pays a large stock dividend but uses stock of a *subsidiary* for the dividend. After the distribution, shareholders hold interest in two separate businesses: the old parent less the spun-off subsidiary and the spun-off subsidiary. If the transaction qualifies as tax-free under Section 355, the distribution is tax-free to the parent's shareholders and to the divesting parent firm.

In order for such a distribution to qualify for tax-free treatment under Section 355, several general requirements must be met:

- The distributing corporation must have control of the divested subsidiary prior to the distribution. Control is defined as 80% ownership of the subsidiary.
- The divesting parent must distribute a controlling block of subsidiary's stock to shareholders. Control is defined as 80% of the divested subsidiary's stock.

[18] If the divesting parent sells some of its subsidiary stock, an accounting gain or loss is recognized. In addition, a divesting parent can elect to recognize a gain on an equity carve-out under SEC *Staff Accounting Bulletin* (SAB) 51. See J. Hand, and T. Skantz, "The Economic Determinants of Accounting Choices: The Unique Case of Equity Carve-Outs Under SAB 51," *Journal of Accounting and Economics* (December 1997), pp. 175–204, for additional details.

FIGURE 17.6 Illustration of a Tax-Free Spin-Off



- After the distribution, both the parent and the divested subsidiary must be involved in an active trade or business.
- The transaction cannot be designed as a device for distributing the earnings and profits to the shareholders of the parent.
- The historical shareholders of the divesting parent must maintain a continuity of interest in the parent and spun-off subsidiary.
- The divesting parent cannot have acquired the divested subsidiary during the previous 5 years in a taxable transaction.
- The divestiture must have a valid business purpose and the shareholders of the divesting parent must maintain control of the parent and the divested subsidiary post-spin-off.
- The divesting parent or the spun-off entity cannot be acquired within 2 years of or 2 years after the spin-off.

In a spin-off, the divesting parent's shareholders allocate their basis in the stock of the parent to the stock of the divested subsidiary and to the "new" parent in proportion to the fair market values of the two separate businesses at the date of the spin-off.

For example, consider a shareholder that had a tax basis in a divesting parent's stock of \$100 per share prior to the spin-off. At the date of the spin-off, assume that the fair market value of the spun-off business was \$200 per share and the value of the remaining parent business (old parent less the divested subsidiary) was \$50. The shareholder would have a basis in the stock of the spun-off subsidiary of \$80 [(200/(\$200 + \$50)] × \$100 basis and a basis in the stock of the parent of \$20. The tax basis of the net assets of the remaining parent and the divested subsidiary carry over, that is they are the same as they were for the combined business.

A spin-off is accounted for in the same manner as a stock dividend. Retained earnings are debited in an amount equal to the fair market value of the spun-off subsidiary. Unlike the case in an equity carve-out, there is no direct cash infusion for the parent or the divested subsidiary.

How Can a Spin-Off Be Used to Distribute Earnings and Profits?

We can use an example to illustrate this concept. Consider a publicly traded corporation (BREAKUP) that is owned by ten shareholders. These ten shareholders have a basis in their stock of \$1,000. BREAKUP has two subsidiaries: GREEN and RED. BREAKUP's tax basis in the stock and assets of GREEN is \$10 and its tax basis in the stock and assets of RED is \$500. BREAKUP's market value is \$2,000, and investment bankers believe that GREEN is worth \$1,500 and RED is worth \$500.

BREAKUP decides to do a spin-off of GREEN. After the spin-off, BREAKUP's shareholders own the stock of GREEN and BREAKUP, which is now essentially just RED. Their basis in the stock of GREEN will be equal to \$750, or \$1,500 fair market value of GREEN divided by the fair market value of BREAKUP (\$2,000) multiplied by preshareholder spin-off basis (\$1,000), and their basis in BREAKUP will be \$250. As a result of the spin-off, the shareholders of BREAKUP obtained a tax-free step-up in the basis of the stock of GREEN from \$10 to \$750. Hence, if they sell the GREEN stock post-spin-off, they will have more cash after tax because less tax was paid in total than if BREAKUP sold GREEN for cash and then distributed the proceeds to them in redemption of their shares.

Specifically, if GREEN were sold for \$1,500, BREAKUP would incur a tax liability of \$521.50, or \$1,490 × 35%. After tax, BREAKUP could distribute \$978.50 to shareholders. If this distribution were taxed as a dividend,[19] shareholders would face a tax on the dividend of \$387.48, or \$978.50 times 39.6% ordinary income rate, and would have \$591.01 after tax. (Dividend tax rates are 15% after 2003 but as high as 39.6% before 2003.) On the other hand, if BREAKUP shareholders were to sell the stock of GREEN after the spin-off for \$1,500, they would incur a capital gain of \$750 (\$1,500 less basis in GREEN stock of \$750). This gain would give rise to a capital gains tax of \$150, or \$750 times 20% capital gains rate, which would leave BREAKUP's shareholders with \$1,350 after tax. The result is \$758.99 more than if GREEN were sold directly by BREAKUP and the proceeds were distributed to shareholders.[20] We present the specifics of these computations in Table 17.5.

[19]Such a distribution could be structured in a manner that resulted in capital gain taxation under Section 302(b)(4).

