

13 Taxable Acquisitions of S Corporations

13.1 Tax Consequences of Taxable S Corporation Acquisition Structures: Table 13.1 (p. 13-3) summarizes the basics of each acquisition structure. There are two aspects of this table to note: first, while there is a taxable event at the shareholder level when a section 338(h)(10) election is made, in most cases the gain or loss recognized to the shareholders (in excess of the gain recognized to the corporation) will be zero or very little; second, the principal down-side of an election under section 338(h)(10) is the negative conversion of some capital gain into ordinary income.

13.1.1 Case 1: Taxable Asset Acquisitions: A taxable asset acquisition gives the buyer a cost-basis in the target's assets. Gain (and possibly loss) is recognized by the selling corporation, and that gain is passed through to and reported by the target shareholders. This gain recognition at the shareholder level yields a step-up in the basis of the target stock. Thus, if before the transaction aggregate target asset basis equaled aggregate target stock basis, the effect of the basis step-up is to give the target shareholders a fair market value basis. Accordingly, if the sale proceeds are distributed (note that there is no corporate-level tax on the distribution), the distribution will not generate any gain to the target shareholders.

13.1.2 Case 2: Taxable Stock Acquisitions with a §338(h)(10) Election: In the case of a stock acquisition with an election under section 338(h)(10), the transaction is taxed as if the acquiring corporation purchased target's assets rather than stock, followed by a liquidation of the target corporation. Because an asset sale does not generate any gain to the target corporation itself, the deemed purchase price of the assets equals the purchase price of the stock.

13.1.3 Case 3: Taxable Stock Acquisition Without a §338(h)(10) Election: In the case of a straight stock acquisition, the target shareholders will enjoy capital gain (or loss). There is no step-up in the basis of the target's assets.

13.1.4 Which Structure is Optimal? The equations on pages 13-9 – 13-10 assume that the target assets have appreciated over their original (historic) cost (see footnote 13 at page 13-9). *Leaving the target shareholders indifferent*, we set $ATAX_{338(h)(1)}$ equal to $ATAX_{no338(h)(1)}$ using **equations 15.1 and 15.2**, yielding $Price_{338(h)(10)}(1-t_{cg}) + HC_{asset} * t_{cg} - Accum * t_{oi} = Price_{no338(h)(10)}(1-t_{cg}) + Stock * t_{cg}$, or $Price_{338(h)(10)}(1-t_{cg}) = Price_{no338(h)(10)}(1-t_{cg}) + Stock * t_{cg} - HC_{asset} * t_{cg} - Accum * t_{oi}$, or $Price_{338(h)(10)} = Price_{no338(h)(10)} + [Stock * t_{cg} - HC_{asset} * t_{cg} + Accum * t_{oi}] / (1-t_{cg})$. Note that because we are assuming that the target shareholders have a stock basis equal to the target's asset basis, $HC_{asset} = Stock + Accum$. Accordingly, we can simplify the equation to **$Price_{338(h)(10)} = Price_{no338(h)(10)} + Accum(t_{oi} - t_{cg}) / (1 - t_{cg})$** . In the simplest case in which the accumulated depreciation is \$0, $Stock = HC_{asset}$ and $Accum = 0$ so that $Price_{338(h)(10)} = Price_{no338(h)(10)}$. On these simple assumptions, an election under section 338(h)(10) always should be made. However, if the target assets have considerable recapture under section 1245, there is a positive cost to the election because of character conversion.

