Buyers and Sellers of an S Corporation Should Consider the Section 338 Election

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There are a variety of factors that buyers and sellers consider when deciding whether the acquisition of a 100 percent ownership interest in the target company should be structured as an acquisition of target company equity or as the purchase of target company assets. If the target company is an S corporation for federal income tax purposes, there is a federal income tax opportunity to achieve the best of both worlds—that is, the acquisition of the target company equity treated as a purchase of the target company assets. That federal income tax structure could have a favorable impact (1) on the transaction's after-tax sale proceeds to the seller and (2) on the transaction's after-tax cost to the buyer.

Introduction

A buyer can structure the offer to buy a 100 percent ownership interest in a target company as either (1) the acquisition of the target company equity or (2) the purchase of the target company assets.

The acquisition of the target company equity is an efficient transaction structure. This transactional efficiency is because:

1. all of the income-generating capacity of the target company is uninterrupted by the transaction and
2. the buyer controls all of the target company recorded and unrecorded assets and all of the company recorded and contingent liabilities.

For federal income tax purposes, the basis of the target company assets is "carried over" in the equity acquisition. This means that the target company assets continue to have the same depreciable tax basis after the transaction that they had before the transaction.

The purchase of the target company assets is an attractive transaction structure in many ways. For the buyer, this structure is attractive is because the buyer only: (1) purchases specific (i.e., desirable) target company assets and (2) assumes specific (i.e., undesirable) target company liabilities.

Purchase of Target Company Assets versus Purchase of Target Company Stock

For federal income tax purposes, the buyer's tax basis in each acquired asset is equal to the current fair market value for each asset. The fair market value of the target assets is often greater than the historical cost tax basis of the target assets (i.e., a "step-up" in the asset tax basis).

In that common event, recovering the purchase price through depreciation and amortization deductions provides after-tax cash flow to the buyer. That transaction structure is more attractive (from an income tax perspective) than the after-tax cash flow in the equity-acquisition structure (where an asset tax basis step-up is not permitted for federal income tax purposes).

In most situations, the tax liability to the seller related to a transaction structured as an asset sale is greater than the tax liability to the seller if the same transaction (at the same purchase price) is structured as an equity sale.

Most sale and purchase transactions involving 100 percent close corporation ownership interests are structured as equity acquisitions.

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Section 338(h)(10)

Internal Revenue Code Section 338(h)(10) (the "Section 338 election") provides a particular federal income tax advantage in transactions involving the sale of S corporation equity when compared to the sale of the C corporation equity.

The Section 338 election allows the buyer that acquires the S corporation equity (but only if all of the seller shareholders agree) to treat the transaction as if it was a purchase of S corporation assets. The Section 338 election allows the buyer to enjoy the more attractive depreciation deductions related to the step-up in the tax basis of the purchased assets.

Therefore, in certain situations, the purchase price for an S corporation can be greater than the purchase price for an identical C corporation. However, to the seller of the S corporation who receives a premium purchase price as an incentive to agree to the Section 338 election, there may be no additional after-tax benefit related to the tax election agreement.

Making the Section 338 Election

From the seller's income tax perspective, the same amount of total gain will be recognized by the S corporation shareholders in a sale of all of the S corporation outstanding equity as in a sale of all of the S corporation assets (followed by a complete liquidation of the S corporation).

However, in an asset sale (without the benefit of the Section 338 election), income tax is due on the gain on the sale of the target assets. This income tax is paid by the target company (some at ordinary income tax rates). This is because the target company (and not the S corporation shareholder) is the seller of the company assets.

Upon liquidation of the target company, the shareholders also pay a second level of income tax on the remaining asset sale proceeds that are distributed to them.

Income Tax Benefits

When the Section 338 election is made, for federal income tax purposes, the sale of target company equity by the selling shareholders is ignored. Under the Section 338 election, the target company S corporation status remains in effect throughout the deemed sales process.

And, any gain recognized on the deemed sale then flows through to the S corporation shareholders (who then adjust their basis in the S corporation equity interest for purposes of determining gain on the deemed liquidation).

Income Tax Costs

All of the selling shareholders must consent to the Section 338 election. This is because this tax election can reduce the net after-tax proceeds to the selling shareholders.

However, the positive income tax benefits to the buyer—of the step-up in the basis of the acquired assets available under the Section 338 election—is often much greater than the negative income tax attributes to the seller.

In the following example, the difference in the value of the Section 338 election to the buyer (i.e., accounting for the transaction as the purchase of target company assets instead of as an acquisition of target company equity) is the equivalent of an approximately 13 percent discount in the purchase price.

After increasing the purchase price to the seller by the amount of the negative income tax attributes attributable to the Section 338 election, the income tax attributes available to the buyer are equivalent to a purchase price premium of almost 12 percent.