[20]Note that, as shown in Chapter 14 and in this chapter, the price of a corporation is affected by any tax benefits generated in the transaction. In this case, when GREEN is a subsidiary of BREAKUP, the sale could be structured to provide a step-up in the tax basis of GREEN's assets. The acquirer could be expected to pay for these tax benefits. On the other hand, when GREEN is a freestanding corporation, post-spin-off, a step-up in its assets would not be viable. Hence the sale price of GREEN could be different with and without the spin-off.

TABLE 17.5 Illustration of the Use of a Spin-Off as a Device to Distribute Earnings and Profits

	Base Case: Sale of Appreciated Subsidiary			*Spin-Off Scenario*		
	BREAKUP (Parent)	***RED (Subsidiary)***	***GREEN (Subsidiary)***	***BREAKUP (Parent)***	***RED (Subsidiary)***	***GREEN (Subsidiary)***
Fair market value	$2,000.00	$500.00	$1,500.00	$2,000.00	$500.00	$1,500.00
Net asset basis	510.00	500.00	10.00	510.00	500.00	10.00
Shareholder basis in BREAKUP stock	1,000.00	n/a	n/a	1,000.00	n/a	n/a
Sale price of GREEN			$1,500.00			
Less: net asset basis			10.00			
Taxable gain to BREAKUP[1]			$1,490.00			
BREAKUP's tax on gain on sale of GREEN[2]			521.50			
After-tax cash from sale of GREEN distributed to shareholders as a dividend[3]			$978.50			
Shareholder tax on dividend[4]			387.49			
Shareholders after-tax cash from sale of GREEN[5]			$591.01			
Sale price of GREEN[6]						$1,500.00
Shareholder basis in GREEN post-spin-off[7]						750.00
Taxable gain to GREEN shareholders on sale of GREEN shares post-spin-off[8]						$750.00
Shareholder-level tax on gain on sale of GREEN[9]						150.00
After-tax cash to shareholders from the sale of GREEN (post-spin-off)[10]						$1,350.00

[1]Taxable gain to BREAKUP corporation on sale of GREEN computed as the sale price less the net asset basis of GREEN. [2]Corporate tax on the sale of GREEN computed as the taxable gain (1) multiplied by the corporate tax rate (35%). [3]After-tax cash from sale of GREEN computed as sale price less tax on gain (2). [4]Shareholder-level tax on cash distributed by assuming the distribution is taxed as a dividend and the appropriate shareholder ordinary income rate is 39.6%. [5]BREAKUP's shareholders' after-tax cash from the sale of GREEN. Computed as the dividend (4) less shareholder level dividend taxes (5). [6]Sale price of GREEN post-spin-off. The price is assumed to be the same as when BREAKUP sold the assets of the subsidiary. This assumption is unlikely to be true as illustrated in Section 17.1 of this chapter and in various sections of Chapter 14. That is, the purchase price of GREEN will likely be less in the spin-off case than in the asset sale case because there will not be a step-up in the tax basis of GREEN's assets in such a sale (GREEN is a freestanding C corporation post-spin-off). [7]Shareholder basis in GREEN post-spin-off is computed as the fair market value of GREEN at the spin-off ($1,500) divided by the total fair market value of BREAKUP at the spin-off ($2,000) multiplied by the total shareholder basis in the stock of BREAKUP ($1,000). [8]Taxable gain to GREEN's shareholders on the sale of GREEN stock. Computed as the difference in the sale price and shareholder's basis in their GREEN stock post-spin-off (8). [9]Shareholder level tax on the sale of GREEN stock is computed as the taxable gain on the sale (8) multiplied by the long term capital gains tax rate (20%). [10]Computed as the sale proceeds from the GREEN stock sale less the capital gains taxes on the sale (9).

What Are the Consequences of a Spin-Off That Is Disqualified as Tax-Free?

If a spin-off for any of several reasons fails to qualify for tax-free treatment, or if after the spin-off some disqualifying event occurs, the spin-off will be a taxable event. If the spin-off is deemed to fail to qualify for tax-free treatment, the distribution of the subsidiary's stock to the divesting parent's shareholders is taxed as a **property dividend.** That is, the distributing parent corporation must recognize a gain equal to the difference between the fair market value of the property distributed and the parent's net tax basis in the assets of the divested subsidiary.

Notice that the tax is levied on the distributing parent corporation and not on the spun-off corporation. Shareholders receiving stock in a **disqualified spin-off** must recognize a dividend, taxable at ordinary income rates, equal to the fair market value of the property received, that is, the fair market value of the spun-off business. If a spin-off will fail to qualify for tax-free treatment, the distributing corporation typically will cancel the divestiture.

The disqualification issue is also important in those transactions in which an event occurs subsequent to the spin-off. In particular, the acquisition of the divesting parent *postacquisition* can lead to the violation of the continuity of ownership requirements under **Section 355.** Specifically if the ownership of the parent changes by more than 50% within 2 years after the spin-off, the spin-off's tax-free status can be disqualified.[21] In such a situation, the distribution of the spun-off stock to the parent's shareholders becomes a taxable dividend to the distributing parent.[22] As a result, the parent will face a potentially ominous tax liability.

