



M&A Tax Talk

Tax basis step-up considerations in M&A transactions

Introduction

Obtaining a tax basis step-up remains a planning consideration for enhancing transaction value and post-close tax efficiency. Buyers and sellers can benefit from early alignment on availability, structure, allocation, and expected timing of deductions. When structured and implemented properly, a step-up can increase tax depreciation and amortization deductions, improve after-tax cash flows, and inform negotiations on price and other key deal terms. This discussion explores the strategic considerations, structural alternatives, and practical implementation approaches for tax basis step-up opportunities in M&A transactions.

Understanding and structuring tax basis step-up transactions

A step-up occurs when the tax basis of acquired assets is adjusted to their cost basis (generally, fair market value less rollover, if any) at the time of acquisition, typically resulting in a higher depreciable/amortizable basis for the buyer to the extent the fair market value exceeds the adjusted tax basis in the assets. This adjustment creates immediate tax benefits through increased depreciation and amortization deductions, effectively allowing the buyer to recover the premium paid for appreciated assets through enhanced tax savings over time. Tax basis step-ups are commonly achieved through

legal asset purchases or deemed asset purchases through elections available in stock transactions, such as under section 338(h)(10), section 336(e), or section 338(g), which treat stock sales as deemed asset sales for tax purposes. [Recent tax legislation](#) has increased the focus on tax basis step-up transactions by permanently extending 100% bonus depreciation and enhancing section 179 expensing limits, which accelerate the realization of tax benefits. Additionally, the current interest rate environment and inflationary pressures on asset values have made the timing and structuring of basis step-ups even more critical for enhancing the net present value of tax savings and overall transaction economics.

In addition to corporate transactions, tax basis step ups may also arise in partnership transactions through section 754 elections, which create entity specific basis adjustments under sections 743(b) or 734(b) and can deliver asset level depreciation and amortization benefits, subject to the partnership agreement, transaction structure, and post closing ownership.

In stock acquisition transactions, a stepped-up tax basis in target assets may be achieved through specific elections under the Internal Revenue Code and through targeted pre-closing restructuring, including:

- A section 338(h)(10) election may be made jointly by buyer and seller when a purchasing corporation acquires at least 80% of the stock of a target corporation in a qualified stock purchase and the target is either an S corporation or a member of a consolidated tax group. When available, this election treats the transaction as a deemed asset sale by the target and a new corporation which purchases the assets, followed by a deemed liquidation, allowing the buyer to obtain a stepped-up basis in the target's assets while generally avoiding incremental federal corporate-level tax for S corporations and consolidated group members. However, state and local income, franchise, and entity level taxes can still arise, and these incremental costs are often a key driver of purchase price gross-up negotiations and step up value sharing between the parties.
- A section 336(e) election provides a similar result in certain taxable stock dispositions and may be made jointly by the seller and the target, including in third-party transactions. In private equity buyouts, section 336(e) is often evaluated as an alternative to section 338(h)(10) elections where the buyer is not a corporation, the target is not a subsidiary in a consolidated group, or other technical requirements for a section 338 election are not satisfied.
- In contrast, a section 338(g) election is made unilaterally by a corporate buyer in a qualified stock purchase and generally results in a deemed asset acquisition

for the buyer, but a stock sale without a corresponding deemed liquidation for the seller. Section 338(g) elections are generally used in acquisitions where the seller is not otherwise subject to US corporate income tax on the deemed asset sale, allowing the buyer to obtain stepped-up basis in the target's US tax basis without triggering significant incremental tax cost to the seller.

- In addition to statutory elections, taxpayers may achieve tax basis step-ups through pre-closing restructuring transactions designed to generate deemed asset sale treatment, such as a section 368(a)(1)(F) reorganization (an 'F' reorganization) for S corporations or other internal reorganizations that convert equity sales into asset-level transactions.

Tax basis step-up planning is often most effective when evaluated alongside other transactions and shareholder-level planning considerations, such as state tax considerations and potential installment reporting under section 453. Partnership structures present additional complexity, specifically where section 754 elections and related basis adjustments under sections 734(b) and 743(b) are in play, since the timing of elections, allocations, and post-close transactions can influence the benefit actually realized. State and local tax conformity remains critical, as non-conforming jurisdictions can impact net benefit calculations, often requiring modeling to evaluate competing structures across multiple tax jurisdictions and time periods.

Buyer and seller considerations

For buyers, the primary benefit of a tax basis step-up is typically the incremental depreciation and amortization deductions resulting from stepped-up asset basis, often including tangible assets that may qualify for bonus depreciation or other accelerated recovery, and section 197 intangibles, such as goodwill and certain customer-related intangibles amortizable over 15 years. These deductions can enhance post-acquisition cash flow and

after-tax returns, particularly in capital-intensive or highly leveraged transactions.

