Translating Tax: How Code § 338(h)(10) Converts a Stock Sale into a Deemed Asset Acquisition

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When one company acquires another, buyer and seller alike should pay close attention to how they structure the transaction. In a stock sale, the buyer steps into the target company's ("Target") shoes, acquiring a cost basis in the stock, which the buyer cannot depreciate or amortize. By contrast, in an asset sale, the buyer acquires each asset directly, takes a cost basis in each one and receives a stepped-up basis eligible for depreciation and amortization. Section 338(h)(10) of the Internal Revenue Code of 1986, as amended ("Code"), offers a hybrid approach: the parties may jointly elect to recharacterize a stock purchase as a deemed asset acquisition, giving the buyer a stepped-up basis in Target's assets and giving the seller the opportunity to share in the value of the buyer's enhanced tax position through purchase-price negotiations while preserving the contractual simplicity of a stock-sale form, provided the transaction satisfies certain requirements.

Eligibility and Mechanics

To qualify for a Code § 338(h)(10) election, there must be a "qualified stock purchase," meaning the buyer must acquire, through one or more taxable purchases within a 12-month acquisition window, stock representing at least 80% of Target's total voting power and total value. Code § 338(d)(3) (citing Code § 1504(a)(2)). However, not every stock purchase qualifies; the buyer must be an eligible corporate purchaser and must acquire the stock in a taxable transaction from an unrelated eligible seller. Code § 338(h)(3) (citing Code § 318(a)). In addition, the buyer must acquire the stock from one of three categories of eligible sellers: [1] a selling consolidated group (a consolidated group that includes Target as a member), [2] a selling affiliate (a domestic corporation that owns at least 80% of Target's stock but does not file a consolidated return with Target), or [3] if Target is an S corporation, Target's shareholders immediately before the acquisition date. Treas. Reg. § 1.338(h)(10)-1(c)(1).

Once the parties confirm the transaction is eligible for a Code § 338(h)(10) election, the stock purchase agreement made will then usually include provisions reflecting this. After the closing of the stock purchase, the parties make the election jointly by filing Form 8023, Elections Under Section 338 for Corporations Making Qualified Stock Purchases. Treas. Reg. § 1.338(h)(10)-1(c)(3). If Target is an S corporation, then every shareholder—including "shareholders who do not sell their stock"—must consent to the election. *Id.* The parties must file the election "not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs." *Id.* For example, if the acquisition date falls in August 2026, then the filing deadline would be May 15, 2027. *Id.*

How the Code § 338(h)(10) Tax Fiction Works

Even though the parties still enter into a stock purchase agreement, Code § 338(h)(10) replaces the stock sale reality with a fictitious four-step transaction that produces a deemed asset acquisition. Treas. Reg. § 1.338(h)(10)-1(d).

In step one, the Code deems Target—now referred to as "Old Target"—as selling all of its assets to a new, unrelated entity ("New Target"), "in exchange for consideration that includes the discharge of its liabilities in a single transaction at the close of the acquisition date (but before the deemed liquidation)." Treas. Reg. § 1.338(h)(10)-1(d)(3). Old Target recognizes gain (or loss) on the assets "sold," and New Target takes a fair market value basis in the acquired assets. *Id.*

In step two, the deemed sale gains are reported on Old Target's tax return because Old Target remains "a member of the selling consolidated group (or owned by the selling affiliate or owned by the S corporation shareholders)" at the time of the deemed sale. *Id.* For example, if Old Target was taxed as an S corporation, then the "S corporation shareholders (whether or not they sell their

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stock) take their pro rata share of the deemed sale tax consequences into account…and increase or decrease their basis in [Old Target] stock." Treas. Reg. § 1.338(h)(10)-1(d)(5).

In step three, after the deemed asset sale, the Code treats Old Target as distributing all of its remaining assets (the deemed sale proceeds) to its shareholders in complete liquidation before the acquisition date. Treas. Reg. § 1.338(h)(10)-1(d)(4). If Old Target belonged to a consolidated group, this deemed distribution generally qualifies as a tax-free liquidation under Code § 332. If Old Target was an S corporation, then this deemed distribution is a taxable liquidation under Code § 331; however, the upward basis adjustments from step two may offset most or all of the liquidation gain. *See* Treas. Reg. § 1.338(h)(10)-1(d)(5); Code § 1367. Regardless of whether the seller recognizes gain or loss on Old Target's deemed liquidation, the seller "recognize[s] no gain or loss on the sale or exchange of [New Target] stock included in the qualified stock purchase" because steps two and three already capture the entire economic gain or loss. Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii).

Lastly, in step four, the parties disregard the seller's actual sale of New Target stock to the buyer for cash. The Code treats New Target as a new corporation that purchased all of Old Target's assets at fair market value, giving it a stepped-up basis in those assets. Code § 338(a); Treas. Reg. § 1.338(h)(10)-1(d)(2) (citing Treas. Reg. § 1.338-5(c)). This stepped-up basis represents the buyer's primary economic benefit, while the reduction in sales proceeds from additional taxes constitutes the seller's economic cost.

Best Practices and Planning Considerations

The parties should weigh a Code § 338(h)(10) election carefully; once they make the election, they cannot revoke it. Treas. Reg. § 1.338(h)(10)-1(c)(4). The seller should begin by comparing its net tax basis in its Target stock ("outside basis") against Target's net tax basis in its assets ("inside basis") to preliminarily gauge the election's possible tax impact. When the gap between outside basis and inside basis is minimal, the election is unlikely to generate significant incremental tax on the seller, making the decision more straightforward. In that scenario, the buyer obtains a stepped-up basis at minimal tax cost to the seller.

Even in such a scenario where a Code § 338(h)(10) election results in only a minimal amount of additional gain for the seller, when the target is an S corporation, the selling shareholders should be aware of the possible differences in the tax character of the gain that results from asset-sale treatment. For example, gain that would have qualified for long-term capital gain treatment may instead be taxed as ordinary income on account of depreciation recapture on the sale of assets under Code §§ 1245 and 1250. The election may also create a character mismatch on the deemed liquidation (causing a capital loss with limited benefit) or trigger corporate-level built-in gains tax under Code § 1374. Because the election primarily benefits the buyer—who receives a depreciable and amortizable stepped-up basis in Target's assets—and the seller often bears the added tax liability, the seller should leverage the election's joint nature to negotiate a purchase price premium and gross-up that compensates for, *inter alia*, the increased tax liability from ordinary income recognition and state and local taxes tied to the assets' location.

One important caveat to the general upside for buyers is, although step three deems Old Target to have wound up, "[New Target] remains liable for the tax liabilities of [Old Target] (including the tax liability for the deemed sale tax consequences)." Treas. Reg. § 1.338(h)(10)-1(d)(2). Consequently, the buyer should negotiate a robust indemnity provision in the stock purchase agreement to guard against this residual exposure.

It is also worth noting that the ultimate decision whether to make a § 338(h)(10) election should be based on both tax and nontax considerations, such as third-party consents or non-assignable licenses. Moreover, although a Code § 338(h)(10) election can be a valuable mechanism for obtaining a basis step-up, a selling consolidated group can often achieve a similar result by first liquidating the subsidiary in a tax-free transaction and then selling Target's assets. Under that approach, the acquiring corporation generally would take a cost basis in the acquired assets under Code § 1012.

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