THE M&A TAX REPORT

The Monthly Review of Taxes, Trends & Techniques

Volume 6, Number 12 July 1998

TAX INSTITUTE

Editor-in-Chief

Robert W. Wood
Robert W. Wood, P.C.
San Francisco

Associate Editor

Vaughne Sprowls
Tax Institute
San Francisco

Advisory Board

Gilbert D. Bloom
KPMG Peat Marwick
Washington

Lawrence B. Gibbs
Miller & Chevalier
Washington

Richard M. Lipton
Sonnenschein, Nath & Rosenthal
Chicago

Steven K. Matthias
Deloitte & Touche
San Francisco

Mark A. Muntean
Bechtel Group, Inc.
San Francisco

Matthew A. Rosen
Skadden, Arps, Slate, Meagher & Flom
New York

Joseph L. Schiffhouer
Federal Express Corp.
Memphis

Mark J. Silverman
Steptoe & Johnson
Washington

Robert Willens
Lehman Brothers
New York

Acquiring an S Corporation

by Robert Willens • Lehman Brothers, New York
and Robert W. Wood • San Francisco

A corporate purchaser nearly always prefers to purchase a target's assets rather than acquiring its stock. There are nontax reasons for this preference, given the liabilities of the target that attach to a stock purchase. From a tax viewpoint, of course, an asset purchase is desirable because it gives the buyer a cost basis in the target's

Continued on Page 3

ALSO IN THIS ISSUE:

❑ Poison, Chewable Pills, and More 4
❑ Confusion Reigns in In-House Mergers .. 6
❑ Index to *The M&A Tax Report*, Volume 6 (Aug. 1997-July 1998) 6
❑ More Spins in the News 8

ACQUIRING AN S CORP

Continued from Page 1

assets, and hence maximizes the buyer's tax benefits by allowing depreciation and amortization deductions derived from a higher benchmark.

Section 197 of the Code enhances these benefits because it allows (and indeed requires) the amortization to be taken over 15 years for any goodwill, going concern value, and other enumerated purchased intangibles. This is a plus when it comes to goodwill, that historically qualified for no tax benefits until Section 197 came along. But it is a decided minus when it comes to many other intangibles, particularly covenants not to compete.

Thus, there are many good nontax and tax reasons why a corporate acquirer typically proposes initially to purchase the target's assets. Unfortunately, corporate buyers only rarely get to close a purchase of a target's assets. After all, the target will incur the wrath of the corporate tax on an assets sale. As a result of 1986 repeal of the *General Utilities* doctrine, a sale of corporate assets is a fully taxable transaction. Plus, a second level of tax is imposed (on the seller's shareholders) if the after-tax proceeds are distributed in liquidation.

Good News for S Corporations

This impediment does not operate in the case of an S corporation seller. In most cases, the buyer can achieve a coveted cost basis in a target's assets at the cost of only a single tax imposed on the selling group. Where an S corporation sells its assets to a buyer, the buyer achieves a cost basis in those assets. The asset sale gain, because of the unique taxing

Continued on Page 4

ACQUIRING AN S CORP Continued from Page 3

regime applicable to S corporations, flows through to the entity's shareholders, who report the gain on their individual tax returns.

Significantly, the stock basis of the shareholders increases by the passed-through gain. The result is that liquidating distributions (consisting of the sales proceeds) will not result in double taxation. Hence, they receive a higher basis at the cost of a single tax.

Moreover, this benefit can be enjoyed even if the transaction is structured, for nontax reasons, as a sale of stock. Under recently amended regulations, a selling S corporation's shareholders, together with the corporate purchaser, can execute a joint Section 338(h)(10) election. Such an election converts the sale of stock into an asset sale and purchase, followed immediately by a Section 331 liquidation. The results would be the same as depicted above.

Built-In Gains Tax

In some cases, an asset sale by an S corporation will trigger corporate-level tax, making the above strategy unworkable. This will occur where the S corporation is subject to the built-in gains provisions embodied in Section 1374. Section 1374 applies where the S corporation previously operated as a C corporation and sells assets within 10 years of its conversion to S status. Here, the S corporation will be constrained to recognize (and pay taxes on) the gains inherent in its assets as of the beginning of its first year as an S corporation. The tax is designed to tax only appreciation that occurred in the assets during the C corporation years.

The S corporation's built-in gains are taxed if they are recognized through, among other things, sales of the relevant assets during the first 10 years of its existence as an S corporation. It is incumbent on the S corporation seller to prove the portion of the realized gain that was built-in at the time of the S election. If these gains represent a significant portion of the total realized gain from the asset disposal, the asset sale strategy is mortally wounded because the transaction will feature the undesirable tax attributes normally associated with a C corporation's asset sale.

Ordinary vs. Capital Concerns

Even in cases where the built-in gains tax is not an impediment, the asset sale strategy (whether structured as an outright asset sale or a stock sale coupled with a Section 338(h)(10) election) can change the character of the income imputed to the S corporation's shareholders. Naturally, a sale of stock (without a Section 338(h)(10) election) will give rise to capital gains, potentially taxable at only a 20% rate.

If the asset sale technique is employed, the gain passed through to the S corporation's shareholders may embody a significant ordinary income component. This ordinary income can be taxed at rates as high as 39.6%. Accordingly, to convince the S corporation shareholders to agree to an actual or constructive asset sale, the purchase price may have to be increased for the purpose of allowing them to garner the same after-tax proceeds they would have enjoyed from a sale of their stock. ■