For sellers, the trade-offs are often more complex, as deemed asset sale treatment commonly accelerates gain recognition and may alter the character of gain by asset class. Even where goodwill and other section 1231 assets may receive favorable capital gain treatment (i.e., in section 338(h)(10) transactions), ordinary income may arise with respect to items such as accounts receivable (if the seller is on the cash method), inventory, and depreciation recapture. In addition, timing effects associated with accelerated recognition can influence estimated tax payment obligations and potential exposure to the net investment income tax. Finally, deemed asset sale treatment can impact the amount of gain recognized (not only the character) depending on differences between the seller's stock basis and inside asset basis.

In practice, these divergent economic interests are typically reconciled through negotiated purchase price adjustments, tax gross-ups, and other deal terms designed to allocate the economic value of the basis step-up between the parties.

Monetizing tax basis step-ups

From a dealmaking standpoint, sellers typically monetize step-up value through a mix of price and purchase agreement negotiations supported by a buyer-benefit analysis. In some transactions, parties may also explore structural and economic arrangements that reflect the shared value in order to align incentives. In practice, that shared value is often realized through deal terms such as:

- Purchase price premium (supported by a tax benefit study): Sellers use a buyer-benefit model to quantify the net present value (NPV) of expected amortization/depreciation deductions from the step-up and negotiate for a portion of that value through an increased purchase price (often framed as "sharing" the tax shield).

- Purchase price allocation: How purchase price is allocated may have different tax consequences to the buyer and seller and is generally determined under the applicable tax rules. Purchase price allocated to shorter lived assets (e.g., inventory or fixed assets) can be recovered more quickly for tax purposes, which may result in an enhanced benefit to the buyer, whereas gain among these assets may be ordinary for the seller. As such, how purchase price is allocated can drive contrasting consequences between buyer and seller.
- Tax gross-up payment (seller “make-whole” for incremental tax): If achieving the buyer’s desired step-up requires a form or election that increases the seller’s tax burden versus an alternative (e.g., asset-sale treatment or deemed asset sale), the seller may negotiate a gross-up to the consideration so they are kept whole on an after-tax basis for the incremental federal/state (and, where relevant, local) taxes triggered by the step-up structure.

In auction processes, sellers are increasingly using tax benefit modeling as a differentiating factor, providing detailed analyses to preferred bidders and structuring management presentations around the quantified value of available tax attributes (i.e., tax basis step-up).

Calculating and modeling tax basis step-ups

Step-up value ultimately depends on purchase price allocation and defensible valuation that balances tax enhancement with financial reporting requirements and IRS compliance standards. The process typically starts with a purchase price allocation for financial reporting purposes and a parallel tax allocation framework under section 1060 and related provisions, supported by independent valuation work that identifies and measures tangible assets, identifiable intangible assets, and goodwill.

At the asset level, valuation methods vary by category and fact pattern. Tangible assets are commonly valued using cost, market, or income approaches, while identifiable intangible assets often require

specialized valuation techniques. Once values are determined, the step-up is effectively the difference between fair value and the seller’s adjusted tax basis, with resulting deductions following the applicable recovery periods and eligibility rules (including bonus depreciation where relevant). Because small changes in allocation can shift timing and character of deductions, the analysis often includes scenario testing across alternative allocations and sensitivity to key assumptions.

A common approach to decision-making is parallel track modeling that frames the total value by comparing (i) the seller’s incremental tax cost from a deemed asset sale construct (including character and timing effects) against (ii) the present value of buyer deductions from the step-up. The same model can also be used to test gross-up concepts and other value-sharing structures, with sensitivity analysis around key variables including tax rates, discount rates, asset useful lives, and timing of deductions. This framework can help parties identify where a step-up creates a net-positive outcome and how that value can be reflected in price and terms considering what valuations and documentation can support. From a negotiation standpoint, seller gross ups are not limited to any single entity type. While most common in S corporation and partnership transactions, gross ups are increasingly negotiated wherever the buyer’s desired step up structure creates incremental tax cost to the seller relative to a baseline stock sale.

Private equity buyers must routinely balance tax considerations against audit risk, indemnity exposure, and financial reporting alignment, given that allocations favoring short-lived assets may be challenged.

Nuances and challenges / traps for the unwary

While tax basis step ups can significantly enhance after tax returns, they can also introduce execution, valuation, and negotiation risks that are frequently underestimated in early stage deal

modeling. For private equity sponsors, these risks often surface late in diligence or during documentation, where misalignment between modeled benefits and realized economics can affect bid pricing, required gross ups, or investment committee decision making.