Several conglomerates have used a pending spin-off to fend off a hostile suitor by using this peculiarity of spin-off taxation. That is, a target corporation (divesting parent) can create a tax "poison pill" by completing a spin-off prior to its acquisition by an unwanted suitor. A freestanding target that spins off a division with highly appreciated assets (low basis, high fair market value) will cause an acquirer to pay the tax associated with disqualifying the spin-off's tax-free status. Such disqualification occurs when the hostile suitor acquires the target (divesting parent).[23] The requirements under Section 355 thereby provide targets with a tax-related takeover defense mechanism.

Other Variants of the Spin-Off: Split-Ups, Split-Offs, and Tracking Stock

A spin-off involves the pro rata distribution of the stock of the divested subsidiary to shareholders of the parent. A **split-up** occurs when the divesting parent forms two subsidiary companies and distributes the stock in these two companies to its shareholders

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[21]These rules were created in part to prevent so-called "monetizing Morris Trust" transactions. A Morris Trust transaction typically involves the spin-off of assets that the parent wishes to retain followed by an acquisition of the remaining, unwanted, assets in a tax-free transaction by a third party. See A. Sloan, "The Loophole King," *Newsweek* (March 31, 1997), p. 55, for additional discussion of monetizing Morris Trust transactions.

[22]Essentially, the divesting parent corporation is treated as if it sold the spun-off business's assets in a taxable transaction.

[23]ITT threatened to use this defensive tactic, preacquisition, to halt Hilton's unwanted takeover attempts. See "ITT Plans to Split into Three Companies: Firm to Take on New Debt, Buy Back Stock in Move to Thwart Hilton Offer," *The Wall Street Journal* (July 17, 1997), p. A3.

in liquidation of the divesting parent. After the transaction is complete, the historical parent corporation no longer exists and shareholders hold stock in two separate businesses. The distribution of the stock of the two subsidiary companies may or may not be pro rata.

In a **split-off,** the divesting parent corporation distributes the stock of the divested subsidiary to its shareholders in redemption for some of their stock in the parent. After the transaction has been completed, the parent's shareholders own stock of the parent and the new subsidiary. The distribution may or may not be pro rata. In either case, the distribution is tax-free to the divesting parent and its shareholders as long as it meets the requirements of **Section 355.**[24]

These spin-off alternatives provide flexibility to shareholders with respect to satisfying their demands for the stock of the divested subsidiary and divesting parent corporation.

In the late 1990s and early 2000s, tracking stocks became a popular divestiture variant. With the typical **tracking stock,** the parent firm creates a stock whose value is designed to track the value of one of the parent company's subsidiaries. In many cases, the tracking stock pays a cash dividend related to the financial performance of the tracked subsidiary. Shareholders of the parent corporation receive the tracking stock in a stock dividend transaction in a procedure similar to a spin-off. However, with a tracking stock, the parent corporation does not distribute a controlling share of the tracked subsidiary to shareholders. Rather, the parent retains control of the tracked subsidiary. For this reason, tracking stock is significantly different from a spin-off. With the bear market of the recent past, tracking stocks seems to have lost much of their luster.

Factors That Influence Divestiture Method Choice

In this chapter, we have provided a mathematical framework from which to quantify the tax and cash flow effects of various divestiture methods. In order to effectively structure a divestiture, however, we need to consider a number of other factors. Table 17.6 provides an overview of the major tax and nontax consequences of the divestiture methods described and analyzed in this chapter. How does a tax planner determine which of these methods is optimal, given a pending divestiture?

Of course, the choice of method will be a function of the tax and nontax preferences of the divesting parent, and the tax and nontax attributes of the subsidiary to be divested. If the parent is in need of cash, it could select one of the methods that generates cash, such as a stock sale or equity carve-out. If the subsidiary to be divested has a market value that greatly exceeds the tax basis of the subsidiary's net assets, the divesting parent may want to consider a spin-off rather than a subsidiary sale structure.

Conversely, if the subsidiary to be divested has a basis that exceeds its fair market value, the divesting parent may want to consider a sale to capture the taxable loss on the sale. Similarly, if the divesting parent has capital loss or operating loss carryforwards, the sale of an appreciated subsidiary may allow the use of the divesting parent's tax attributes in a relatively tax-efficient manner. If the divesting parent is interested in generating accounting gains in order to "smooth" its earnings, a taxable subsidiary sale—or in some cases an equity carve-out—could provide the needed accounting gains.

[24]Because split-off distributions can be non-pro rata, when the shareholders of the parent disagree about the operation of the components of the combined entity, a split-off allows for a tax-free divestiture of the operations of the parent.

TABLE 17.6 Overview of Tax and Nontax Implications of Various Divestiture Methods

Tax or Structural Factor	*Tax-Free Subsidiary Sale*	*Taxable Subsidiary Asset Sale*	*Taxable Subsidiary Stock Sale without a §338(h)(10) Election*	*Taxable Subsidiary Stock Sale with a §338(h)(10) Election*[1]	*Tax-Free Spin-Off*	*Equity Carve-Out*
Divesting parent receives cash	No	Yes	Yes	Yes	No[2]	Yes
Divesting parent maintains control of divested subsidiary	No	No	No	No	No	Yes[3]
Taxable gain or loss at the divesting parent level	No	Yes	Yes	Yes	No	No[4]
Taxable gain for divesting parent shareholders	No	No	No	No	No	No
Step-up in the *tax basis* of the divested subsidiary's assets	No	Yes	No	Yes	No	No
Accounting gain or loss recognized by divesting parent	Possibly	Yes	Yes	Yes	No	Possibly

(1)Subsidiary stock sale that is taxed as if the divesting parent sold the assets of the subsidiary, rather than subsidiary stock.
(2)In some cases, the spun-off subsidiary pays a debt-financed dividend to the divesting parent pre-spin-off.
(3)A carve-out can involve less than or more than enough equity to constitute control of the divested subsidiary.
(4)If the subsidiary sells the shares in the IPO, there is no taxable gain. If the shares sold are shares owned by the divesting parent, a taxable gain or loss results.

