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TAXATION

# Obtaining a Higher Tax Basis: Acquisition Strategy or Trap?

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When a business is acquired, a buyer may structure the acquisition in a manner that results in an increase in the tax basis of that business's assets. Often, a seller will attempt to extract a higher price, or a buyer will offer a higher price, based on the purported value of this tax basis to a buyer. This article will describe some of the basic requirements related to obtaining this increase in tax basis, and then focus on how the value of this benefit can be analyzed, including certain factors that may unexpectedly impact that analysis.

## Why Pay for Tax Basis?

The requirements and methods of a basis step up are described in more detail later in this article. Tax basis can often be depreciated or amortized—therefore, more tax basis should mean more deductions. A deduction can reduce net taxable income, and therefore more deductions should mean less tax to pay. But does it always mean that?

A buyer may pay for tax basis where it knows there will be additional tax savings from an increase in deductions. However, sometimes a buyer will not expect to be able to use the additional deductions, or does not expect the use will result in meaningful tax savings. For example, a buyer's projections of the acquired business's performance may not result in any need for additional deductions (this can be for many reasons, such as the presence of other deductions from compensation or interest payments). Or the business or buyer may have "net operating loss carryforwards" (NOLs, which are unused losses from prior years that can be carried into, and used in, future years), and so additional deductions may not provide meaningful, incremental value (although the alternative minimum tax typically will result in a small tax charge for using NOLs). A less obvious scenario is where the increased deductions reduce income but do not actually result in any tax savings, which is discussed below.

## Basics: What Is Required?

An increase, or "step-up," in tax basis in connection with a sale can only occur if (1) the current value of the assets exceeds their current tax basis, and (2) the transaction is treated, for tax purposes, as an acquisition of assets. Acquiring the assets (and assuming the liabilities) of a company will have this result, but there are also other transaction structures that are treated, for tax purposes, as asset acquisitions that in form are not asset transfers. Acquiring the stock of a corporation, by itself, does not have this treatment, but there are many simple acquisition structures that *will* have this result, which are described briefly below.

*1. The acquisition of all or a portion of the equity of a "disregarded entity."* Certain types of entities are not regarded as separate entities from their owner unless an affirmative election is made to treat that entity as a corporation for tax purposes (for example, a single member

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limited liability company). Instead, the owner of the entity is treated for tax purposes as the owner, and so a sale of the entity is treated for federal income tax purposes as a sale of assets and assignment of liabilities.

*2. The acquisition of stock of a corporation with a valid §338(h)(10) election.* Sales of "S corporations," and sales of "C corporations" that meet certain other requirements, may be eligible to make an election under §338(h)(10) of the Internal Revenue Code (there are other requirements which go beyond the scope of this article, but should be verified before relying on the availability of this election). If that election is properly made, it has the effect (through a set of "deemed" steps that—for the sake of brevity—are also not described in this article) of treating the transaction in the same manner as an asset sale.

*3. The acquisition of all or a portion of the stock of a Q-Sub.* A "qualified subchapter S subsidiary" (also referred to for short as a "Q-Sub," which is a wholly-owned corporate subsidiary of an "S corporation" that has made a "Q-Sub" election) is treated as a "disregarded entity" for tax purposes and so an acquisition of its shares is treated in the same manner as #1 above.

*4. The acquisition of all or a portion of the equity of a partnership.* An acquisition of a partnership (or an entity that is treated as a partnership for tax purposes) is treated (by the buyer) as an acquisition of all of the assets and assumption of all of the liabilities of the partnership. If less than all of the equity of a partnership is acquired, the partnership must have made (or make for the year of the acquisition) an election under §754 of the Code for the buyer to obtain a step up in the assets of the partnership.[1]

The next step is to evaluate the effect of a step up on the tax basis of the target assets, including the future benefit of that basis step-up. However, the *amount* of the future benefit and the *value* of that benefit to a buyer may not be the same.

## The Effect of a 'Step-Up'

Allocating consideration among the acquired assets of a business is not the focus of the article, so these rules are summarized in short form as follows. Generally, the consideration (which includes the purchase price paid, the liabilities assumed, and certain other acquisition costs incurred by a buyer) must be allocated pursuant to a "waterfall" approach—meaning that, first, all consideration is allocated to a category of assets until the basis of all assets in that category equals their aggregate fair market value, and then the reminder of the consideration is allocated to the next category of assets, and so on until all of the consideration has been allocated among all of the relevant categories. The first category is cash and cash equivalents, and the last category in this waterfall approach is the goodwill of the acquired business.

The tax basis of certain types of assets may be depreciated—which provides deductions—under relevant tax rules. Machinery, equipment, and buildings that are used in a business, for example, are all depreciable over different periods of time and in some cases a portion of those deductions are "accelerated" (i.e., a larger amount is deducted in earlier years, while a smaller amount is deducted in later years). In addition, the tax basis of certain intangible assets may be amortized—which also provides deductions.

## The Value of a 'Step-Up'

So what is the value of additional tax basis to a buyer? As Jerry Maguire and Mr. Wonderful both say … show me the MONEY! Easier said than done—this requires a lot of assumptions … or educated guesswork. While this can be straightforward if the assets are to be held by a "C corporation", it will be more complicated for pass-through entities such as partnerships.

A straightforward approach to valuing a step up is illustrated in the following simple example, where a buyer acquires a business and there is a $150,000 basis step up, all of which is allocable to goodwill. Assuming no exception to the general rule applies, that acquired goodwill can be amortized over 15 years (under §197 of the Code), resulting in a deduction of $10,000 each year for 15 years. The "value" of this deduction can be estimated using a few additional assumptions. The first assumption is having sufficient net taxable income (of at least $10,000 each year), so all of the deductions would be used each year to offset income and reduce tax. The second assumption is the assumed tax rate (which, in the case of a corporation, currently has a maximum marginal federal income tax rate of 35 percent), which results in annual savings of $3,500 of federal income tax. Finally, assuming the buyer will actually operate the business for 15 years so that all of the deductions benefit the buyer, the gross amount of tax saved would be $52,500 (or 35 percent of $150,000).

