

TAXABLE ACQUISITIONS  
OF S CORPORATIONS

After completing this chapter, you should be able to:

1. Explain the tax implications of various taxable acquisition structures of S corporations.
2. Understand when a structure that steps up the tax basis of the acquired S corporation is optimal and when it is not.
3. Compute the prices at which a seller (target shareholders) and an acquirer are indifferent between various taxable acquisition structures.
4. Understand the major tax differences between the taxable sale of an S corporation and the taxable sale of a C corporation.

As illustrated in Chapter 10, the various organizational forms exhibit a number of tax and nontax differences. In this chapter, we analyze the tax treatment of taxable acquisitions of S corporations, which are conduit entities. We concentrate on S corporations but the same basic principles apply to acquisitions of other types of pass-through or conduit entities. As you will see, taxable acquisitions of S corporations and of conduits in general are quite different from taxable acquisitions of C corporations, which we discussed in the prior chapter. We do not discuss tax-free acquisitions of S corporations, although those structures are an option, because tax-free acquisitions of conduits are similar to tax-free acquisitions of C corporations. Moreover, a taxable structure typically dominates a tax-free structure when the target is a conduit such as an S corporation.

Because acquisitions of S corporations, partnerships, and other conduits such as LLCs are quite common, it is important to understand the basic tax issues associated with buying and selling a conduit. In fact, there are more S corporations than C corporations in the United States. Moreover, for medium and large businesses, as defined by the IRS, there are three S corporations or partnerships for every two C corporations.<sup>1</sup>

<sup>1</sup>For example, most joint ventures are conduit-type entities, and these enterprises are frequently sold to one of the partners or a third party. The issues covered in this section are therefore likely relevant in joint venture transactions, among others.

Thus, acquisitions of conduit entities are prevalent. As you will see, there are significant tax benefits available in acquisitions of conduit entities that are not typically available in the purchase of a C corporation. In our analysis of acquisitions of S corporations we do not discuss the nontax implications of various acquisition structures because they are similar to or the same as the nontax implications associated with acquisitions of C corporations.

Although an S corporation could be acquired in a tax-free acquisition, we restrict our analysis to taxable acquisitions of S corporations. Recall that S corporations are conduits whose earnings at the corporate level pass through to shareholders where they are taxed. Generally no tax is due at the S corporation level. We analyze the tax implications of acquiring the assets of an S corporation in a taxable transaction and the tax implications of a taxable stock acquisition of an S corporation. A taxable stock acquisition of an S corporation can be taxed as if the assets of the S corporation were sold if both the buyer and seller make a **Section 338(h)(10) election**.

In the taxable acquisition of an S corporation, the overriding considerations are (1) What are the tax consequences of the transaction for target shareholders?<sup>2</sup> and (2) What are the incremental tax costs and tax benefits if the buyer changes the basis in the target's assets?

## 15.1 TAX CONSEQUENCES OF TAXABLE S CORPORATION ACQUISITION STRUCTURES<sup>3</sup>

Table 15.1 lays out the major tax consequences—for the target company, the acquiring company, and the shareholders of the target company—of the three basic taxable methods used to acquire S corporations, which are:

1. A taxable asset acquisition followed by a complete liquidation of the target
2. A taxable stock acquisition followed by a Section 338(h)(10) election
3. A taxable stock acquisition that is not followed by a Section 338(h)(10) election

As indicated in Table 15.1, the target company recognizes a gain or loss on the sale if it sells assets *or* if it sells its stock and the acquirer and seller elect under Section 338(h)(10) to treat the transaction for tax purposes as a sale of assets. By contrast, a sale of stock that is *not* accompanied by a Section 338(h)(10) election does not generate a taxable gain at the target level. Rather, a tax is assessed at only the shareholder level on the stock sale. Table 15.1 also shows that the target corporation's recognition of a taxable gain is linked to a change in the tax basis of the assets acquired (to market value) for the purchaser.

Shareholders of the target company recognize a taxable gain in each of the three scenarios. In the first two scenarios, the taxable gain at the target corporation level

<sup>2</sup>In general, the shareholders of the acquiring firm experience no tax consequences.

<sup>3</sup>The remainder of the chapter is based in large part on "Tax Benefits as a Source of Merger Premiums in Acquisitions of Privately Held Corporations" by M. Erickson and S. Wang, 2003, University of Chicago and University of Southern California working paper.

**TABLE 15.1 Significant Tax Consequences of Various Taxable Acquisition Structures: Acquisitions of S Corporations**

<i>Structural or Tax Issue</i>	<i>Asset Acquisition<sup>(1)</sup></i>	<i>Stock Acquisition with a §338(h)(10) Election<sup>(2)</sup></i>	<i>Stock Acquisition without a §338(h)(10) Election<sup>(3)</sup></i>
Consideration/method of payment	Cash	Cash	Cash
Taxable gain at target corporation level	Yes	Yes	No
Taxable gain recognized by target shareholders	Yes	Yes	Yes
Nature of target shareholder gain	Ordinary income and capital gain	Ordinary income and capital gain	Capital gain
Step-up in the tax basis of the target's assets	Yes	Yes	No
Tax-based goodwill <sup>(4)</sup>	Yes	Yes	No

<sup>(1)</sup>Transaction in which the target corporation sells its assets to the acquirer for cash. The target corporation does not pay any resulting tax (or receive a tax refund) on the gain (loss) recognized. Any gain or loss recognized passes through to target shareholders.

<sup>(2)</sup>Target corporation shareholders receive cash from the acquiring firm in return for their target corporation shares. The acquiring corporation and the target's shareholders then makes a §338(h)(10) election, which results in a deemed sale of the target's assets. The acquirer takes a stepped-up tax basis in the target's assets.

<sup>(3)</sup>Target corporation shareholders sell their stock to the acquirer, and the §338(h)(10) election is not made. There is no step-up in the tax basis of the target's assets; the acquirer takes a carryover basis in the target's assets.

<sup>(4)</sup>Financial accounting goodwill is typically generated in purchase accounting type acquisitions. Tax-basis goodwill is only created if the tax basis of the target's assets are stepped-up.

flows directly through to shareholders. No tax is levied at the S corporation level because the S corporation is a pass-through or conduit entity. The nature of the gain, whether ordinary or capital, at the S corporation level also passes through to shareholders. In the third scenario, the transaction is taxed as a stock sale, so no direct tax effect occurs at the S corporation level. Shareholders recognize taxable gain or loss on the sale of the S corporation stock.

Having outlined the basic tax consequences of the three basic types of taxable acquisitions of S corporations, we next analyze the factors relevant to choosing among the transactional alternatives. After briefly discussing the tax implications of the three tax structures, we quantify the differences between them.

### Case 1: Taxable Asset Acquisition

The mechanics of a taxable acquisition of an S corporation's assets are essentially identical to those associated with a taxable asset acquisition of a C corporation.<sup>4</sup> Figure 15.1 provides a diagram of the structure of an asset acquisition followed by a liquidation when the target is an S corporation. As in any taxable asset acquisition, the seller recognizes a gain and the acquirer obtains a basis in the assets equal to the purchase price, plus various adjustments in certain circumstances. A major difference in this case, however, is that the S corporation does not pay a tax on the asset sale gain. Rather, that gain passes through to shareholders of the S corporation, who are responsible for any tax associated with the gain.

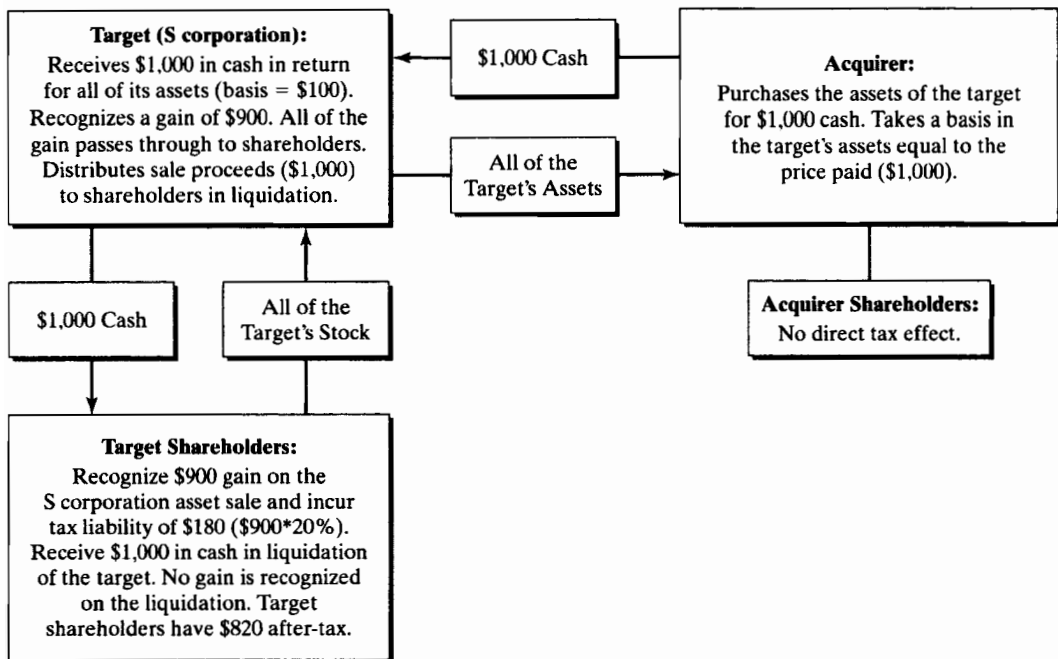
For illustrative purposes, we will use the same set of facts used in Chapter 14 to compare and contrast the tax implications of various acquisition structures. Table 15.2 provides an overview of the computations that follow. We make the following assumptions about the hypothetical S corporation sale:

- The target (T) S corporation has assets with a historical cost of \$100 and accumulated depreciation of \$0.
- T corporation shareholders have a tax basis in their T stock of \$100, which they have held for more than 12 months.
- T corporation has no liabilities.
- The acquirer (A) pays T corporation \$1,000 for the assets of T.