- 13.1.5 Advanced Analysis: S Corporation Acquisition: This example includes accumulated depreciation and so is more realistic. In this case, there is accumulated depreciation of \$200, and that means the cost of the 338(h)(10) election is the taxation of \$200 at a 40% tax rate rather than at the capital gain rate of 20%, for a \$40 (20% of \$200) increase. Why is the tax-indifferent price not \$1,040? Because the additional payment to offset the target shareholder's cost of conversion is itself taxable as capital gain, so the extra \$40 must be grossed up by the capital gain rate, and \$50 equals $\$40(1 - 0.20)$. Thus, as shown on page 13-13, the target shareholders are indifferent between a stock sale price of \$1,000 or an asset sale price of \$1,050 (or, equivalently, a stock sale price with a section 338(h)(10) election).
- 13.2 Comparison of the Sale of Similar S and C Corporations: A purchaser of a target's assets (by way of a direct asset acquisition or via a deemed asset sale under section 338) generally will be willing to pay more (because of the step-up in basis) than a direct purchase of the target's stock. When the target corporation is a C corporation, the cost to the target shareholders of an asset acquisition is greater than the incremental tax benefit to the acquiring corporation; when the target corporation is an S corporation, the tax cost is much lower and so taxation as an asset acquisition generally is preferred. Note that the election provided by section 338 simply allows the parties to be treated as if the target corporation sold its asset to the acquiring corporation and so offers nothing that could not be obtained directly.
- 13.3 Discussion Questions (p. 19):
- 13.3.1 Question 1: The three main issues are: (1) will the transaction be taxable to target shareholders, (2) if taxable, how large will the gain be, and (3) what is the nature of the gain (short term capital gain or long term capital gain). In addition, in a stock acquisition of an S corporation, the incremental tax costs to target shareholders of a joint 338(h)(10) election must be considered. The election often increases the tax cost to the seller.
- 13.3.2 Question 2: In an S corporation acquisition, the incremental cost of a step-up in the tax basis of the target's assets is the difference between the ordinary income rate and the capital gains tax rate on the portion of the gain that is recaptured depreciation. In the acquisition of a C corporation in which a step-up structure is employed, the incremental tax cost is equal to the entire corporate level tax on the gain.
- 13.3.3 Question 3: I would suggest a conduit form to allow early losses to be used effectively. And ideally an S Corporation rather than a partnership to preserve the opportunity for a tax-free sale via a corporate reorganization (discussed in the next chapter). But using an S Corporation restricts the kind and number of shareholders as well as the allowable form of equity interests that can be used. (A partnership removes these restrictions.) If the early investors will be corporations, using a C Corporation may be a reasonable choice because they may not care about the capital gain/ordinary income distinction, and with

interest rates low, deferring losses until the company goes bankrupt (if it does) imposes only a minor time-value-of-money cost.

13.4 Tax-Planning Problems (p. 20):

13.4.1 Problem 4:

13.4.1.1 Part (a): If the sale is structured as a stock acquisition without a §338 (h)(10) election, then the shareholders will receive \$5,000, and because their stock basis equals \$3,000, there will be a taxable capital gain of \$2,000. The tax liability on that capital gain equals \$400, the after-tax proceeds to the shareholders equals \$5,000 less \$400, or \$4,600.

13.4.1.2 Part (b): If the sale is structured as a stock acquisition with a §338(h)(10) election, then there will be gain at the corporate level of \$5,000 less asset basis of \$3,000, for a gain of \$2,000. This gain will be treated as composed of ordinary income of \$1,500 (because of depreciation recapture) and \$5,000 of capital gain, taxable to the shareholders. The ordinary gain generates a tax liability of \$1,500 times 40%, or \$600, while the capital gain generates a tax liability of \$500 times 20%, or \$100, for a total tax of \$700. The shareholders increase their stock basis by the amount of gain recognized on the sale (i.e., by \$2,000), from \$3,000 to \$5,000. Accordingly, the distribution by the corporation of the sales proceeds of \$5,000 is tax-free to the shareholders. Accordingly, the shareholders will have cash of \$5,000 less taxes paid of \$700, for \$4,300 total.

13.4.1.3 Part (c): **Using the simplified form of equation 13.3**, we have $\text{Price}_{338(h)(10)} = \text{Price}_{\text{no}338(h)(10)} + (\text{Accum})(t_{oi} - t_{cg}) / (1 - t_{cg})$. Accordingly, $\text{Price}_{338(h)(10)} = \$5,000 + \$1,500(0.40 - 0.20) / (1 - 0.20)$, $\$5,000 + \$300 / 0.80 = \$5,375$.

13.4.1.4 Part (d): Using **equation 13.6** (p. 13-10), we see that the acquiring corporation should be willing to pay an additional amount equal to the after-tax benefit of the basis step-up. Because the basis step-up equals \$2,000, the corporate tax rate equals 21%, and we are assuming that basis can be recovered ratably over 10 years using a discount rate of 10%, the after-tax benefit of the basis step-up equals $\$200(0.21) + \$200(0.21)/1.1 + \$200(0.21)/1.1^2 + \dots + \$200(0.21)/1.1^9$, and that equals $\$200(0.21)$ times $(1 + 1/1.1 + \dots + 1/1.1^9)$, or \$42 times 6.76, or \$283.9. Therefore, the price equals \$5,000 + \$283.9, or \$5,283.9.

13.4.1.5 Part (e): No: the acquiring corporation should be unwilling to pay the seller's minimum price (\$5,375) for the election.

13.4.1.6 Part (f): The answer was no.

13.4.2 Problem 5:

13.4.2.1 Part (a): Sale of the stock for \$12,500 generates a capital gain of \$12,000 minus \$5,000, or \$7,500, and the tax on that gain equals \$1,500. Accordingly, the shareholders will have \$11,000 after taxes.