So what do you do with this information? How much would you pay for this savings? Show me the MONEY! With a schedule estimating the tax savings, a simple "present value" calculation will calculate a value of this stream of payments. (A spreadsheet program, like Microsoft Excel or Google Sheets, will make this math very easy.) A discount rate must be used for this calculation; this may be the rate at which the buyer could borrow the same funds from a lender today. Uncertainty on some of the assumptions, such as the likelihood of having sufficient taxable income or of holding the investment for the entire 15 years, may justify a higher discount rate. For example, applying an 8 percent discount rate to 15 annual payments of $3,500 has a present value of approximately $30,000. At a 15 percent discount rate, the present value is lowered to nearly $20,000. Other factors may lead to a buyer using different assumptions, such as lower projected taxable income or a shorter holding period for the assets. There is no single right approach to measuring this value, and each circumstance may dictate a different approach.

So, should the buyer pay an extra $20,000 or $30,000 when an acquisition will result in $150,000 of amortizable goodwill? The analysis is intended to take into account the uncertainty of the timing and of the assumptions, and so when a business is operated or owned by a corporation, the example above reflects a seemingly fair model of valuing a step-up. The corporation will (subject to the reliability of the assumptions) have actual cash savings from the increased deductions. However, what if the buyer does not hold the business in a corporate structure, but instead through a fully flow-through structure?

## Value of a 'Step-Up': Redux

In a fully flow-through structure, entity-level (i.e., corporate) federal income tax is not relevant. Instead, each partner is allocated its share of income or gain, and is responsible for paying their taxes. Accordingly, the partnership will not bear this tax liability, although often a partnership will make distributions of cash to its partner to help fund the tax liability associated with their ownership in the partnership. Regardless of whether tax distributions are made, a smaller tax liability would appear beneficial to the partner. A partner that is a corporation would pay federal income tax at a maximum marginal rate of 35 percent, while a partner that is an individual U.S. citizen would be subject to federal income tax on ordinary income at a top marginal rate of 39.6 percent or 20 percent in the case of capital gains (in each case, ignoring Medicare and other taxes that may apply).

In the case of a partnership, the analysis in the example above must be adjusted using the partners' applicable tax rates. If the example above were repeated, assuming all partners were U.S. individuals subject to tax at the higher 39.6 percent rate, then the present value of the tax savings appears to increase by a few thousand dollars (representing the reduction in taxes of the partner). If the most important factor for a buyer is measured by pre-tax results (for example, internal rate of return, or IRR, on an investment is often measured using pre-tax results), this cash savings by the partnership would be illustrated by this present value calculation, and due to the higher tax rates for individuals than corporations, this IRR benefit may be slightly higher for a partnership investment than one held by a corporation. This apparently "richer" result for a partnership (with individual U.S. partners), however, does not factor in the after-tax results from these deductions. If a buyer intends to look at value on an after-tax basis, an unsophisticated or under-advised buyer may make the mistake of assuming this present value is the end of the analysis.

## Partnership Conundrum

A partner's tax basis in its ownership interests in a partnership is increased by its share of net income, and reduced by its share of net loss. This is not the case for corporations, where the results of the operations of the corporation will generally have no impact on the shareholders tax basis in their shares.

Accordingly, in the case of our example above, $150,000 in deductions will also result in $150,000 of less tax basis in the partners' partnership interests than if those deductions were not available. The detriment of having less tax basis in the partnership interest cannot be ignored. When the business is eventually sold, the partners' gain will be higher (by $150,000) than if the deductions were not available. In addition, this gain (to the extent associated with the amortized goodwill) will result in ordinary income—not capital gain—due to "recapture" rules that convert capital gain into ordinary income when recognized gain is attributable to prior depreciation or amortization (including goodwill). Accordingly, if all $150,000 is deducted and the company is later sold (whether such sale occurs as a sale of assets or as a sale of the entire partnership) for a price that includes the same (or higher) value attributable to such goodwill, the partners will recognize an additional $150,000 income that will be ordinary income and not capital gain. Thus, depending on the subsequent sale price, there will be a complete reversal of all of the prior savings described in the example. This is not the case for a corporation because the shareholders' tax bases would remain unchanged (but don't let this discreet point have a skewed result on a comparison of the tax benefits of partnerships and corporations, as there are many other benefits offered by a partnership to its partners that are not available to a corporation and its shareholders).

So where is the savings? As is often a too-frequently given answer by a tax advisor, it relates to timing. In the partnership example, the tax savings is reversed when the company is sold (assuming it is sold). So the savings must be given back. However, until that sale occurs, there has been a benefit, in the form of more cash for the partnership or the partners. The availability of this cash is a savings that is actually recognized by the partnership and its partners, as this cash can be used for other purposes or reduce the borrowing needs of the company. However, the present value to the partners is very different than in the example with the corporation—because there is now a repayment of the savings in the form of additional taxes. This repayment requirement will significantly reduce the "value" of the step-up (by how much will ultimately depend on the discount rate one applies, but often the net value can be 50 percent or less than in the corporation example).

Show me the MONEY? Sure, just be careful you don't show too much.

## Endnotes:

1. This is not a complete list. For example, certain merger transactions are treated, for tax purposes, as asset acquisitions (e.g., a "forward merger"), and an election under §336(e) of the Code can provide a similar outcome as the election under §338(h)(10).