The asset sale will give rise to a gain of \$900 (\$1,000 price less \$100 basis in the assets) at the T corporation level. This gain is capital in nature because no accumulated depreciation was associated with T's assets. Any recaptured depreciation on the sale would be ordinary income.<sup>5</sup> No tax will be due on the \$900 capital gain at the T corporation level. The acquirer (A) will take a basis in the assets of T equal to the

<sup>4</sup>If the S corporation target was converted to S corporation status from C corporation status, additional taxes are levied on the sale of the S corporation's assets under Tax Code Section 1374.

<sup>5</sup>The type of property sold determines the tax treatment of recaptured depreciation. For purposes of this text, we assume that all recaptured depreciation is taxed as ordinary income. It is important for readers to be aware here, as elsewhere, that numerous additional technical complications must be considered. For example, recaptured depreciation on certain types of property (Section 1250 property) is taxed at 25% under current law, while other recaptured depreciation can be taxed at rates as high as 35%. Similarly, if some of the target's assets were inventory, the gain arising from the sale of those assets would be ordinary income.

**FIGURE 15.1** Taxable Asset Acquisition with Subsequent Liquidation of the Target: Target Is an S Corporation

purchase price (\$1,000). Therefore, A corporation obtains a step-up in tax basis of \$900, as shown in Table 15.3. The purchase price will be allocated to the tangible and intangible assets of T in accordance with the residual method described in Chapter 14. Any portion of the purchase price allocated to goodwill will be amortizable over 15 years under **Section 197**.

The shareholders of T corporation will recognize a capital gain of \$900 on the sale of T's assets. The nature of the gain (ordinary or capital) at the S corporation level passes through to the shareholders of T, hence the gain at the shareholder level is capital given our facts. Assuming the shareholders of T are individual investors—corporations cannot hold stock of S corporations—who are subject to the maximum statutory federal capital gains tax rate under current law, the shareholder tax on the asset sale is \$180, or \$900 multiplied by a 20% capital gains tax rate. Notice that T's shareholders must pay this tax whether or not they receive any cash from T corporation.

We are assuming here that T corporation liquidates after the asset sale. What is the tax on its shareholders on the liquidation? When T corporation recognizes the \$900 gain on the asset sale, the gain is passed through to shareholders. Consequently, shareholders increase their basis in the stock of T corporation by the amount of the gain. The increase in shareholder basis occurs anytime that the S corporation recognizes gains, and provides the mechanism to ensure that only a single level of tax is levied on S corporation shareholders. Therefore, prior to the liquidation of T, the

**TABLE 15.2** Comparison of the Tax Consequences of Various Taxable Acquisition Structures: Acquisitions of S Corporations

**Fact Pattern:**

Stock purchase price	\$1,000.00	$t_c =$	35%
Asset purchase price	\$1,000.00	$t_{oi} =$	40%
Net tax basis in assets	100.00	$t_{cg} =$	20%
Historical cost	100.00	$r =$	10%
Accumulated depreciation	0.00	Amortization/depreciation	
Shareholder's tax basis in target's stock	100.00	period ( $n$ ) =	10
Liabilities of target	0.00		

	<i>S Corporation Acquisition Structure</i>			
	<i>Taxable Asset Acquisition</i>	<i>Taxable Stock Acquisition with a §338(h)(10) Election<sup>(1)</sup></i>	<i>Taxable Stock Acquisition without a §338(h)(10) Election</i>	<i>Taxable Stock Acquisition with a §338(h)(10) Election<sup>(1)</sup></i>
Purchase price	\$1,000.00	\$1,000.00	\$1,000.00	
Acquirer indifference price <sup>(2)</sup>				\$1,246.58
<b>Target Corporation:</b>				
Taxable gain <sup>(3)</sup>	\$900.00	\$900.00	\$0.00	\$1,146.58
Taxable liability <sup>(4)</sup>	0.00	0.00	0.00	0.00
<b>Shareholder Effect:</b>				
Taxable gain <sup>(5)</sup>	\$900.00	\$900.00	\$900.00	\$1,146.58
Cash to shareholders	\$1,000.00	\$1,000.00	\$1,000.00	\$1,246.58
Tax liability <sup>(6)</sup>	180.00	180.00	180.00	229.32
After-tax cash	<u>\$820.00</u>	<u>\$820.00</u>	<u>\$820.00</u>	<u>\$1,017.27</u>
<b>Acquirer Cost:</b>				
Gross cost	\$1,000.00	\$1,000.00	\$1,000.00	\$1,246.58
Less: tax benefits <sup>(7)</sup>	193.55	193.55	0.00	246.58
Net after-tax cost	<u>\$806.45</u>	<u>\$806.45</u>	<u>\$1,000.00</u>	<u>\$1,000.00</u>
<b>Acquirer Basis in:</b>				
Target's stock	n/a	\$1,000.00	\$1,000.00	\$1,246.58
Target's net assets	<u>\$1,000.00</u>	<u>\$1,000.00</u>	<u>\$100.00</u>	<u>\$1,246.58</u>

<sup>(1)</sup> A §338(h)(10) election causes the stock sale to be taxed as if the target's shareholders sold the assets of the target corporation instead of the target's stock.

<sup>(2)</sup> The purchase price at which the acquirer is indifferent between a transaction that is taxed as an asset sale (stock sale with a §338(h)(10) election) relative to a transaction that is taxed like a stock sale at a purchase price of \$1,000 (column 3).

<sup>(3)</sup> Taxable gain at the target corporation level from the sale of the target's assets or the deemed sale of the target's assets under a §338(h)(10).

<sup>(4)</sup> Tax liability at the target corporation level on the taxable gain from the asset sale, stock sale or the deemed asset sale under §338(h)(10) election.

<sup>(5)</sup> Taxable gain at the target shareholder level. This gain is equivalent to the gain at the target corporation level as the gain passes through to target shareholders. The gain retains its character (ordinary or capital) as it passes through to target shareholders.

<sup>(6)</sup> Target shareholder tax liability is the taxable gain from the asset sale at the target corporation level multiplied by the appropriate tax rate [the value defined by footnote (3) multiplied by the shareholder tax rate on ordinary income or capital gains] or the taxable gain on a stock sale multiplied by the capital gains tax rate.

<sup>(7)</sup> The present value of the tax savings resulting from stepping-up the tax basis of the target's assets assuming that the step-up is amortized/depreciated straight-line over a 10-year period, the applicable tax rate is 35% and the after-tax discount rate is 10%.

**TABLE 15.3** Estimation of Tax Benefits from Stepping up the Tax Basis of a Target's Assets**Fact Pattern:**

Purchase price	\$1,000.00
Target's net asset basis	100.00
Step-up <sup>(1)</sup>	900.00
Amortization/depreciation period	10
Depreciation method	straight-line
Annual incremental amortization/depreciation <sup>(2)</sup>	\$90.00
$t_c =$	35.00%
$r =$	10.00%

Period	Incremental Depreciation <sup>(2)</sup>	Tax Savings <sup>(3)</sup>	Present Value of Tax Savings <sup>(4)</sup>
1	\$90.00	\$31.50	\$28.64
2	90.00	31.50	26.03
3	90.00	31.50	23.67
4	90.00	31.50	21.51
5	90.00	31.50	19.56
6	90.00	31.50	17.78
7	90.00	31.50	16.16
8	90.00	31.50	14.69
9	90.00	31.50	13.36
10	90.00	31.50	12.14
Total	<u>\$900.00</u>	<u>\$315.00</u>	<u>\$193.55</u>

<sup>(1)</sup>Step-up is the increase in the tax basis of the target's assets computed as the purchase price less the net asset basis pre-acquisition.

<sup>(2)</sup>Incremental amortization/depreciation deductions are the step-up divided by the amortization period.

<sup>(3)</sup>Tax savings are incremental amortization/depreciation deductions multiplied by the corporate tax rate ( $t_c$ ).

<sup>(4)</sup>Present value of tax savings discounted at the after-tax rate discount rate ( $r$ ).

shareholders of T have a basis in their T stock of \$1,000 (\$100 original basis plus the \$900 gain on the asset sale). Consequently, when T liquidates and distributes the proceeds of the asset sale (\$1,000) to its shareholders in return for their T stock, no gain is recorded on the liquidation because the shareholders of T have a basis in their T stock of \$1,000.<sup>6</sup> After the liquidation then, T's shareholders have \$820 after tax (\$1,000 received in the liquidation less \$180 tax on the capital gain).

<sup>6</sup>The taxation of conduit entities causes the entity owner to increase its basis in the stock of the entity for any gain recognized. In our example, the shareholders of the target would increase their basis in the stock of the target by the amount of the gain recognized on the asset sale (\$900). Shareholder basis after the asset sale but before the liquidating distribution would therefore be \$1,000 or the \$100 presale basis plus the \$900 corporate-level gain on the asset sale. Consequently, the target shareholder's basis in the stock of the S corporation is \$1,000 before the corporate liquidation. This required basis adjustment prevents double taxation of the S corporation's income. Notice here that there is no gain or loss because the shareholder's stock basis is equivalent to the amount of the distribution.

### **Case 2: Taxable Stock Acquisition with a Section 338(h)(10) Election**

Rather than acquire the assets of the S corporation, an acquirer can purchase the stock of the corporation. The transaction costs of acquiring the stock of an S corporation might be much lower than the costs of acquiring its assets because S corporations are by definition closely held, and an acquirer is likely dealing with a small group of shareholders. Therefore, the transaction costs associated with acquiring their shares would probably be relatively small.