In this sense, the value of the target company as an S corporation is greater than the value of the target company as a C Corporation.

Simplified Illustrative Example

Let's assume that a C corporation buyer initially offers to buy the closely held target S corporation equity from the seller for $15.0 million in cash on December 31, 2011. The buyer will effectively reduce the transaction purchase price by:

1. convincing the selling S corporation shareholder to agree to the Section 338 election and
2. incentivizing the seller to accept the negative income tax consequences.

The Target S Corporation

The most recent information regarding the target S corporation as of December 31, 2011, reflects the following data:

1. The target company has been an S corporation since its inception (more than 10 years ago).
2. The target S corporation uses the cash method of accounting. (This assumption provides a simpler analysis than the analysis using another accounting method; however, the income tax conclusion remains the same).
3. The target company's equipment originally cost $800,000 when it was purchased by the subject S corporation. The current fair market value of the target company equipment is equal to its current tax basis of $600,000.
4. The S corporation's ordinary income for the year was $2 million. The S corporation's sole shareholder, Jones, has a tax basis in the target company stock of $1 million.
5. The S corporation has an accounts payable balance of $700,000.
6. The S corporation has an accounts receivable balance of $1,000,000.
7. The S corporation has a cash balance of $500,000.

Federal Income Tax Rates

Let's assume that any excess purchase price (i.e., purchase price in excess of the equipment fair market value) is attributable to the target company's goodwill.

In addition, let's assume that the selling shareholder Jones is in:

1. the 35 percent federal income tax bracket for ordinary income purposes and
2. the 15 percent federal income tax bracket for long-term capital gain purposes.

Does the Section 338 election make sense with regard to the above-described illustrative transaction scenario?

Simplified Illustrative Analysis

For illustrative purposes only, this analysis ignores the possible impact of:

1. the alternative minimum tax,
2. state and local income taxes, and
3. any applicable deprecation or other recapture income.

However, it is important for actual transaction participants to consider these additional income tax implications.

There will be no negative built-in gains tax ramifications for the S corporation. This is because the subject company was an S corporation for more than 10 years, and all of the statutory requirements have been met.

Further, let's assume that the subject S corporation is not subject to the excess net passive income tax or the LIFO recapture tax.

The sale of the subject S corporation equity does not cause a termination of its S election status. However, the S corporation status will terminate on the acquisition date as a result of the acquisition of the subject S corporation equity by a C corporation—that is, an ineligible shareholder.

Seller Income Tax Issues

There are several income tax issues affecting the selling shareholder Jones. For example, the target company operating income of $2 million, which was generated by the S corporation, passes through to Jones as ordinary income whether the Section 338 election is made or not.

Let's assume that the transaction parties make the Section 338 election. The taxable income to shareholder Jones includes the income tax consequences of the deemed sale by the S corporation of all of its assets. This taxable income flows through to Jones at the individual taxpayer level.

The Deemed Sale Price

The deemed sale of its assets by the target S corporation is analyzed as follows:

	Amount of cash paid to the selling S corporation: $15.0 million
Plus	Accounts payable of the S corporation: $0.7 million
Equals	The aggregate deemed sales price (ADSP)—i.e., the amount realized: $15.7 million

The allocation of the ADSP is summarized as follows:

Attributable to cash: $0.5 million

Attributable to accounts receivable: $1.0 million

Attributable to equipment: $0.6 million

ADSP balance attributable to purchased goodwill: $13.6 million

Income Tax Consequences

The resulting income tax consequences to selling shareholder Jones are summarized in the following three components:

1. Flow-through of $2 million in ordinary income from the S corporation for the period before the acquisition:

   $2 million times 35% tax rate = $0.7 million in income tax

2. Ordinary income from the S corporation based on the sale of accounts receivable:

   $1 million times 35% tax rate = $0.35 million in income tax

3. The S corporation adjusted stock basis for Jones would be calculated as follows:

   Initial stock basis ($1 million)

   Plus: Ordinary income from the operations ($2.0 million)

   Plus: Ordinary income from sale of accounts receivable ($1.0 million)

   Plus: Capital gain on the sale of goodwill ($13.6 million)

   Equals: The final stock basis of $17.6 million.

The capital loss on the deemed liquidation of the subject S corporation is calculated by comparing:

1. the deemed liquidation proceeds of $15 million with
2. the final stock basis of $17.6 million.

Accordingly, $2.6 million is the long-term capital loss that Jones will report on this transaction.

The capital gains tax rate will be applied to the net long-term capital gain of $11 million. The long-term capital gain results from:

1. the capital gain of $13.6 million on the sale of the company goodwill (as calculated above), minus
2. the capital loss of $2.6 million on the deemed liquidation of the S corporation, calculated as follows:

   $11 million times 15% long-term capital gain tax rate = $1.65 million

With the Section 338 Election

Therefore, the total transaction-related federal income tax liability imposed on the selling shareholder Jones after making the Section 338 election is $2.7 million. This federal income tax liability is the sum of the three components noted above.