To a large extent, the divestiture method chosen is a function of the relative demand for the divested subsidiary. That is, does the subsidiary have willing buyers? Conversely, the spin-off of a poorly performing subsidiary may not be well received by the parent's shareholders, making it a wealth reducing divestiture mechanism.

17.3 ADVANCED DIVESTITURE TECHNIQUES

Other mechanisms can be used to accomplish a divestiture, some of which may provide a divesting parent with cash tax-free. The liquidity provided by these techniques does come at additional transaction costs, however. We briefly introduce such divestiture strategies in this section.

Tax-Free Subsidiary Sale under Section 351 Followed by Secured Borrowing

In some cases, a divesting firm is averse to taxable treatment for a divestiture, but still wants to **monetize** a subsidiary. We saw this situation in Section 16.8 of Chapter 16, but the target was a freestanding C corporation in that case. What divestiture technique might provide a divesting parent with tax-free treatment in the sale of a highly appreciated asset, while at the same time providing cash on the sale?

Recall from Chapter 16 the analysis of tax-free acquisitions through **Section 351.** In that type of tax-free acquisition, the acquirer and target contributed stock or assets to a new corporation in a tax-free corporate formation transaction. A similar technique can be used in the acquisition of a subsidiary.

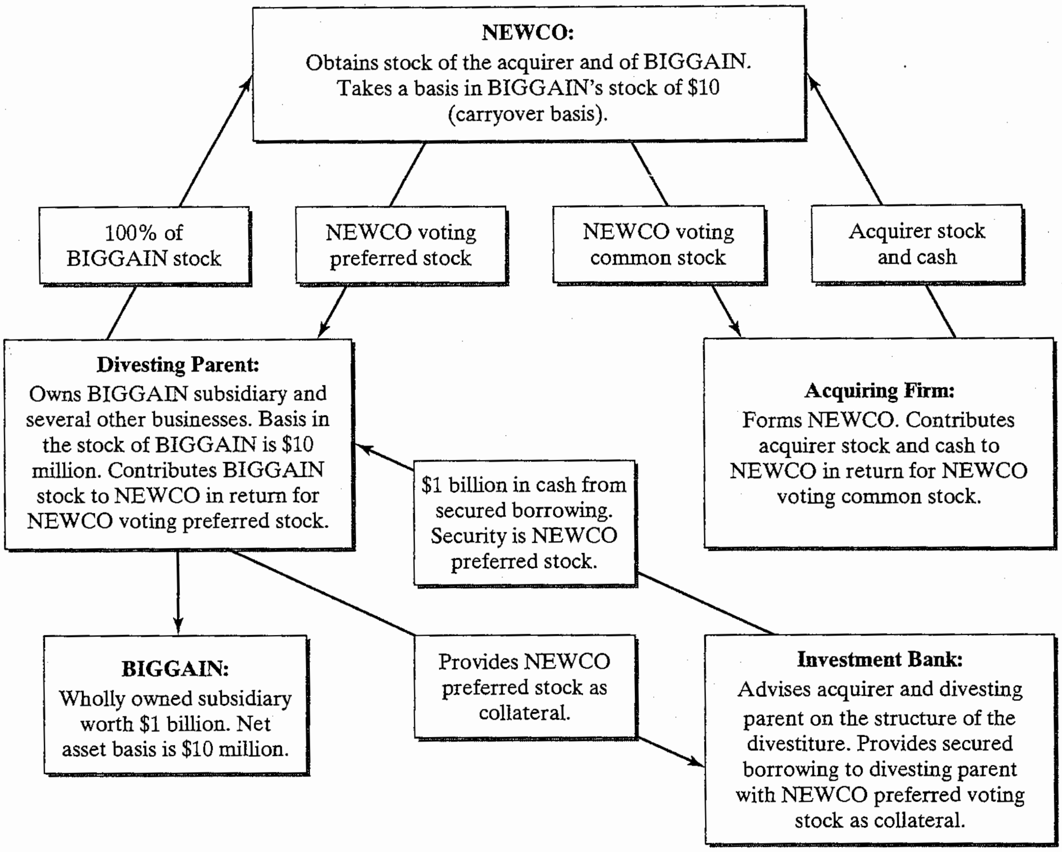
Consider a divesting parent that owns a subsidiary (BIGGAIN) with a fair market value of $1 billion. The divesting parent's tax basis in the stock and net assets of BIGGAIN are $10 million. Hence, a taxable subsidiary sale would give rise to a $990 million taxable gain and a tax liability to the divesting parent of $346.50 million, or 35% of $990 million.