However, a stock acquisition does not produce a step-up in the tax basis of the target's assets. An acquirer may prefer the tax consequences of a taxable asset purchase, while seeking to avoid the associated transaction costs. Under Section 338(h)(10), a taxable stock acquisition of an S corporation can be taxed as if the acquirer purchased the target's assets instead of its stock. A Section 338(h)(10) election is made jointly by the buyer and the seller.<sup>7</sup> In order to qualify for a Section 338(h)(10) election, the acquirer must obtain at least 80% of the target's stock during a 12-month period. In addition, the acquirer must obtain the explicit cooperation of the target's shareholders in the making of the election. Without the seller's consent, the acquirer cannot make a valid Section 338(h)(10) election.

It is important to note that, when a Section 338(h)(10) election is made, no tax is due on the stock sale, only a tax on the asset sale. Using the facts outlined in Case 1 and assuming a taxable stock acquisition followed by the Section 338(h)(10) election, we find that the shareholders of T would have \$820 after tax (\$1,000 purchase price less \$180 tax liability), and the acquirer would obtain a \$1,000 tax basis in the stock and assets of T. Table 15.2 illustrates the tax consequences of a taxable stock acquisition with a Section 338(h)(10) election, and Figure 15.2 illustrates the structure of the transaction. One difference between a taxable asset acquisition and a taxable stock acquisition is that T corporation would survive as a subsidiary of the acquirer in a taxable stock acquisition. T would lose its S corporation status however because one of its shareholders (A) would now be a corporation.

### **Case 3: Taxable Stock Acquisition without a Section 338(h)(10) Election**

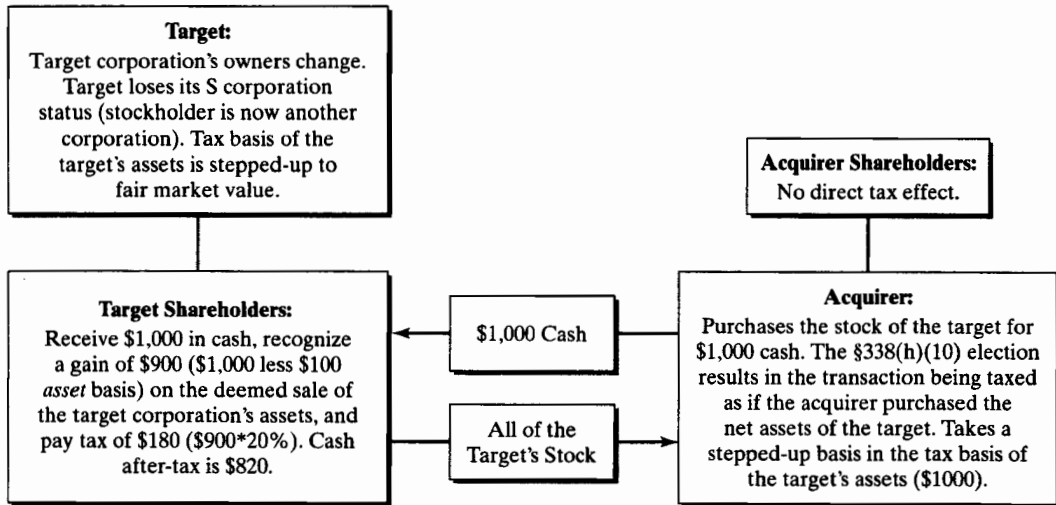
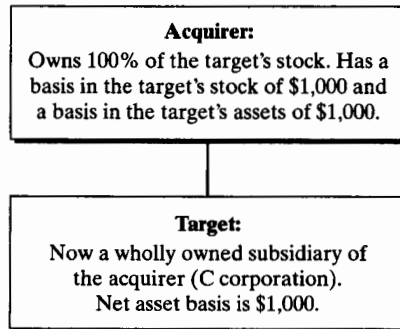
An acquirer can also purchase an S corporation in a taxable stock acquisition in which a Section 338(h)(10) election is not made. If the election is not made, the transaction is taxed as a stock sale, and the tax basis of the target corporation carries over, meaning that there is no step-up in the tax basis of the target's assets. Figure 15.3 illustrates the structure of a taxable stock sale of an S corporation without a Section 338(h)(10) election.

Returning to our facts from Case 1, assume that the acquirer is willing to pay \$1,000 for the stock of T and that no Section 338(h)(10) election will be made. Under this structure, T corporation would become a subsidiary of the acquirer, and T corporation would lose its S corporation status because it would be owned by a corporation. A will take a

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<sup>7</sup>Recall that a regular Section 338 election is made unilaterally by the acquirer.

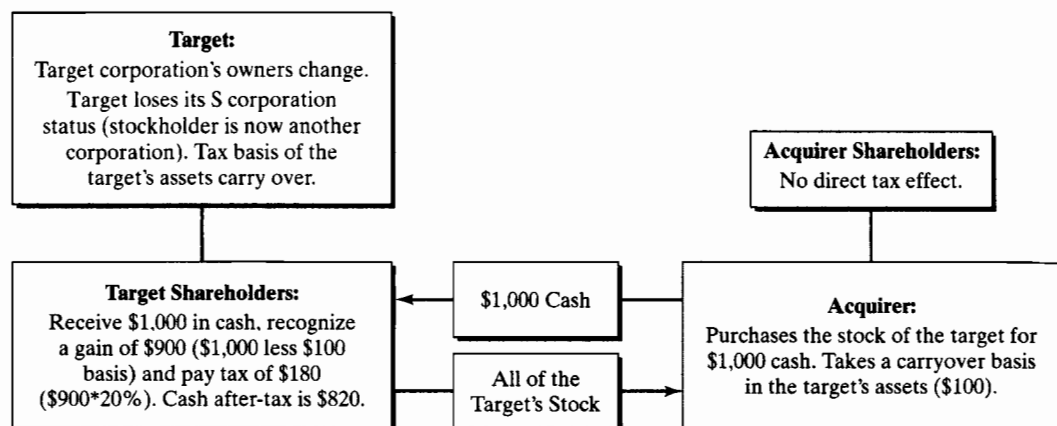
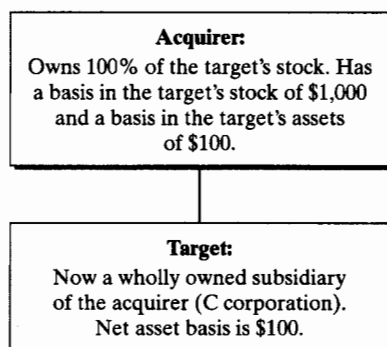


**FIGURE 15.2** Taxable Stock Acquisition of the Target with an I.R.C. §338(h)(10) Election: Target Is an S Corporation**Postacquisition:**

basis in the *stock* of T corporation equal to the price paid, or \$1,000. The tax basis of T's assets will carry over and be \$100. Hence, A does not obtain a step-up in the tax basis of T's assets and the corresponding tax benefits associated with the step-up. The shareholders of T corporation will recognize a capital gain of \$900 on the sale of their *shares* to A for \$1,000. Stock is a capital asset, and therefore the sale of stock gives rise to a capital gain. Assuming the appropriate capital gains tax rate is 20%, T's shareholders will face a capital gains tax liability of \$180 and have \$820 after tax.

### Which Structure Is Optimal in the Sale of an S Corporation?

Which of the three taxable acquisition structures discussed is optimal in the sale of an S corporation, and what are the pivotal issues influencing the structure of an

**FIGURE 15.3** Taxable Stock Acquisition of the Target without an I.R.C. § 338(h)(10) Election: Target is an S Corporation**Postacquisition:**

S corporation acquisition? Because the tax consequences of Cases 1 and 2 are identical, we compare Case 2 and Case 3, which also avoid nontax cost differences between stock and asset sales because Case 2 and Case 3 are both stock sales.

Which structure then is optimal between Case 2 and Case 3? We can algebraically express the relationship between the two structures in terms of target shareholder after-tax *wealth* and acquiring firm after-tax *cost*. In Case 2, a Section 338(h)(10) transaction, target shareholders after-tax wealth can be expressed as:

$$\begin{aligned}
 ATAX_{338h10} &= \text{Price}_{338h10} - \text{TAX} \\
 &= \text{Price}_{338h10} - (\text{Price}_{338h10} - \text{Basis})t \\
 &= \text{Price}_{338h10} - [(\text{Price}_{338h10} - \text{HCasset})t_{cg} + (\text{Accum} \times t_{oi})] \\
 &= \text{Price}_{338h10}(1 - t_{cg}) + \text{HCasset} \times t_{cg} - \text{Accum} \times t_{oi}
 \end{aligned} \tag{15.1}$$

where

Price<sub>338h10</sub> = the purchase price in a Section 338(h)(10) transaction<sup>8</sup>

Basis = the net asset basis of the target's assets, which is equal to the historical cost basis of the target's assets (HCasset) less the accumulated depreciation and amortization associated with the target's assets (Accum)<sup>9</sup>

$t$  = the tax rate

$t_{cg}$  = the appropriate capital gains tax rate for individual shareholders

$t_{oi}$  = the ordinary income rate for individual shareholders

In Case 3, target shareholder's after-tax wealth can be expressed as

$$\begin{aligned} ATAX_{no338h10} &= Price_{no338h10} - TAX \\ &= Price_{no338h10} - (Price_{no338h10} - Stock)t_{cg} \\ &= Price_{no338h10}(1 - t_{cg}) + Stock \times t_{cg} \end{aligned} \quad (15.2)$$

where

Price<sub>no338h10</sub> = the purchase price if the Section 338(h)(10) is not made

Stock = the target shareholder's basis in the stock of the target firm

The other variables are as defined previously.