In step-up structures that create asset-sale treatment at the entity level, whether an actual asset sale or a deemed asset sale under sections 338(h)(10), 336(e), or 338(g), the seller is treated as disposing of individual assets rather than stock. To the extent assets have been depreciated below fair market value, the gain on deemed disposition must be characterized between ordinary income recapture and capital gain. Section 1245 recapture applies to tangible personal property (e.g., machinery, equipment, furniture, fixtures) and recaptures all depreciation previously claimed as ordinary income to the extent of gain. For businesses with substantial depreciable assets, particularly manufacturing, logistics, healthcare, or equipment-intensive operations, a large portion of the total gain could be recaptured as ordinary income. A common trap for practitioners is that initial step-up models often assume blended capital gains treatment or use effective tax rates that don’t fully account for the ordinary income component, potentially understating the seller’s true tax cost.

State and local tax considerations are often another complexity in step-up economics, particularly regarding the multiple layers of taxation imposed on pass-through entity shareholders. One of the primary traps involves the compounding effect of entity-level and shareholder-level state taxes. In a deemed asset sale, shareholders of S corporations and partnerships incur state taxation on income apportioned to states where the entity operates, resident state taxation on the same income in their home states, and entity-level state taxes in jurisdictions that impose franchise or other taxes on pass-through entities. This layering effect can add additional effective tax cost beyond federal calculations.

The emergence of pass-through entity tax (PTET) elections, now available in over 30 states, compounds these challenges. PTET elections are typically made at the entity level without contemplating a near-term transaction, leaving limited flexibility when a step-up deal emerges. Moreover, PTET elections often benefit high-income shareholders subject to the state and local tax (SALT) cap but may be a detriment for shareholders in low- or no-tax states, creating non-uniform impacts across the shareholder base.

Furthermore, not all states provide complete credit for PTET paid to other states, and some states don't conform to the federal treatment of PTET deductibility, creating federal-state mismatches. These state tax nuances frequently surface late in diligence when detailed shareholder-by-shareholder and state-by-state modeling occurs, often revealing the seller's true tax cost is higher than federal-only calculations may suggest. Avoiding surprises can be addressed with a prioritized focus on state and local tax conformity, apportionment, PTET election status, and jurisdiction-by-jurisdiction analysis of shareholder tax consequences before definitive agreements are signed.

Private equity insights

For private equity investors, tax basis step up decisions are evaluated not only on the amount of incremental tax depreciation or amortization generated, but also on how those benefits align with the fund's capital structure, expected holding period, and exit strategy. While step ups that accelerate deductions may enhance

near term cash flow and debt service capacity during the holding period, they may also influence the valuation, buyer appetite, and recapture exposure on exit. Accordingly, private equity sponsors should consider the interplay between purchase price allocation, holding company structure, and entity form—such as partnerships, corporations, or blocker structures—since these choices directly affect who benefits from the step up, how quickly tax benefits are monetized, and whether tax costs arise at the entity level, investor level, or both.

Valuation and purchase price allocation risk

In partnership transactions, beyond aggregate seller tax cost, purchase price allocation may have a direct impact on the **character** of income recognized by selling investors. For example, allocations that increase value attributed to depreciable tangible assets, inventory, or accounts receivables may be beneficial cash flow items for the buyer but can convert what private equity sponsors and their limited partners (LPs) expect as capital gain into ordinary income for US federal income tax purposes through depreciation recapture or asset specific character rules. The distinction is critical from a private equity perspective, as ordinary income recognized by US taxable LPs may be taxed at significantly higher rates than long term capital gain, reducing net investor proceeds even where total consideration remains unchanged. Accordingly, valuation and allocation decisions must be evaluated not only for tax benefit timing, but also for LP level character outcomes.

Blocker entity considerations

The presence of corporate holding company 'blocker' entities in operating partnership structures introduces an additional layer of complexity in evaluating the economic value of a tax basis step up. Where a pass-through entity is held through an existing blocker, or where the buyer acquires blocker stock rather than pass-through entity interests, any existing step up benefit may be partially or fully trapped at the corporate level, and no new step-up would be delivered to the buyer with respect to the blocker's retained ownership in the underlying pass-through entity. In these cases, depreciation and amortization deductions generated by any previous step up reduce taxable income inside the blocker, but do not always translate into equivalent after tax cash savings for fund investors due to corporate level tax friction.

As a result, the net present value of step up benefits in private equity structures may be viewed differently depending on the holding company structure.

Conclusion

The ability to effectively identify, structure, and implement tax-basis step-up strategies remains a critical differentiator for value-oriented investors and strategic acquirers. Effective outcomes are typically achieved when parties quantify buyer value and seller costs early, anticipate potential friction points, and support negotiations with credible modeling and documentation.



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