MERGERS & ACQUISITIONS

Tax Break When Buying S Corp Assets
(M&A Tax Report)

Buying assets beneficial. Corporate aquirors prefer buying, whenever possible, a target's assets rather than its stock, since the latter can bring unwanted liabilities and tax burdens. When a company buys assets in a merger or acquisition, only the liabilities attached to the assets transfer, and the assets themselves provide tax benefits in the form of a higher starting point for depreciation and amortization. Yet buyers rarely get their preference, because sellers are hit with income tax at two levels in assets sales.

S corp. sale taxed only once. Profits from S corporations are taxed only at the shareholder level. Their asset sales provide the coveted tax basis for the buyer and only one level of tax for the seller. The gain passing through to the shareholders increases their basis in the S corporation stock; the subsequent liquidating distributions made to the shareholders thus result in less gain and a lower tax burden. Even if the parties decide to transfer stock rather than assets, they can mutually agree to structure the purchase and sale as an asset deal, using a Section 338 election. The subsequent cash distributions made in liquidation of the corporation are taxed to the shareholders, resulting in a tax burden similar to an asset sale.

Tax pitfalls for sellers. If an S corporation was previously organized as a regular corporation, the asset sale may be subject to built-in gains tax. The S corporation is subject to this tax if the sale takes place less than 10 years after it converted from C corporation status. The tax is on the asset appreciation realized by the corporation during the time it was a C corporation. If a significant part of the gain on the sale of the assets is subject to the built-in gains tax, the parties should restructure the deal as if the seller were still a C corporation. The S corporation must also consider whether some of the gains on the sale of its assets may be subject to tax rates as high as 39%, rather than the capital gains rate of 20%. This ordinary gain may be from depreciation recapture or the sale of assets that normally generate ordinary income when sold.

Acquiring An S Corporation, by Robert Willens (Lehman Brothers, New York, NY) and Robert Wood. ***M&A Tax Report,*** Vol. 6, No. 12, Pgs. 1, 3-4. Tax Institute, 235 Montgomery Street, Suite 972, San Francisco, CA 94104. A dilemma faced by growing small companies is whether to be acquired or go public; see "To Sell Or Not To Sell" by Seth Fineberg, *Venture Capital Journal,* June 1998, Pgs. 41-43.