We can find the purchase price with the election (Case 2) that leaves target shareholders indifferent between Case 2 and Case 3 at a given purchase price in Case 3, the no Section 338(h)(10) election scenario. We can do so by setting equation (15.1) and (15.2) equal to each other and then simplifying.

$$Price_{338h10} = Price_{no338h10} + [Stock \times t_{cg} - HCasset \times t_{cg} + Accum \times t_{oi}]/(1 - t_{cg}) \quad (15.3)$$

Using equation (15.3), we see that target shareholders are indifferent between receiving \$1,000 in Case 3 or \$1,000 in Case 2 where the Section 338(h)(10) election is made.<sup>10</sup> Under Case 2 or Case 3, T's shareholders ultimately have \$820 after tax when they receive \$1,000 pretax. They are therefore indifferent between Case 2 and Case 3 at any price, given our simple fact pattern.

The acquiring firm's pretax cost of acquiring T corporation is \$1,000 in each case. Under Case 2, A takes a tax basis in T's assets of \$1,000; while under Case 3, A takes a basis in T's assets of \$100. The \$900 step-up in tax basis under Case 2 generates gross

<sup>8</sup>We assume that Price<sub>338h10</sub> exceeds HCasset. The algebraic relationship is slightly different if Price<sub>338h10</sub> is less than HCasset. As readers grasp the logic presented in equations (15.1) through (15.6), they can develop financial models that deal with various fact patterns and contingencies.

<sup>9</sup>Recall that recaptured depreciation can be taxed as ordinary income. Under the assumption that all recaptured depreciation gives rise to ordinary income, equation (15.1) estimates tax liabilities on recaptured depreciation at ordinary rates. The excess of the purchase price over the historical cost of the assets (HCasset) is capital gain. As a practical matter, in many circumstances some or all of what we are defining as recaptured depreciation will be taxed at capital gains rates. The algebraic expressions herein, and the corresponding financial models, can be modified to reflect these additional complexities. Alternatively, we could alter the fact pattern such that a portion of the target's assets are inventory. The deemed sale of inventory at a price in excess of cost would typically generate ordinary income.

<sup>10</sup>The second term on the right-hand side of equation (15.3) is equal to zero because (stock) basis equals asset basis (HCasset - Accum), and there is no accumulated depreciation on the assets of the target.

undiscounted tax savings of \$315 (\$900 multiplied by a 35% tax rate) for A. Assuming that these incremental depreciation deductions occur evenly over 10 years and an appropriate after-tax discount rate is 10%, the present value of the tax benefits from the step-up is \$193.55 (see Table 15.3). The acquirer's *net* after-tax cost under Case 2 is therefore \$806.45 (\$1,000 less \$193.55), while net after-tax cost is \$1,000 under Case 3. Therefore Case 2 dominates Case 3.

It is apparent that, given our example numbers, the acquirer is willing to pay a higher pretax price in order to obtain the target shareholders' consent in making the Section 338(h)(10) election, because the acquirer's after-tax cost is lower, other things equal, when the Section 338(h)(10) election is made. How much more, then, is the acquirer willing to pay the seller to induce the seller to make the Section 338(h)(10) election, assuming that the acquirer believes \$1,000 is a reasonable price to pay to acquire the target if the basis of the target's assets does not change (Case 3)? With Case 2, the net after-tax cost of the acquisition to the acquirer can be expressed as:

$$\begin{aligned} ATAXCOST_{338h10} &= \text{Acqprice}_{338h10} - \text{Incremental tax benefits} \\ &= \text{Acqprice}_{338h10} - t_c(PVANN)[(\text{Acqprice}_{338h10} - \text{Asset})/n] \quad (15.4) \end{aligned}$$

where

$\text{Acqprice}_{338h10}$  = the price that the acquirer will pay in a Section 338(h)(10) transaction

$PVANN$  = the present value of an annuity

$t_c$  = the corporate tax rate

$\text{Asset}$  = the net tax basis of the target's assets

$n$  = the useful life of the target's assets postacquisition

Under Case 3, the acquirer's net after-tax cost can be expressed as

$$\begin{aligned} ATAXCOST_{\text{no}338h10} &= \text{Acqprice}_{\text{no}338h10} - \text{Incremental tax benefits} \\ &= \text{Acqprice}_{\text{no}338h10} - \$0 \quad (15.5) \end{aligned}$$

where

$\text{Acqprice}_{\text{no}338h10}$  = the price the acquirer will pay if the Section 338(h)(10) election is not made

The acquirer gains no incremental tax benefits in Case 3, because the tax basis of the target's assets is not stepped-up. The acquirer is indifferent between Case 2 and Case 3 when equation (15.4) equals equation (15.5). We assume for ease of exposition that  $\text{Acqprice}_{\text{no}338h10}$  and  $\text{Price}_{\text{no}338h10}$  are equivalent. That is, we assume that the acquirer and the target agree on the value of the target corporation if the Section 338(h)(10) election is not made and the tax basis of the target's assets does not change. Simplifying, we find

$$\text{Acqprice}_{338h10} = (\text{Price}_{\text{no}338h10} - t_c \times \text{Factor} \times \text{Asset}) / (1 - t_c \times \text{Factor}) \quad (15.6)$$

where  $\text{Factor}$  is equal to  $PVANN/n$  and all other variables are as defined previously.

Given  $\text{Price}_{\text{no}338h10}$  equals \$1,000, the acquirer is indifferent between Case 3 at \$1,000 and Case 2 at a price of \$1,246.58 computed as<sup>11</sup>

$$\text{Acqprice}_{338h10} = (\$1,000 - .21506 \times \$100) / (1 - .21506)$$

<sup>11</sup>Factor equals .61445 when  $n = 10$  and  $r = 10\%$ , so  $\text{Factor} \times t_c = .21506$ .

At that price, the acquirer would take a basis in the assets of T of \$1,246.58. Stated another way, the acquirer would obtain a step-up in basis of \$1,146.58. Under the same assumptions (10-year straight-line amortization,  $t_c = 35\%$ ,  $r = 10\%$ ), the present value of the \$1,146.58 step-up is \$246.58. Therefore, A's net after-tax cost under Case 2 at a price of \$1,246.58 is \$1,000.

Note that, even at a 24% pretax premium, or  $(\$1,246.58 - \$1000)/\$1,000$ , in Case 2 A is equally well off after tax under Case 2 as it is in Case 3. At a purchase price of \$1,246.58, T's shareholders would recognize a capital gain on the sale of T's assets of \$1,146.58 (\$1,246.58 less \$100 basis in T's stock), pay capital gains taxes of \$229.32 ( $\$1,146.58 \times 20\%$ ) and have \$1,017.27 after tax. It amounts to \$197.27 (\$1,017.27 minus \$820) more after tax than under the original Case 3. The last column of Table 15.2 illustrates these computations.

### Advanced Analysis: S Corporation Acquisition

In Section 14.2 of Chapter 14, we illustrated why sales of freestanding C corporations are rarely structured in a manner that results in a step-up in the tax basis of the target's assets. In this section, we illustrated that, in S corporation acquisitions, structuring the transaction to achieve a step-up in the tax basis of the target's assets can leave both the acquirer and the target's shareholders better off after tax.

How do we explain why different acquisition structures are preferred with different target organizational forms? As with any tax planning strategy, the fundamental issue is a comparison of incremental tax costs with incremental tax benefits, holding nontax factors constant. In the case of an acquisition of a C corporation, the incremental cost of obtaining a step-up is usually the tax rate multiplied by the amount of the step-up (in Section 14.2 of Chapter 14, this amount was \$315). The incremental tax savings from the step-up is the present value of the tax savings from the step-up (in Section 14.2, we estimated this amount as \$193.55), which is always less than the incremental tax cost if tax rates are constant and discount rates are greater than 0%.

In the case of an S corporation acquisition, the incremental cost of the step-up is not the tax rate multiplied by the step-up amount. It is usually something less.<sup>12</sup> This is true because there is only one level of tax on an "asset sale" in an S corporation, while there are two levels of tax on an "asset sale" of a C corporation.<sup>13</sup> The example that we used for an S corporation acquisition is oversimplified, but it illustrates these fundamental principles. We next work through a more realistic example in which the incremental cost of asset sale tax treatment for the S corporation's shareholders is not \$0.

The facts for our more realistic example are the following:

- T corporation, the target, is an S corporation that has assets with a net tax basis of \$200. The historical cost of these assets is \$400, and the assets have accumulated depreciation of \$200.

<sup>12</sup>In our simple example, the incremental cost of the step-up was \$0 because, under either Case 2 or Case 3, target shareholders faced a tax liability of \$180.

<sup>13</sup>These two levels are the oft-repeated "double tax" on C corporations that was a centerpiece of the Bush Administration's refrain for reduction in individual investor dividend and capital gains tax rates in 2002 and 2003.

- T corporation has no liabilities, and it is owned by individual shareholders that have held their shares for more than 12 months and are subject to federal income taxes at the top statutory rates (20% for capital gains and 40% for ordinary income). T's shareholders have a basis in their T stock of \$200.
- All recaptured depreciation is taxable at the ordinary income rate.
- The acquiring firm is willing to pay \$1,000 to acquire the stock of T corporation when a Section 338(h)(10) election will not be made.