This analysis assumes that the S corporation cash basis accounts payable totaling $0.7 million is not deductible on its final stub period income tax return. However, a final S corporation tax return income tax deduction may be justifiable.

Now, let's assume that the Section 338 election is not made in this transaction.

Without the Section 338 Election

The income tax ramifications for shareholder Jones assuming that he does not make the Section 338 election can be summarized in two components:

1. Flow-through of the $2 million ordinary income from the S corporation for the period before the acquisition:

   $2 million times 35% tax rate = $0.7 million in income tax

2. Long-term capital gain tax on the sale of the S corporation equity which has an adjusted tax basis of $3 million (i.e., an initial stock basis of $1 million plus ordinary income from operations of $2 million).

   The sale proceeds of $15 million minus the stock basis of $3 million yields a long-term capital gain of $12 million:

   $12 million times 15% long-term capital gain tax rate = $1.8 million in income tax

Therefore, if shareholder Jones does not make the Section 338 election related to this transaction, his total federal income tax liability would be $2.5 million.

Summary of the Illustrative Section 338 Analysis

Based on the above-described analysis and calculations, shareholder Jones would be wise to not agree to make the Section 338 election related to the sale transaction.

That is, Jones will save $200,000 in after-tax dollars by not agreeing to make the Section 338 election.

The Section 338 election must be made jointly by the buyer C corporation and the seller S corporation. And, the Section 338 election tax forms must be signed by all of the S corporation shareholders.

In this illustrative example, Jones should use this information as a negotiation tool to maximize the tax and the nontax issues related to the proposed sale transaction.

The positive income tax consequence of the Section 338 election to the buyer C corporation is the ability to amortize $13.6 million of the purchase price (i.e., the goodwill value) over a 15-year Section 197 amortization period.

This goodwill value represents an annual amortization deduction of more than $900,000. At a 35 percent C corporation income tax rate, the annual income tax benefit would be $317,300.

And, at a present value discount rate of 17.5 percent, this amortization tax deduction represents a savings from the Section 338 election to the buyer C corporation of more $1.9 million.

If the buyer C corporation provides an incentive to Jones by paying him an extra purchase price amount of $200,000 to offset the negative Section 338 tax consequence—then the buyer C corporation could recognize the positive income tax consequences of the Section 338 election.

By convincing the selling S corporation shareholder to agree to the Section 338 election (i.e., by increasing the purchase price by the negative tax consequences of $200,000), the buyer increases after-tax cash flow by a present value of more than $1.7 million.

This $1.7 million cash flow benefit represents an effective price discount from the original $15,000,000 purchase price of 11.6 percent.

The extra $200,000 purchase price would become part of the capital gain to seller Jones, and it would become part of the amortizable goodwill amount to the buyer C corporation.

So, after recomputing these figures to include this $200,000 purchase price incremental adjustment, the economic benefit due to the Section 338 election in this example increases.

Of course, Jones does not have to agree to make the Section 338 election. Based on these facts (and assumptions), the purchase price premium from the buyer C corporation for agreeing to the Section 338 election is $200,000.

Summary and Conclusion

Based solely on an additional $200,000 in the offered purchase price, Jones is indifferent from a financial standpoint. To Jones, even though the purchase price increases by 1.3 percent, he will receive no after-tax price premium related to his company's S corporation tax status.

Jones could try to negotiate to receive an additional portion of the buyer's income tax benefit attributable to the Section 338 election. That income tax benefit is not available to either the buyer or the seller without the seller's acquiescence.

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A Section 338 election cost/benefit analysis such as the one illustrated here should include an estimate of the fair market value of all of the assets of the seller S corporation.

Such a cost/benefit analysis should help the seller (and the buyer) to negotiate a more favorable:

1. transaction purchase price and
2. transaction tax structure.

Notes:

1. For purposes of this discussion, non-tax issues and the seller's income tax attributes will not be considered. Non-tax issues include the possibility that some assets would not be transferable (e.g., certain contracts, leases, and licenses) from the seller to the buyer. When assets are sold, the selling company's income tax attributes stay with the selling company. Such income tax attributes include net operating loss carryovers. In addition, other income tax attributes may be permanently lost. State and local income taxes may be due upon the sale of assets. Such state and local income taxes may not be due in a transaction involving the sale of equity.
2. For example, contingent liabilities (such as potential lawsuits over previous activities of the target company) remain the responsibility of the selling company and, in the purchase of assets, may be avoided by the buyer.
3. That is, the sale of at least 80 percent of the equity.

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