If an acquirer offered to acquire BIGGAIN in a Section 351 transaction, the divesting parent could defer the $346.50 million of tax liability. Consider the following structure. The acquirer and the divesting parent form NEWCO with the acquirer contributing acquirer stock worth $2 billion and $500 million of cash in return for $2.5 billion of NEWCO voting common stock. The NEWCO common stock has voting rights of two votes per share. Further assume that the divesting parent contributes the stock of BIGGAIN in return for $1 billion of NEWCO voting preferred stock. The preferred stock has voting power equal to one vote per share. The transaction qualifies for tax-free treatment under Section 351 because the contributors have control of NEWCO postcontribution. Figure 17.7 illustrates the structure of this transaction.

While this Section 351 transaction does provide the divesting parent with gain deferral on the sale of BIGGAIN, it does not provide it with cash. Solving this problem is relatively simple. The divesting parent can borrow cash from a financial intermediary using the NEWCO preferred stock as collateral. As a practical matter, the financial intermediary that assisted with consummating the transaction could also provide the secured borrowing. Of course, such a loan will result in nontrivial transaction costs.

As with other tax planning strategies described and analyzed in this text, the net tax savings from the strategy (deferral of $346.50 million of taxes here) must be compared with the nontax costs (transaction costs) in determining the viability of the strategy. It is

FIGURE 17.7 Tax-Free Subsidiary Sale under §351 Followed by a Secured Borrowing



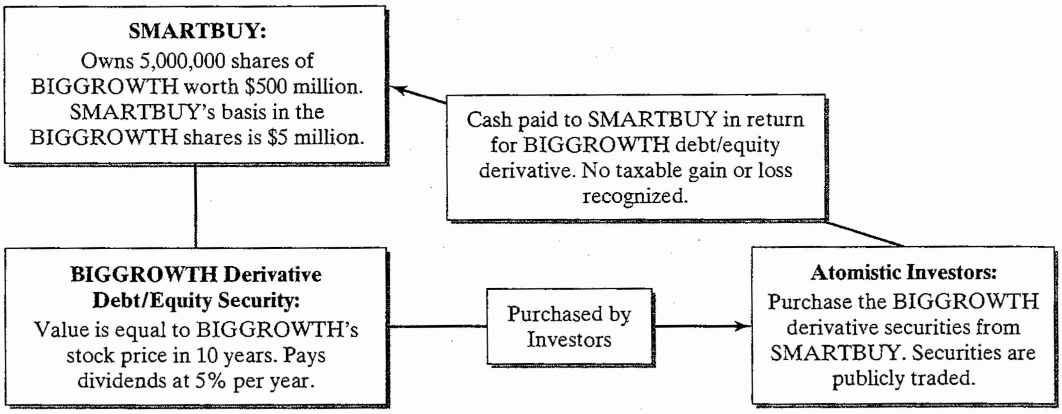
also important to incorporate the lower purchase price that would accompany this transaction, relative to a taxable sale, due to the lack of a step-up in the divested subsidiary's assets. Financial models like those presented throughout the last three chapters, especially Table 16.3, Table 16.5, and Table 17.4 provide a mechanism for quantifying the incremental benefits and costs (tax and nontax) of such a tax strategy.

Derivative-Based Divestiture Techniques

As we discussed briefly in Chapter 16, derivatives can provide significant tax benefits to buyers and sellers in acquisitions and sales of freestanding corporations. The same is true in divestitures.

Consider a corporation (SMARTBUYER) that acquired a block of five million shares of **restricted stock** of an Internet company (BIGGROWTH.com) for $1 per share. Further assume that this stock appreciated in value to $100 per share, making the total value of the position $500 million, and SMARTBUYER wants to monetize its position in BIGGROWTH, preferably in a tax-deferred manner. SMARTBUYER cannot sell the stock of BIGGROWTH because the stock is restricted. In addition, a sale would generate a large taxable gain.

FIGURE 17.8 Derivative-Based Divestiture Technique



One potential solution for SMARTBUYER is to create a new security that contractually is a **derivative,** which it can sell in the capital markets. This new security will carry the right to receive the value of BIGGROWTH in cash in 10 years. Alternatively, holders of the security could receive the stock of BIGGROWTH in 10 years based on some conversion metric. In the interim, assume that this derivative security provides holders with an annual dividend of 5%. Essentially, the security contains the features of a convertible debt instrument. In some ways, the issuance of the derivative is similar to an equity carve-out. Figure 17.8 illustrates this divestiture technique.

What is the tax treatment for SMARTBUYER of the issue of this derivative-type security? If structured correctly, the sale of the security does not give rise to a taxable gain or loss because the issuance is treated much like any stock or debt issue. That is, an issuing firm doesn't recognize a taxable gain or loss when it issues debt or stock. In addition, in some cases firms issuing this type of derivative were able to obtain an interest deduction for the recurring "dividend" payments to holders of the derivative. When SMARTBUYER redeems the derivative or closes out its position in BIGGROWTH, its action would trigger a taxable gain or loss.

This technique has been used by a number of companies. In one of the more notable examples Times Mirror issued a derivative called a premium equity participating security, or PEPS, tied to its position in Netscape.[25] Times Mirror acquired the Netscape stock for about $2 per share, and it appreciated in value rapidly thereafter, leading Times Mirror to seek this derivative-based divestiture solution.