Should the acquirer and seller make the Section 338(h)(10) election? Table 15.4 illustrates the following computations. Starting with our base facts (column 1 of Table 15.4), T shareholders would have \$840 after tax in a taxable stock sale without the election. The acquiring firm's net after-tax cost of this acquisition structure would be \$1,000, with no incremental tax benefits from a step-up. To determine what structure is optimal, we must set one party to the transaction indifferent and find which structure is preferable to the other party, under the terms defined by the first party's indifference. At what pretax price, assuming that a Section 338(h)(10) election is made, would the target's shareholders be indifferent relative to the \$1,000 purchase price and no election? We can solve for the pretax price by finding the price that leaves target shareholders with \$840 after tax from equation (15.3).

$$\begin{aligned}
 \text{Price}_{338h10} &= \text{Price}_{\text{no}338h10} + (\text{Stock} * t_{cg} - \text{HCasset} * t_{cg} + \text{Accum} * t_{oi})(1 - t_{cg}) \\
 &= \$1,000 + [\$200(t_{cg}) - \$400(t_{cg}) + \$200(t_{oi})]/(1 - t_{cg}) \\
 &= \$1,050
 \end{aligned}$$

At a purchase price of \$1,050, the stock sale accompanied by a Section 338(h)(10) election would give rise to a \$850 taxable gain at the T corporation level. Of this gain, \$200 would be ordinary income (recaptured depreciation) and \$650 would be capital gain (\$1,050 less historical cost of \$400). The \$850 gain and the character of the gain passes through to T's shareholders. T's shareholders would therefore have a tax liability of \$210 computed as 40% multiplied by \$200 of ordinary income and 20% multiplied by \$650 of capital gain. They would have \$840 after tax (\$1,050 price less \$210 of taxes) and would be indifferent between receiving \$1,000 pretax in a stock sale with no election and \$1,050 in a stock sale with a Section 338(h)(10) election (see column 2 of Table 15.4).

Which structure then does A prefer: no election at a price of \$1,000 or a deal priced at \$1,050 with the election? The net after-tax cost of a taxable stock acquisition without a Section 338(h)(10) election is \$1,000 (\$1,000 purchase price and zero incremental tax benefits). If the election is made, and the purchase price is \$1,050, A's net after-tax cost is \$867.20.<sup>14</sup> The size of the step-up, if the election is made, is \$850 (\$1,050 purchase price less \$200 net basis in T's assets), and the present value of the tax savings from the step-up is \$182.80, using the same assumptions about depreciable lives, tax, and discount rates as previously. Clearly then, A prefers to pay the higher pretax price to get the step-up in T's assets.

<sup>14</sup>Notice that the acquirer's net after-tax cost is about 13% lower than when the election was not made.

**TABLE 15.4** Comparison of the Tax Consequences of Various S Corporation Acquisition Structures: Advanced Example

**Fact Pattern:**

Stock purchase price	\$1,000.00	$t_c =$	35%
Net tax basis in assets	200.00	$t_o =$	40%
Historical cost	400.00	$t_{cg} =$	20%
Accumulated depreciation	200.00	$r =$	10%
Shareholder's tax basis in target's stock	200.00	Amortization/depreciation	
Liabilities of target	0.00	period ( $n$ ) =	10

	<i>S Corporation Acquisition Structure</i>			<i>Tax Benefit Split<sup>(1)</sup></i>	
	<i>Taxable Stock Acquisition without a §338(h)(10) Election</i>	<i>Taxable Stock Acquisition with a §338(h)(10) Election<sup>(2)</sup></i>	<i>Taxable Stock Acquisition with a §338(h)(10) Election<sup>(2)</sup></i>	<i>Taxable Stock Acquisition with a §338(h)(10) Election<sup>(2)</sup></i>	<i>Estimated Incremental After-Tax Benefit</i>
Purchase price—Base case	\$1,000.00				
Seller's indifference price <sup>(3)</sup>		\$1,050.00			
Acquirer's indifference price <sup>(4)</sup>			\$1,219.19		
Tax benefit split <sup>(1)</sup>				\$1,134.60	
<b>Target Corporation:</b>					
Taxable gain <sup>(5)</sup>	\$0.00	\$850.00	\$1,019.19	\$934.60	
Taxable liability <sup>(6)</sup>	0.00	0.00	0.00	0.00	
<b>Shareholder Effect:</b>					
Taxable gain <sup>(7)</sup>	\$800.00	\$850.00	\$1,019.19	\$934.60	
Cash to shareholders	\$1,000.00	\$1,050.00	\$1,219.19	\$1,134.60	
Tax liability <sup>(8)</sup>	160.00	210.00	243.84	226.92	
After-tax cash	<u>\$840.00</u>	<u>\$840.00</u>	<u>\$975.35</u>	<u>\$907.68</u>	<u>\$67.68</u>
<b>Acquirer After-Tax Cost:</b>					
Gross cost	\$1,000.00	\$1,050.00	\$1,219.19	\$1,134.60	
Less: tax benefits <sup>(9)</sup>	0.00	182.80	219.19	200.99	
Net after-tax cost	<u>\$1,000.00</u>	<u>\$867.20</u>	<u>\$1,000.00</u>	<u>\$933.61</u>	<u>\$66.39</u>
<b>Acquirer Basis in:</b>					
Target's stock	\$1,000.00	\$1,050.00	\$1,219.19	\$1,134.60	
Target's net assets	\$200.00	\$1,050.00	\$1,219.19	\$1,134.60	

<sup>(1)</sup>Purchase price that splits, approximately evenly, the net tax benefits from stepping-up the tax basis of the target's assets.

<sup>(2)</sup>A §338(h)(10) election causes the stock sale to be taxed as if the target's shareholders sold the assets of the target instead of the target's stock.

<sup>(3)</sup>The purchase price at which the seller is indifferent between making the §338(h)(10) election and not making the election when the purchase price is \$1,000 (column 1).

<sup>(4)</sup>The purchase price at which the acquirer is indifferent between making the §338(h)(10) election and not making the election when the purchase price is \$1,000 (column 1).

<sup>(5)</sup>Taxable gain at the target corporation level from the sale of the target's assets or the deemed asset sale associated with the §338(h)(10) election.

<sup>(6)</sup>Tax liability at the target corporation level on the taxable gain from the sale of the target's assets or the deemed sale of its assets with the §338(h)(10) election.

<sup>(7)</sup>Taxable gain at the target shareholder level. This gain is equivalent to the gain at the target corporation level in an asset sale or a stock sale with the §338(h)(10) election as the gain passes through to target shareholders. The gain retains its character (ordinary or capital) as it passes through to target shareholders. In a stock sale without the §338(h)(10) election, the gain is computed as the difference between the purchase price and target shareholder's stock basis. In the latter case, the gain is capital in nature.

<sup>(8)</sup>Target shareholder tax liability is the taxable gain from the stock or asset sale multiplied by the appropriate tax rate [the value defined by footnote (7) multiplied by the shareholder tax rate on ordinary income or capital gains].

<sup>(9)</sup>The present value of the tax savings resulting from stepping-up the tax basis of the target's assets assuming that the step-up is amortized/depreciated straight-line over a 10-year period, the applicable tax rate is 35% and the after-tax discount rate is 10%.

From A's perspective, the incremental cost of obtaining a step-up is \$50 (\$1,050 purchase price less \$1,000 price without the election), and the incremental tax benefit is \$182.80. Thus, A is better off by \$132.80 after tax when the transaction is structured in a manner that results in a step-up in T's assets.<sup>15</sup> The \$132.80 can be thought of as the net tax benefits from stepping up the tax basis of the target's assets. Incidentally, these tax benefits can be split between the acquirer and the target, as we will illustrate in a moment.

Under our new facts, we see the purchase price at which the acquirer is indifferent or the maximum price the acquirer will pay when T's assets are stepped-up is given by equation (15.6).

$$\begin{aligned}\text{Acqprice}_{338h10} &= (\$1,000 - .21506 \times \$200) / (1 - .21506) \\ \text{Acqprice}_{338h10} &= \$1,219.19\end{aligned}\tag{15.6}$$

The acquirer will therefore be indifferent between a stock acquisition without the Section 338(h)(10) election at a price of \$1,000 and a stock acquisition with the election at a price of \$1,219.19, because the acquirer's net after-tax cost under either scenario is \$1,000, as illustrated in the first and third columns of Table 15.4.

For an advisor to target shareholders, the ability to estimate this price is obviously quite useful because the shareholders benefit from knowing the maximum price the acquirer will pay under varying acquisition tax structures. Notice that, at a price of \$1,219.19, with the election, target shareholders have \$975.35 after tax, which is about 16% more than if the election is not made and the purchase price is \$1,000.

At any price between \$1,050 and \$1,219.19, with the Section 338(h)(10) election, both the acquirer and target shareholders are better off after tax than if the deal is priced at \$1,000 and the election is not made jointly by the buyer and seller. As the purchase price approaches \$1,050 (\$1,219.19), the acquirer (target shareholders) is (are) relatively better off. Essentially, the difference between \$1,050 and \$1,219.19 is the incremental tax benefits from stepping up the tax basis of the target's assets that can be shared between the buyer and seller. For example, consider a price exactly halfway between these amounts (\$1,134.60). At this price, target shareholder's after-tax wealth is \$907.68, which is \$67.38 more after tax than they receive if the transaction is priced at \$1,000 and the *joint* election is not made. Similarly, the acquirer's net after tax cost is \$66.39 less than if the deal is priced at \$1,000 and the election is not made. The last two columns of Table 15.4 contain these computations. Notice that even at a pretax *premium* of 13.46% [\$(1,134.60 - \$1,000)/\$1,000] the acquirer is better off after tax by about 7% if the tax basis of the target's assets is stepped up.

Is this conclusion reasonable, or is it an ivory tower fantasy? What is the source of this value that increases both the buyer's and the seller's wealth?

The preceding equations formally explain this phenomenon but, stated simply, in an S corporation acquisition a step-up in the tax basis of the target's assets incrementally costs much less than the incremental benefits of such a step-up. That is, in the absence of a step-up election, S corporation shareholders face almost the same amount of tax they do if the step-up election is made. Therefore, the incremental cost of the election is often relatively low. The incremental tax benefit of the election, however, can be

<sup>15</sup>The difference in A's net after-tax cost is \$132.80 as illustrated in the first two columns of Table 15.4.



large. The same is generally true in acquisitions of other types of conduits. The net benefit is the source of wealth gains that can be shared between the buyer and seller. Of course, informed parties should make the most of these net benefits when structuring and pricing an acquisition.