13.4.2.2 Part (b): Sale of the assets for \$12,500 will generate a gain of \$7,500, of which \$2,500 will be ordinary and \$5,000 will be capital. These gains will be passed to the shareholders who will pay a tax of \$1,000 (ordinary) plus \$1,000 (capital gain), and this gain will increase stock basis by \$7,500 to \$12,500. As a result, the deemed distribution is tax-free, so that the only taxes are the \$2,000 described above, leaving \$10,500 after taxes.

13.4.2.3 Part (c): **Using the simplified version of equation 13.3**, $Price_{338(h)(10)} = Price_{no338(h)(10)} + (Accum)(t_{oi} - t_{cg}) / (1 - t_{cg})$. Therefore, $Price_{338(h)(10)} = \$12,500 + \$2,500(0.40 - 0.20) / (1 - 0.20) = \$12,500 + \$2,500(0.20) / 0.80 = \$13,125$.

13.4.2.4 Part (d): The cost of option 1 is \$12,500 while the cost of option 2 is \$13,125 less the incremental tax benefit. The incremental tax benefit is the ability to amortize an additional \$8,125 over 10 years, and that equals $0.21 [(\$812.50 / (1.12)^1 + \$812.50 / (1.12)^2 + \dots + \$812.50 / (1.12)^{10}]$, or \$13,125 less $0.21 [(\$812.50) * 5.65]$, or \$13,125 - \$964.03, or \$12,160.97. Thus, the net cost of option 2 is lower.

13.4.2.5 Part (e): From **equation 13.6** (p. 13-10), $Acqprice_{338(h)(10)} = (Price_{no338(h)(10)} - t_c * Factor * Asset) / (1 - t_c * Factor) = (12,500 - 0.21 * 0.565 * \$5,000) / (1 - (0.21 * 0.565)) = (12,500 - \$593.25) / (0.88135) = \$13,509.75$.

13.4.2.6 Part (f): Yes, because any price between \$13,125 and \$13,509.73 profits both parties.

13.4.2.7 Part (g): If the sale is made for \$13,509.73 and an election under §338(h)(10) is made, the selling shareholders will net \$13,509.73 less ordinary income taxes of 40% of \$2,500 plus 20% on \$6,009.72, for a total tax liability of \$1,000 plus \$1,201.94, or \$2,201.94 total. As a result, the shareholders will net \$13,509.73 less \$2,201.94, or \$11,307.79 after taxes. But if the sale price had been \$12,500, the selling shareholders would only have had \$12,500 (less 40% of \$2,500 plus 10% of \$5,000), or \$12,500 less \$1,500, or \$11,000 after-taxes. Increase in the seller's wealth, before paying your fee, is \$307.79 and your 30% fee would therefore be about \$92.37.

13.4.3 Problem 6:

13.4.3.1 Part (a): The acquiring corporation will pay a maximum of \$10,000 plus the after-tax value of the basis step-up (see the first line of **equation 12.8** at page 12-13), and that gives us the equation immediately below equation 12.9 (p. 12-4), to wit: $Acqprice_{stock} = (Price_{stock} - Asset * Factor * t_c) / (1 - Factor * t_c)$. With $r = 7\%$, $n = 10$, and $t_c =$

21%, we get factor = 0.702 so that factor* t_c = 0.14742, so that the maximum price = $(\$10,000 - 500*(0.14742))/(1 - 0.14772) = (\$10,000 - 73.71)/0.85228 = \$11,646.75$.

13.4.3.2 Part (b): It will pay an additional amount equal to the net present value of the anticipated tax benefits, which is the same as in part (a) above. Accordingly, the maximum price it will pay is again \$11,646.75.

13.4.3.3 Part (c): Using **equation 12.6** (p. 12-11), we see that the shareholders will be indifferent if they receive $(\$10,000 - (\$500*(0.21))/(1 - 0.21) = (\$10,000 - \$105)/(0.79) = \$12,525.32$.

13.4.3.4 Part (d): Using **the simplified version of equation 13.3**, the shareholders will demand a premium of \$1,500 times $(0.40 - 0.20)/(1 - 0.20)$, or \$1,500 times $(0.20/0.80) = \$375$. Accordingly, the minimum price will equal \$10,375.

13.4.3.5 Part (e): No, because the shareholders will demand more than the buyer is willing to pay.

13.4.3.6 Part (f): Yes, because any price between \$11,646.75 and \$10,375 will be mutually beneficial.

13.4.3.7 Part (g): The shareholder after-tax proceeds in the case of a C Corporation equals \$8,100 while the after-tax proceeds in the case of an S Corporation sale at a price of \$11,646.75 equals $\$11,646.75 - (600 + \$1,929.35)$, or $\$11,646.75 - \$2,529.35$, or \$9,117.40, a difference of \$1,017.40.