Summary of Key Points

1. A corporation can divest a subsidiary or division in several ways. The most common divestiture methods are subsidiary sales, spin-offs, and equity carve-outs.
2. A sale of the entire subsidiary is typically structured in a manner that gives rise to a taxable gain or loss. An equity carve-out or a spin-off is typically tax-free; the former generates cash flow for the divesting parent firm while the latter does not.

[25]See for example T. Pratt, "At Last, Morgan Monetizes Times Mirror/Netscape Stake; Sweetens Terms of 'Peps' Deal to Counter Bad News," *Investment Dealers' Digest* (March 18, 1996); and R. Atlas, "Netscape, for Less," *Forbes* (May 20, 1996).

3. A subsidiary sale can be taxed as a stock sale or an asset sale. Asset sale tax treatment results in a step-up in the tax basis of the sold subsidiary's assets. A stock sale may be preferable due to the costs of title transfer associated with an asset sale. Certain types of stock sales can be taxed under Section 338(h)(10) as if the subsidiary had sold its assets.
4. If an acquirer purchases 80% or more of a subsidiary's stock within a 12-month period, the acquirer and seller can jointly elect to have the stock sale taxed as an asset sale under Section 338(h)(10).
5. Subsidiary sales are often structured in a manner that results in a step-up in the tax basis of the sold subsidiary's assets. As we noted in Chapter 14, sales of freestanding C corporations rarely result in a step-up in the tax basis of the target's assets.
6. In a subsidiary sale, the tax attributes of the sold subsidiary always survive. The tax attributes of the subsidiary stay with the divesting parent in a taxable asset sale or in a taxable stock sale followed by a Section 338(h)(10) election and remain with the subsidiary in a taxable stock sale without a Section 338(h)(10) election.

Discussion Questions

1. If a corporation wishes to divest a subsidiary and needs cash, what possible alternative methods can it consider?
2. If a corporation wishes to divest a subsidiary in a tax-free manner and wants its historical shareholders to maintain a direct ownership in the divested subsidiary, what technique should it employ?
3. Why are tax-free subsidiary sales relatively uncommon?
4. In general, when should a Section 338(h)(10) election be made in a subsidiary sale? Consider the relationship between purchase price, subsidiary stock basis, and subsidiary net asset basis.
5. In general, when should a Section 338(h)(10) election not be made in a subsidiary sale? Consider the relationship between purchase price, subsidiary stock basis, and subsidiary net asset basis.
6. Name four requirements for a spin-off to qualify as tax-free.
7. In a taxable subsidiary stock sale without a Section 338(h)(10) election, do the sold subsidiary's tax attributes such as NOLs survive? If so, who obtains/maintains these attributes?

Tax Planning Problems

1. You are a summer associate at a large Wall Street investment bank and your direct supervisor has informed you that the Sunglass Hut (the acquirer) has engaged your firm to analyze the prospect of acquiring RK, Inc., a wholly owned subsidiary of Consumer Devices, Inc. Consider the following relevant facts:
   - RK has assets with net tax basis of $800 million and fair market value of $1.9 billion. RK has no liabilities.
   - RK is 100% owned by Consumer Devices.
   - Consumer Devices has a tax basis in RK stock of $1 billion. Consumer Devices acquired this stock 5 years ago.
   - Sunglass Hut wants to acquire the stock of RK from Consumer Devices for $1.9 billion in cash.
   - RK, Consumer Devices, and Sunglass Hut are all C corporations.

   Assume that the transaction is structured as a taxable stock sale without a Section 338(h)(10) election.

   a. What tax basis in the assets of RK will Sunglass Hut have postacquisition?

b. How much cash after tax will Consumer Devices have from the transaction? Assume that Consumer Devices' marginal tax rate is 35%.

Now assume that the transaction is structured as a taxable stock sale with a Section 338(h)(10) election.

c. What tax basis in the assets of RK will Sunglass Hut have postacquisition?
d. How much cash after tax will Consumer Devices have? Assume that Consumer Devices' marginal tax rate is 35%.
e. At what price is Consumer Devices indifferent between a stock sale with a Section 338(h)(10) and a stock sale without a Section 338(h)(10) election at a $1.9 billion purchase price?
f. At what price is Sunglass Hut indifferent between a stock sale with a Section 338(h)(10) and a stock sale without a Section 338(h)(10) election at a $1.9 billion purchase price? Assume that any basis step-up in RK's assets in a Section 338(h)(10) transaction is depreciated/amortized over 10 years and that the appropriate discount rate for any tax savings from these additional deductions is 10%. Assume that Sunglass Hut's tax rate is 35%.
g. Should the Section 338(h)(10) election be made? Why?
h. If Sunglass Hut captured all the net tax benefits associated with the Section 338(h)(10) election (assuming that your answer to part (g) is yes), how much *lower* would its net *after-tax* cost be relative to a sale without a Section 338(h)(10) election at a $1.9 billion purchase price?
i. If Consumer Devices captured all the net tax benefits associated with the Section 338(h)(10) election (assuming that your answer to part (g) is yes), how much higher would its after-tax wealth be relative to a sale without a Section 338 (h)(10) election at a $1.9 billion purchase price?