## **15.2 COMPARISON OF THE SALE OF SIMILAR S AND C CORPORATIONS**

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Important differences mark the way in which acquisitions of conduits (S corporations) and C corporations are taxed. Notably, two levels of tax characterize the acquisition of a C corporation and only one in the acquisition of an S corporation. Another difference relates to the tax rates that apply to the asset sale. In the case of a C corporation, the tax rate on the “asset sale” is 35% while, in an S corporation, the tax rate on the asset sale can be as low as 15%.<sup>16</sup> Here, via numerical illustration, we want to highlight these differences. The computations discussed in this section are illustrated in Table 15.5. The facts for this example include the following:

- The two identical corporations are T1 and T2: T1 is a C corporation and T2 is an S corporation.
- The net tax basis of each firm’s assets is \$200 (\$400 historical cost, \$200 accumulated depreciation).
- Neither firm has any liabilities.
- Shareholders of both T1 and T2 are individuals facing the maximum ordinary and capital gains tax rates (40% and 20%) under current U.S. law and have a tax basis in the stock of each corporation of \$200.
- All parties agree that the present value of the after-tax future cash flows of T1 and T2 is \$900 each.
- T1’s ordinary income tax rate is 35% as is its capital gains tax rate.
- All recaptured depreciation is taxed at the ordinary income rate.
- An acquirer wishes to purchase both T1 and T2 and is willing to pay \$900 for each company in a taxable stock acquisition in which the tax basis of the target’s assets carries over.

What price will an acquirer (A) pay to purchase the *assets* of T1 and T2 in a taxable acquisition? Will shareholders accept this price? We first consider the tax consequences of a taxable stock sale.

### **Tax Consequences for T1 and T2 Shareholders in a Taxable Stock Sale**

In each case, shareholders will have a capital gain of \$700 (\$900 purchase price less \$200 stock basis) and will pay tax of \$140 ( $\$700 \times 20\%$ ). After tax, the shareholders of both T1 and T2 will have \$760.

<sup>16</sup>Notice that the tax rate on incremental tax deductions arising from a step-up in the tax basis of the target’s assets (asset sale tax treatment) can be 35% or higher if the acquirer is a C corporation.

**TABLE 15.5** Comparison of Acquisition Prices of S Corporations and C Corporations with Identical Tax Attributes and Cash Flows**Fact Pattern:**

Stock purchase price	\$900.00	$t_c =$	35%
Net tax basis in assets	200.00	$t_o =$	40%
Historical cost	400.00	$t_{cg} =$	20%
Accumulated depreciation	200.00	$r =$	10%
Shareholder's tax basis in target's stock	200.00	$N =$	10
Liabilities of target	0.00		

	<i>S Corporation Acquisition Structure</i>			<i>C Corporation Acquisition Structure</i>		
	<i>Taxable Stock Acquisition without a §338(h)(10) Election</i>	<i>Taxable Stock Acquisition with a §338(h)(10) Election</i>	<i>Taxable Stock Acquisition with a §338(h)(10) Election</i>	<i>Taxable Stock Acquisition without a §338 Election</i>	<i>Taxable Asset Acquisition</i>	<i>Taxable Asset Acquisition</i>
Purchase price	\$900.00			\$900.00		
Seller's indifference price <sup>(1)</sup>		\$950.00			\$1,276.92	
Acquirer's indifference price <sup>(2)</sup>			\$1,091.79			\$1,091.79
<b>Target Corporation:</b>						
Taxable gain <sup>(3)</sup>	\$700.00	\$750.00	\$891.79	\$0.00	\$1,076.92	\$891.79
Tax liability <sup>(4)</sup>	0.00	0.00	0.00	0.00	376.92	312.13
<b>Shareholder Effects:</b>						
Taxable gain <sup>(5)</sup>	\$700.00	\$750.00	\$891.79	700.00	700.00	579.66
Cash received	\$900.00	\$950.00	\$1,091.79	\$900.00	\$900.00	\$779.66
Tax liability <sup>(6)</sup>	140.00	190.00	218.36	140.00	140.00	115.93
After-tax cash	<u>\$760.00</u>	<u>\$760.00</u>	<u>\$873.43</u>	<u>\$760.00</u>	<u>\$760.00</u>	<u>\$663.73</u>
<b>Acquirer After-Tax Cost:</b>						
Gross cost	\$900.00	\$950.00	\$1,091.79	\$900.00	\$1,276.92	\$1,091.79
Less: tax benefits <sup>(7)</sup>	0.00	161.29	191.79	0.00	231.60	191.79
Net after-tax cost	<u>\$900.00</u>	<u>\$788.71</u>	<u>\$900.00</u>	<u>\$900.00</u>	<u>\$1,045.32</u>	<u>\$900.00</u>
<b>Acquirer Tax Basis in the:</b>						
Target's stock	\$900.00	\$950.00	\$1,091.79	\$900.00	n/a	n/a
Target's net assets	\$200.00	\$950.00	\$1,091.79	\$200.00	\$1,276.92	\$1,091.79

<sup>(1)</sup>The purchase price at which the seller is indifferent between making the §338(h)(10) election and not making the election when the purchase price is \$900 (column 1) when the target is an S corporation. When the target is a C corporation, the purchase price at which the seller is indifferent between an asset sale and a taxable stock sale without a §338 election at a price of \$900 (column 4).

<sup>(2)</sup>The purchase price at which the acquirer is indifferent between making the §338(h)(10) election and not making the election when the purchase price is \$900 (column 1) when the target is an S corporation. When the target is a C corporation, the purchase price at which the acquirer is indifferent between an asset sale and a taxable stock sale without a §338 election at a price of \$900 (column 4).

<sup>(3)</sup>Taxable gain at the target corporation level from the stock sale or the deemed sale of the target's assets (S corporation) or the sale of the target's assets (C corporation).

<sup>(4)</sup>Tax liability at the target corporation level on the taxable gain from the stock sale, the deemed asset sale (S corporation) or the asset sale (C corporation).

<sup>(5)</sup>Taxable gain at the target shareholder level. This gain is equivalent to the gain at the target corporation level if the target is an S corporation as the gain passes through to target shareholders. The gain retains its character as it passes through to target shareholders. If the target was a C corporation, this is the gain on the liquidation (redemption of target shares by the target) of the C corporation after the asset sale.

<sup>(6)</sup>Target shareholder tax liabilities are computed based on<sup>(5)</sup> and the nature of the gain to the target's shareholders if the target was an S corporation. If the target was a C corporation, the tax liability is the gain<sup>(5)</sup> multiplied by the capital gains tax rate.

<sup>(7)</sup>The present value of the tax savings resulting from stepping-up the tax basis of the target's assets assuming that the step-up is amortized/depreciated straight-line over a 10-year period, the applicable tax rate is 35% and the after-tax discount rate is 10%.

## Tax Consequences for A Corporation

A will take a basis in the stock of T1 equal to \$900. T1 will become a subsidiary of the acquirer and the net tax basis of T1's assets will be \$200. A will have the same basis in the stock and assets of T2. T2 will also become a subsidiary of A.

### Indifference Point for T1's Shareholders (C Corporation) with an Asset Sale Structure

T1's shareholders will be indifferent between a stock sale at \$900 and an asset sale when they have \$760 after-tax from the asset sale. We can compute the purchase price they will demand as follows using Equation (14.6) from Chapter 14.<sup>17</sup>

$$\begin{aligned}\text{Price}_{\text{asset}} &= (\text{Price}_{\text{stock}} - \text{Asset} \times t_c) / (1 - t_c) \\ \text{Price}_{\text{asset}} &= (\$900 - 200 \times t_c) / (1 - t_c) \\ \text{Price}_{\text{asset}} &= \$1,276.92\end{aligned}\quad (14.6)$$

### Indifference Price for T2's Shareholders (S Corporation) with an Asset Sale Structure

T2's shareholders will be indifferent between a stock sale at \$900 and an asset sale (stock sale with a Section 338(h)(10) election) when they have \$760 after tax under the asset sale structure. We can compute the purchase price they will demand as follows using equation (15.3).<sup>18</sup> The second column of Table 15.5 presents this computation.

$$\begin{aligned}\text{Price}_{338h10} &= \text{Price}_{\text{no338h10}} + [\text{Stock}(t_{cg}) - \text{HCasset}(t_{cg}) + \text{Accum}(t_{oi})] / (1 - t_{cg}) \\ &= \$900 + [200(t_{cg}) - 400(t_{cg}) + 200(t_{oi})] / (1 - t_{cg}) \\ &= \$950\end{aligned}$$

<sup>17</sup>Alternatively, we can use a more general approach such as:

$$\begin{aligned}\text{ATAX}_{\text{shareholder}} &= \text{Liquidation proceeds} - \text{Tax basis} \\ \$760 &= \text{Liquidation proceeds} - [(\text{Liquidation proceeds} - \$200)20\%] \\ \$760 &= \text{Liquidation proceeds} - 20\% \text{ Liquidation proceeds} + \$40 \\ \$720 &= 80\% \text{ Liquidation proceeds} \\ \text{Liquidation proceeds} &= \$900 \\ \text{Liquidation proceeds} &= \text{Price} - \text{Tax} \\ \$900 &= \text{Price} - [(\text{Price} - \$400) \times 35\% + (\$200 \times 35\%)] \\ \$900 &= .65 \text{ Price} + \$70 \\ \text{Price} &= \$1,276.92\end{aligned}$$

<sup>18</sup>Alternatively, we can use a more general approach such as:

$$\begin{aligned}\text{ATAX} &= \text{Price} - \text{Tax} \\ \text{ATAX} &= \text{Price} - (\text{Price} - \text{Basis}) \times \text{Tax rate} \\ \text{ATAX} &= \text{Price} - [(\text{Price} - \text{Historical cost}) \times \text{Capital gains tax rate} \\ &\quad + (\text{Accumulated depreciation}) \times \text{Ordinary income tax rate}] \\ \$760 &= \text{Price} - [(\text{Price} - \$400) \times 20\% + (200 \times 40\%)] \\ \$760 &= \text{Price} - 20\% \text{ Price} + \$80 - \$80 \\ \$760 &= 80\% \text{ Price} \\ \text{Price} &= \$950\end{aligned}$$

### **Will the Acquirer Pay T1's (C Corporation) Indifference Price in a Taxable Asset Sale?**

In a taxable asset sale, A will obtain a step-up in the basis of the target's assets. We already computed that T1's shareholders will not agree to a taxable asset sale structure unless A pays them at least \$1,276.93. Is A willing to pay that price to obtain a step-up in T1's assets?

