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Testing ‘Related Party’ Acquisitions for 338 Election Eligibility

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When a taxpayer is considering purchasing a foreign corporation, tax planning must be part of the process in order to mitigate unwanted tax consequences. For example, an election under section 338(g) of the Code has been a longstanding tax-planning tool for taxpayers considering the purchase of a foreign target.

Overview

In general, a 338(g) election allows an acquiring corporation to treat what would otherwise be a stock acquisition as an asset acquisition, solely for tax purposes. If the election is made, the target entity is deemed to sell its assets to a “new” target entity in a fully taxable asset sale. This deemed sale happens on the seller’s watch and results in a stepped-up basis in the assets of the target and eliminates the historic tax attributes, including earnings and profits, of the target corporation.

The many planning opportunities associated with making a 338(g) election, including considerations in light of the Tax Cuts and Jobs Act of 2017, are beyond the scope of this article, as are certain planning issues associated with a 338(g) election. This article focuses on when a 338(g) election is available and, in particular, targets one, sometimes overlooked, limitation when selling shareholders reinvest in the acquiring entity or its indirect owners into the acquisition chain (sometimes referred to as “roll”). In particular, this article focuses on the requirement that stock of the target company be acquired by “purchase” from unrelated persons, and how a potential roll into the acquisition chain might impact the ability to make a 338(g) election.

Requirements of a 338(g) Election

To make a 338(g) election for a target corporation, the purchasing corporation must acquire the target’s stock in a qualified stock purchase (QSP). A QSP is any acquisition or series of acquisitions in which, during a 12-month period, a corporate acquirer “purchases” target corporation stock possessing at least 80 percent of the target’s voting power and value.

The acquiring corporation “purchases” the target’s stock only if (1) the target stock is acquired in a transaction that does not result in the purchaser taking a carryover tax basis (in whole or part) from the target’s former shareholders; (2) the target stock is not acquired in an exchange to which sections 351, 354, 355 or 356 of the Code apply; and **(3) the target stock is not acquired from a person the ownership of whose stock would, under section 318(a) of the Code (other than an option attribution rule therein), be attributed to the person acquiring such stock.**[1]

The application of the first two tests, while seemingly straightforward, will raise red flags when more than 20 percent of the stock of the target is acquired via a tax-free rollover or some other tax-free transaction. The third test, however, is more difficult to work through because its wording is awkward and can lead to unexpected results.

Frequently, item 3 is cited for the proposition that an acquiring corporation cannot purchase stock from a “related party.” Whether the purchaser is related to the seller is tested immediately after the acquisition of the target stock or, when the purchase is part of a series of transactions pursuant to an integrated plan, immediately after the last transaction in such a series. Rollovers are often part of the overall acquisition plan.

“Roll” Issues in Section 338(g)

The meaning of the language in item 3 is not intuitive. The question it poses is whether the purchaser would be treated as owning stock **owned by** the seller under the constructive ownership rules of section 318 of the Code. At least one commentator (Ginsburg and Levin) agrees with this interpretation.[2]

The application of this rule can lead to surprising results in seller rollovers. In a case where the rolling sellers own less than 20 percent of the stock of the target corporation, item 3 generally should not make a 338 election unavailable (assuming no other affiliation).

However, in the case of any roll (even a very small percentage) by a seller that owns 80 percent or more of the target, there is a chance that a 338(g) election will be unavailable because the seller is treated as related to the purchaser after the roll under item 3.

Many acquisition structures, particularly in the private equity context, involve a chain of wholly owned entities that are established for various legal and economic reasons. For example, an aggregating partnership may own a chain of a few flow-through entities (partnership or disregarded entities) that own one or two corporations, with the last corporation in the chain being the purchasing corporation. Often, management, and sometimes one or more of the sellers *(e.g.,* a private equity fund seller where the buyer wants them to keep some economic interest), will obtain a co-invest interest in one of the entities in the acquisition chain.

If the seller is acquiring an interest in an entity in the acquisition chain that is a corporation for U.S. income tax purposes, this generally presents little risk of invalidating a QSP, as the seller would need to own more than 50 percent of the entity under section 318(a) (2)(C) in order for stock that it owns to be attributed into the acquisition chain and down to the purchaser, thus running afoul of item 3.

A more inclusive set of constructive ownership rules apply, however, under section 318(a) (3)(C), where the seller acquires a continuing interest in the acquisition chain in an entity that is a partnership. In this case, even if the seller only acquires a small interest (no percentage threshold at all, unlike the 50 percent threshold for corporations) in an acquisition chain entity that was a partnership (or becomes one upon the seller’s investment), stock owned by the seller would be attributed to the acquisition chain partnership under section 318(a)(3)(A). Assuming that a partnership (or another flow-through entity down the chain that the partnership invested in) owns more than 50 percent of the acquiring corporation (or another corporation that owns more than 50 percent of the acquiring corporation), the stock attributed to the partnership from the seller would, in turn, be attributed down the chain via sections 318(a)(3)(C) and 318(a)(2)(C). Thus, because stock owned by the seller is attributed (through the flow-through entities in the acquisition chain in which the seller invests) to the purchaser, the purchaser's acquisition of any target stock from the seller does not qualify as a "purchase" because it does not satisfy item 3 and no QSP of the target occurs.

This means that, even if the roll amount is very small *(e.g.,* 1 percent), if an 80 percent or more owner sells interests in the target and rolls into a partnership in the acquisition chain, it may be treated as a related party if the stock it owns is attributed to the purchaser under section 318. Note that this remains true regardless of whether the seller roll is taxable or tax-free, as the test is not whether there is a section 351 or some other carryover basis transaction, but only whether the parties are "related" immediately after the purchase (and all related transactions pursuant to the same integrated plan).

Pepper Perspective

A taxpayer considering making a 338(g) election should carefully review the ownership structure if a seller intends to roll a portion of their ownership interest as part of the overall acquisition transaction. This is particularly true when a seller that owns a large portion of the target is taking a continuing interest in the acquisition chain. If an issue arises, there may be mitigating steps that can be taken, and, thus, advance planning and consideration of these issues are critical to achieving the desired tax results that a 338(g) election can provide.

Endnotes

[1] Code Section 338(h)(3)(A)(iii).

[2] Ginsburg & Levin, Mergers, Acquisitions, and Buyouts, ¶205.1.1 (2018).

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