2. Consider only circumstances involving the sale of a subsidiary of a C corporation.
   a. Under what circumstances does a Section 338(h)(10) election make sense?
   b. When is a Section 338(h)(10) election suboptimal in the sale of a subsidiary of a C corporation? Be concise.
3. You are a newly hired analyst at a large Wall Street investment bank and your direct supervisor has informed you that Arnie's Army (the acquirer) has engaged your firm to analyze the prospect of acquiring JM, Inc., a wholly owned subsidiary of Nicklaus. Consider the following relevant facts.
   - JM has assets with net tax basis of $300 million and fair market value of $900 million. JM has no liabilities.
   - JM is 100% owned by Nicklaus.
   - Nicklaus has a tax basis in JM stock of $600 million. Nicklaus acquired this stock 5 years ago.
   - Arnie's Army wants to acquire the stock of JM from Nicklaus for $900 million in cash.
   - JM, Nicklaus, and Arnie's Army are all C corporations.

   Assume that the transaction is structured as a taxable stock sale without a Section 338(h)(10) election.

   a. What tax basis in the assets of JM will Arnie's Army have postacquisition?
   b. How much cash after tax will Nicklaus' have from the transaction? Assume that Nicklaus' marginal tax rate is 40%.

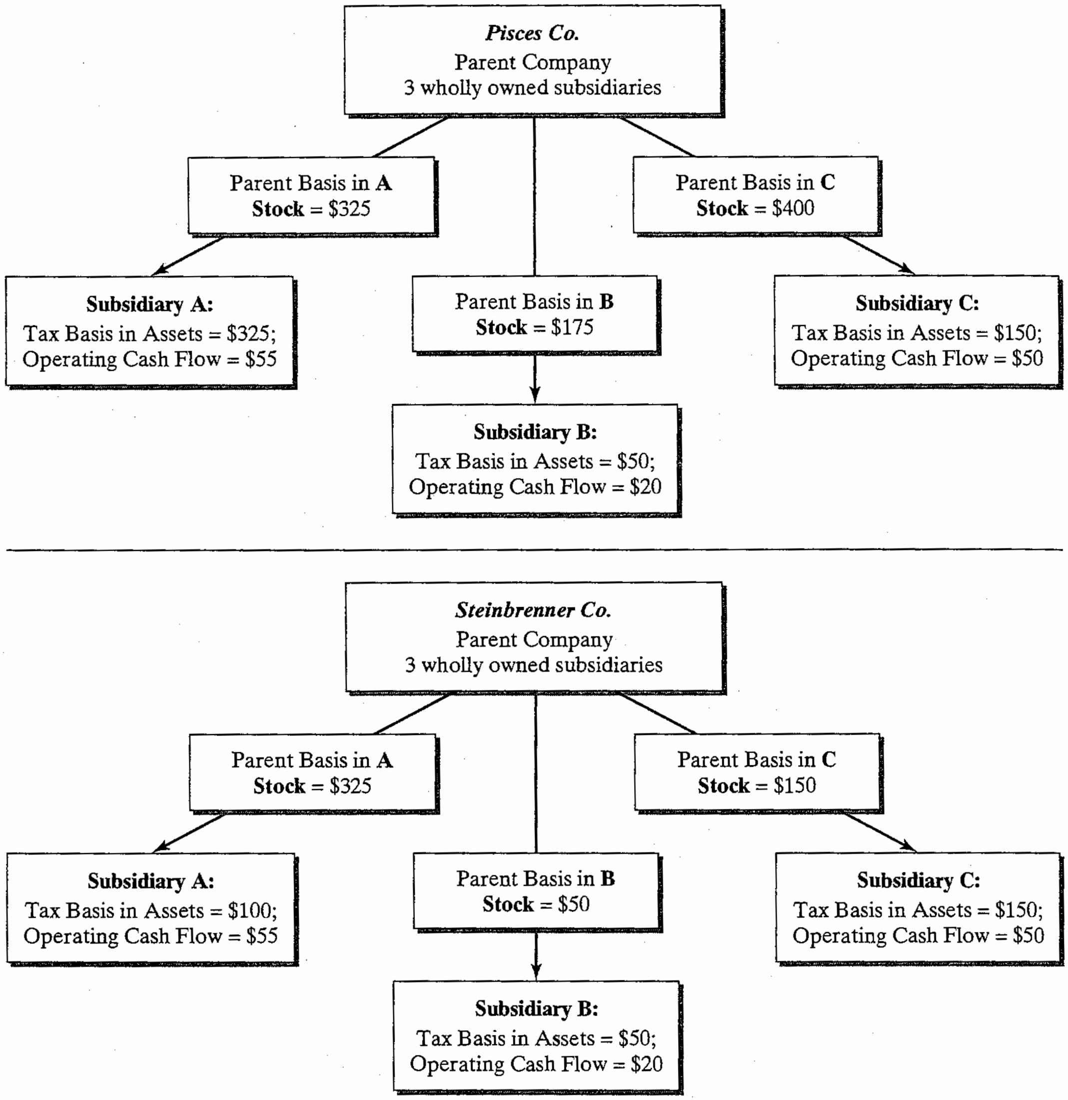
   Assume that the transaction is structured as a taxable stock sale with a Section 338(h)(10) election.

   c. What tax basis in the assets of JM will Arnie's Army have postacquisition?
   d. How much cash after tax will Nicklaus have? Assume that Nicklaus' marginal tax rate is 40%.