If A pays \$1,276.93 in a taxable asset acquisition, it will take a basis in T1's assets of \$1,276.93. This step-up in basis is equal to \$1,076.93 (\$1,276.93 less \$200 net tax basis in T1's assets preacquisition). Assuming that the step-up in basis is amortized straight-line over 10 years, that the appropriate tax rate is 35%, and that the after-tax discount rate is 10%, the present value of tax savings from the step-up is \$231.60. A's net after-tax cost is therefore \$1,045.43, which is more than A's net after-tax cost in a taxable stock acquisition (\$900).

Alternatively, as the sixth column of Table 15.5 indicates, the maximum price that the acquirer will pay in a taxable asset sale is \$1,091.79, which is computed using Equation (14.9) from Chapter 14. At that price, T1's shareholders receive \$663.73 after tax, which is less than they receive in the taxable stock acquisition case at a price of \$900. T1's shareholders would therefore not accept a taxable asset sale at \$1,091.79. Therefore, a step-up in T1's assets is not optimal. This result is the same as obtained in Section 14.2 of Chapter 14. Notice here that the incremental cost of the step-up to A is \$376.93 (\$1,276.93 less \$900 price with no step-up) and the incremental tax benefits from the step-up are \$231.60.

### **Will the Acquirer Pay T2's (S Corporation) Indifference Price in a Taxable Asset Sale (Stock Sale with a Section 338(h)(10) Election)?**

We already computed that T2's shareholders will not agree to a taxable asset sale structure—a stock sale with a Section 338(h)(10) election—unless A pays them at least \$950. Is A willing to pay that price to obtain a step-up in T2's assets?

If A pays \$950 in a taxable asset acquisition, it will take a basis in T2's assets of \$950. This step-up in basis is equal to \$750 (\$950 less \$200 net tax basis in T2's assets preacquisition). Assuming that the step-up in basis is amortized straight-line over 10 years, that the appropriate tax rate is 35%, and that the after-tax discount rate is 10%, the present value of tax savings from the step-up is \$161.29. A's net after-tax cost is therefore \$788.71 (see the second column of Table 15.5), which is less than A's net after-tax cost in a taxable stock acquisition (\$900). So A will (gladly) pay \$950 in a taxable stock acquisition followed by a Section 338(h)(10) election.

Continuing with the example, A will pay T2 more than \$950 in a taxable asset acquisition. A will pay a pretax price that leaves its after-tax cost equal to \$900. Specifically as illustrated in the third column of Table 15.5, A will pay up to \$1,091.79 pretax in a transaction that is taxed as an asset acquisition and still be as well off as when it pays \$900 in a taxable stock sale.<sup>19</sup> At a price of \$1,091.79, and a taxable asset sale structure, T2's shareholders would have \$873.43 after tax, which is \$113.43 more after tax than in a taxable stock sale at \$900. It is important to notice that S corporation

<sup>19</sup>We can compute this amount using equation (15.5).

shareholders are able to obtain \$113.43 (about 15%) more after tax than their counterparts who sold the C corporation (T1).<sup>20</sup> Again, any price between \$950 and \$1,091.79 with a taxable asset sale type structure in an S corporation acquisition leaves both the acquirer and seller better off, and any price within that range provides a split of the tax benefits from the asset sale structure.

The point of these numerical exercises is simple but important. An S corporation can often be sold for a higher price pretax than a similar C corporation because the sale of an S corporation can be structured in a manner that results in a step-up in the tax basis of the target's assets in a cost-effective manner. That is, acquirers are willing to pay S corporation target shareholders for the tax benefits associated with the step-up. The same is not true of sales of C corporations. Acquirers of C corporations are not willing to incur the incremental costs of stepping up the tax basis of the target's assets. For tax planners who are selecting an organizational form for a new or reorganized business entity, conduits such as S corporations provide significant tax benefits relative to C corporations if and when the entire entity is sold to an acquirer, as illustrated in this section and in Table 15.5.<sup>21</sup>

## Valuation Consequences and Issues

As we have seen in Section 15.1, the price at which a conduit entity (S corporation) is sold is a function of the tax structure of the transaction (e.g., taxable stock sale with and without a Section 338(h)(10) election). In Section 15.2, we demonstrated that comparable S and C corporations could sell for different prices due to tax differences that spring from organizational form. Specifically, the sale of an S corporation often includes a premium that is associated with incremental tax benefits from stepping up the S corporation's assets.

When evaluating a potential target corporation, or when contemplating the sale of a business, we often derive an estimate of the value of the subject company from comparable acquisitions. Similarly, the reasonableness of a purchase or sale price is often evaluated relative to comparable transactions. It is common to use various valuation benchmarks including multiples such as acquisition price to earnings or cash flows. Readers performing a so-called comparables analysis should be aware of the effect of organizational form and acquisition tax structure on acquisition prices as illustrated in Sections 15.1 and 15.2.

## Installment Sale Tax Treatment

In many instances, buyers of privately held S corporations want to pay with installment debt, and S corporation shareholders are willing to accept installment debt because installment sale tax treatment can provide significant benefits to selling shareholders. As shown in this chapter, a taxable asset acquisition structure or a taxable stock sale with a Section 338(h)(10) election is usually the optimal tax structure in the purchase of an S corporation. Because installment sale tax treatment is possible in asset sale transactions or in a stock sale followed by a Section 338(h)(10) election, selling S corporation shareholders may defer reporting gain from the transaction until future installment payments are received.

<sup>20</sup>Compare the third and fourth columns of Table 15.5.

<sup>21</sup>The same basic principles apply to the sale of other types of conduit entities such as partnerships and LLCs with, of course, additional complicating factors.

### Summary of Key Points

1. Acquisitions occur across a number of transactional forms. These alternative forms yield varying tax consequences to the target company, to the purchasing company, and to the shareholders of the target company.
2. In the sale of a freestanding C corporation, a structure that results in a step-up in the target's assets is usually suboptimal from a tax perspective because the incremental tax cost associated with the step-up usually exceeds the incremental tax benefits. The notable exception to this general rule occurs when the target has substantial NOLs, which can be used to reduce the incremental cost of the step-up.
3. In the sale of a conduit entity, such as an S corporation, it often makes sense to structure the acquisition in a manner that steps up the tax basis of the target's assets because the incremental cost of stepping up the basis of the target S corporation's assets is usually less than the tax savings associated with the step-up. Sales of conduits (S corporations) are quite different from acquisitions of C corporations in this respect.
4. A taxable stock sale of an S corporation can be taxed as an asset sale if the buyer and seller (target corporation shareholders) agree to make a Section 338(h)(10) election.
5. Tax planners who are considering organizational forms for a new entity should consider the differences in the taxation of acquisitions of conduits relative to the taxation of C corporations. Specifically, if planners anticipate a sale of the entire entity rather than an IPO, for example, a conduit can be sold for a higher pretax price than a C corporation, everything else being equal. As a result, the conduit entity may be the wealth-maximizing organization form, holding other factors constant.

### Discussion Questions

1. What are the main tax considerations to a purchaser in the sale of a target's stock when the target is an S corporation?
2. What are the disadvantages of effecting a change in the basis of all the target's assets either by their sale or by a stock purchase along with a Section 338(h)(10) election to treat the stock purchase as a purchase of all the firm's assets?
3. What types of acquisitions of S corporations generate tax-deductible goodwill? How many acquisitions of S corporations, as a general rule, give rise to tax-deductible goodwill?
4. Why does the taxable acquisition of an S corporation give rise to incremental tax benefits from stepping up the target's assets while the acquisition of a freestanding C corporation does not?
5. If you were advising the founders of a new Internet-based business, what would you tell them about the benefits of using a conduit organizational form to operate their business?

### Tax Planning Problems

1. Hurricane, Inc., is an S corporation. Orleans, Inc., wants to acquire Hurricane for cash. Hurricane's shareholders have a tax basis in their stock of \$3,000 and Hurricane has assets with a net tax basis of \$3,000 (cost = \$4,500, accumulated depreciation = \$1,500). Hurricane has no liabilities. Assume that the transaction can be structured one of two ways:

*Option 1:* As a taxable stock acquisition without a Section 338(h)(10) election

*Option 2:* As a taxable stock acquisition with a Section 338(h)(10) election

Further assume that Orleans is willing to pay \$5,000 to acquire Hurricane under either structure, and that all depreciation claimed to date must be recaptured to the extent of the purchase price. Assume that all recaptured depreciation is taxed at the highest ordinary income rate and that no additional taxes will apply in an asset sale due to Tax Code restrictions relating to S corporations.