e. At what price (P) is Nicklaus indifferent between a stock sale with a Section 338(h)(10) and a stock sale without a Section 338(h)(10) election at a $900 million purchase price?
f. Given the price (P) that you computed in part (e), which structure does Arnie's Army prefer: a taxable stock sale without a Section 338(h)(10) election for a price of $900 million or a taxable stock sale with a Section 338(h)(10) election at price (P)? Assume that any basis step-up in JM's assets in a Section 338(h)(10) transaction is depreciated/amortized over 12 years and that the appropriate discount rate for any tax savings from these additional deductions is 7%. Assume that Arnie's Army's tax rate is 40%.
g. Should the Section 338(h)(10) election be made? Why?
h. If Arnie's Army captured all the net tax benefits associated with the Section 338(h)(10) election (assuming that your answer to part (g) is yes), how much *lower* would its net *after-tax* cost be relative to a sale without a Section 338(h)(10) election at a $900 million purchase price?
i. If Nicklaus captured all the net tax benefits associated with the Section 338(h)(10) election (assuming that your answer to part (g) is yes), how much higher would its after-tax wealth be relative to a sale without a Section 338(h)(10) election at a $900 million purchase price?

4. Figure 17.9 contains a diagram of two companies, each of which has three subsidiaries. The subsidiaries are identical in terms of risk and lines of business. That is, subsidiary C of Pisces is identical to subsidiary C of Steinbrenner from both an operational standpoint and in terms of asset (inside) tax basis. Assume that the value of each subsidiary is ten times operating cash flow if no step-up is taken in the tax basis of its assets. The corporate tax rate is 35%, the personal ordinary income rate is 40%, and the personal capital gains rate is 20%.
   a. What is the pretax liquidation value (or cash received in the sale) of subsidiary A of these two companies? Is it the same or different? Be concise.
   b. What is the after-tax liquidation value (or cash received on the sale) of subsidiary A of these two companies? Is it the same or different? Be concise. Assume that the seller can induce the acquirer into paying its maximum indifference price relative to a taxable stock acquisition with no Section 338(h)(10) election.
   c. Do the answers to questions in parts (a) and (b) have any implication in the valuation assigned to a conglomerate (a firm with many divisions and subsidiary corporations) in an acquisition?
5. Neptune, Inc., is interested in acquiring the Blackfin, Inc., subsidiary of Bertram, Inc. Here are the facts related to this pending transaction:
   - Bertram has a tax basis in the stock and assets of Blackfin of $10 million.
   - The fair market value of Blackfin is $500 million.
   - Bertram's tax rate is 35%.
   - Neptune's tax rate is 35%.
   - The after-tax rate of return is 6.5% and any step-up in the basis of Blackfin's assets will be amortized straight-line over 15 years.
   - Neptune is offering to acquire Blackfin from Bertram in a Section 351 transaction in which Bertram will receive $500 million of voting preferred stock of NEWCO (formed by Neptune). The NEWCO preferred stock pays dividends at 10%.
   - Further, Neptune has arranged for an investment bank to provide a $500 million loan, secured by the NEWCO preferred stock, to Bertram. The loan has an interest rate of 10%.

FIGURE 17.9 The Effect of Stock and Asset Basis on Subsidiary Liquidation Value



- The investment bank will charge a fee of $2.5 million per year on the loan.
- Bertram will hold the NEWCO preferred for 20 years when it will be sold to pay off the loan.
- Ignore the tax effects of interest deductions and preferred stock dividends in your computations.

a. What is the present value of deferring the capital gains tax on the subsidiary sale using Section 351 relative to a taxable stock sale at a price of $500 million? That is, how much tax savings will Bertram realize from deferring the capital gain that would be triggered in a taxable sale?

b. What is the present value after-tax cost of the loan fee to Bertram ($n = 20, r = 6.5\%, t_c = 35\%$)?

c. What is the maximum price that Neptune would pay in a taxable stock sale with a Section 338(h)(10) election, assuming that it is willing to pay $500 million in a transaction (taxable or tax-free) that does not step-up the tax basis of Blackfin's assets?
d. At the maximum price that Neptune will pay computed in part (c), how much is the incremental after-tax increase in Bertram's wealth resulting from the Section 338(h)(10) election, relative to a taxable transaction with no election?
e. The amount computed in part (a) can be considered, for purposes of this problem only, as the gross tax savings from this tax strategy. The sum of the amounts computed in parts (b) and (d) can be considered the costs of the strategy. Given your computations, what is the net tax saving (cost) of this strategy?

6. Briefly explain the uses and/or restrictions of each of the following Tax Code sections:
   - Section 351
   - Section 332
   - Section 338
   - Section 338(h)(10)
   - Section 368 "A"
   - Section 368 "B"
   - Section 368 "C"
   - Section 355
   - Section 382
   - Section 197
   - Section 1060
   - Section 1231
   - General Utilities

References and Additional Readings

Cases:

Erickson, M., 2003. "Analyzing Quaker Oats' Sale of Snapple to Triarc," in *Cases In Tax Strategy,* edited by M. Erickson. Upper Saddle River, NJ: Pearson Prentice Hall.

Erickson, M., 2003. "Tax Benefits in Triarc's Sale of Snapple to Cadbury Schwepps," in *Cases In Tax Strategy,* edited by M. Erickson. Upper Saddle River, NJ: Pearson Prentice Hall.

See list at the end of Chapter 13.