- a. How much cash after tax will Hurricane's shareholders have under Option 1? Assume the tax rate appropriate for capital gains is 20% and for ordinary income is 40%.
  - b. How much cash after tax will Hurricane's shareholders have under Option 2? Assume the tax rate appropriate for capital gains is 20% and for ordinary income is 40%.
  - c. Assume that Orleans is willing to pay \$5,000 using Option 1. At what purchase price when employing Option 2 are Hurricane's shareholders indifferent between the two transaction structures?
  - d. What is the maximum price that Orleans will pay under Option 2 assuming that Orleans will pay \$5,000 under Option 1? Assume that any step-up amount is depreciated/amortized over 10 years using the straight-line method, that the marginal tax rate for Orleans is 35%, and that the after-tax discount rate is 10%.
  - e. Should the Section 338(h)(10) election be made? Why or why not?
  - f. If the answer to part (e) was yes, how much better off are Orleans and Hurricane at the midpoint price between the amounts you computed in parts (c) and (d), if the election is made, relative to no election at a price of \$5,000?
2. Cambridge, Inc., is an S corporation. Courtesan, Inc., wants to acquire Cambridge for cash. Cambridge's shareholders have a tax basis in their stock of \$5,000 (they have held the stock for 5 years), and Cambridge has assets with a net tax basis of \$5,000 (cost = \$7,500, accumulated depreciation = \$2,500). Cambridge has no liabilities. Assume that the transaction can be structured one of two ways:

*Option 1:* As a taxable stock acquisition without a Section 338(h)(10) election, or

*Option 2:* As a taxable stock acquisition with a Section 338(h)(10) election (Recall that this election results in the transaction being taxed as an asset sale.)

Further assume that Courtesan is willing to pay \$12,500 to acquire Cambridge under either structure, and that all depreciation claimed to date must be recaptured to the extent of the purchase price. Assume that no additional taxes will apply in an asset sale due to Tax Code restrictions relating to S corporations.

- a. How much cash after tax will Cambridge's shareholders have under Option 1? Assume the tax rate appropriate for capital gains is 20% and for ordinary income is 40%.
- b. How much cash after tax will Cambridge's shareholders have under Option 2? Assume the tax rate appropriate for capital gains is 20% and for ordinary income is 40%.
- c. Assume that Courtesan is willing to pay \$12,500 using Option 1. At what purchase price P when employing Option 2 are Cambridge's shareholders indifferent between the two transaction options?
- d. Given the purchase price you computed in part (c), which structure is optimal from Courtesan's perspective [Option 1 at a purchase price of \$12,500, or Option 2 at a price P computed in part (c)]? Assume that any step-up amount is depreciated/amortized over 10 years using the straight-line method, the marginal tax rate for Courtesan is 35%, and the after-tax discount rate is 12%.
- e. What is the maximum price that Courtesan will pay under Option 2 assuming that Courtesan will pay \$12,500 under Option 1? Assume that any step-up amount is depreciated/amortized over 10 years using the straight-line method, the marginal tax rate for Orleans is 35%, and the after-tax discount rate is 12%.

- f. Should the Section 338(h)(10) election be made? Why or why not?
  - g. Assume that you are an advisor to Cambridge's shareholders and that they agreed to pay you 30% of any after-tax increase in their wealth associated with your advice on this transaction. Could you increase their after-tax wealth beyond what they receive under Option 1? If yes, explain briefly how (20 words will do). If yes, how much could you increase their wealth after tax approximately (before your 30% fee) if Cambridge persuaded Courtesan to pay the maximum price computed in part (e)? How much would you stand to make if they listened to you? Use the assumptions in part (e) if necessary.
3. The following facts relate to the purchase of an S corporation and a C corporation. These two corporations have identical tax bases and are similar in every respect except for their organizational form. The acquirer is willing to pay \$10,000 to purchase the stock of each corporation.

***Fact Pattern:***

Stock purchase price	\$10,000.00
Net tax basis in assets	500.00
Historical cost of assets	2,000.00
Accumulated depreciation	1,500.00
Shareholder's tax basis in target's stock	500.00
Liabilities of target	0.00
$t_c =$	35%
$t_o =$	40%
$t_{cg} =$	20%
$r =$	10%
$n =$	10

- a. What is the maximum price that an acquirer will pay to acquire the target C corporation in taxable asset sale given that it will pay \$10,000 in a taxable stock acquisition?
  - b. What is the maximum price that an acquirer will pay to acquire the target S corporation in taxable stock sale followed by a Section 338(h)(10) election given that it will pay \$10,000 in a taxable stock acquisition without the election?
  - c. What is the minimum price that the target's shareholders will accept under part (a)?
  - d. What is the minimum price that the target's shareholders will accept under part (b)?
  - e. Given your answer to parts (a) and (c), should a taxable asset sale structure be employed in the sale of the C corporation?
  - f. Given your answers to parts (b) and (d), should the Section 338(h)(10) election be made in the sale of the S corporation?
  - g. How much more cash after tax can shareholders of the S corporations get, relative to shareholders of the C corporation, assuming the acquirer pays the maximum price that it will pay in a Section 338(h)(10) transaction? Note that the C corporation is sold in a taxable stock sale at \$10,000 and the S corporation is sold for the price you computed in part (b).
4. Assume that you are performing a comparable company analysis for a pending acquisition. You are advising the target company and the target company is a privately held S corporation. The comparable company acquisitions, for which you have data, are exclusively taxable acquisitions of freestanding C corporations.



Your assistant has computed the following common valuation benchmarks for the comparable company acquisitions.

	<i>Mean</i>	<i>Median</i>
Price to revenues	.82	.76
Price to book value	2.21	2.07
Price to earnings	23.4	18.6
Price to EBITDA	9.58	7.13

Further assume that the target company is considered similar to the comparable companies in terms of revenue and profitability prospects—that is, the target company is about the same as the comparables in terms of operations.

Would you recommend any adjustments to the comparable company analyses or would you tell your client to accept an acquirer's offer that is equal to the average price to EBITDA of the comparable company acquisitions?

## References and Additional Readings

### Cases:

Erickson, M., 2003. "The Effect of Entity Organizational Form on the Structure of, and Price Paid in, the Hi-Stat Acquisition," in

*Cases In Tax Strategy 3rd edition* edited by M. Erickson. Upper Saddle River, NJ: Pearson Prentice Hall.

See list at the end of Chapter 13.

5. It was announced today that Florida, Inc., will acquire Menlo Park, Inc. Menlo Park has assets with a gross tax basis of \$6 million and has \$1.5 million of liabilities. Prior to being acquired, Menlo Park had no goodwill on its tax books, although it had approximately \$2 million of goodwill on its financial statements. Menlo Park's identifiable assets, which include intangible assets other than goodwill, are estimated by Florida to have a fair market value of \$22 million, and its liabilities have a fair market value of \$1.5 million.

Menlo Park has two primary classes of shareholders. The first consists of taxable investors, who own 1,200 of Menlo Park's outstanding shares with an aggregate basis of \$10 million. For simplicity, assume these stockholders have all held Menlo Park stock more than 12 months and all purchased the stock at the same price. The second consists of various nontaxable entities such as pension funds and certain foreign investors that own the remaining 800 outstanding Menlo Park shares. These stockholders have an aggregate basis of \$1 million.

Neither Florida nor Menlo Park has any net operating loss carryovers, and both face a 35% tax rate. Assume any boot is taxable at capital gains rates of 20%.

Florida gives voting common stock in itself in exchange for all of the outstanding stock of Menlo Park, a Section 368 "B" structure. Menlo Park becomes a wholly owned subsidiary of Florida. At the time of the exchange, the Florida stock given has a market value of \$20 million.

- a. What tax basis will Florida take in the stock of Menlo Park acquired?
- b. What tax basis will Menlo Park and Florida through its ownership of Menlo Park have in its net assets following the acquisition?

Instead, assume Florida gives voting stock in itself of \$16 million and \$5 million in cash, and Menlo Park is merged under state law into a newly created, wholly owned acquisition subsidiary of Florida, called Biscayne, Inc., which is a triangular 368 "A" structure.

- c. Assume that the cash and stock portions of the purchase price are prorated so that each Menlo Park shareholder gets a package of cash and Florida stock. That is, every share of Menlo Park stock is exchanged for \$2,500 cash and \$8,000 of Florida stock (\$10,500 of consideration per share of stock multiplied by 2,000 shares outstanding is \$21 million). How much tax will Menlo Park's shareholders pay in aggregate at the time of the sale?
  - d. What tax basis will Florida's Biscayne subsidiary have in the net assets of Menlo Park?
  - e. How much tax-deductible goodwill will Florida/Menlo Park have postacquisition?
6. Assume the following factors in assessing the sensitivity of the optimal acquisition structure when the target has NOLs:
- The target corporation (a freestanding C corporation) has NOLs of \$16,500.
  - The net basis in the target's assets is \$1,800.
  - The cash price that an acquirer is willing to pay for the stock of the target is \$19,275.
  - Target shareholders have a basis in the stock of the target of \$4,000.
  - The corporate tax rate is 35%.
  - The shareholder capital gains tax rate is 20%.
  - The after-tax discount rate is 7%.
  - Any step-up in the tax basis of the target's assets is amortized over 15 years on a straight-line basis.
  - The appropriate long-term tax-exempt rate applicable to target NOLs under Section 382 is 5%. The target's NOLs will expire in 12 years.

- a. Should the acquirer make a Section 338 election and use the target's NOLs to offset any gain on the step-up, or should it forego the election and preserve the target's NOLs?
- b. Now instead assume that the after-tax discount rate is 9%. What structure—to make or forego the Section 338 election—do you recommend?
- c. Starting with the part (a) assumptions, assume instead that the target's NOLs expire in 17 years and the after-tax discount rate is 7%. What structure—to make or forego the Section 338 election—do you recommend?
- d. Starting with the part (a) assumptions, assume instead that the step-up in the tax basis of the target's assets is amortized over 20 years and the after-tax discount rate is 11%. What structure—to make or forego the Section 338 election—do you recommend?

## References and Additional Readings

### Cases:

Erickson, M., 2003. "Comparing the Proposed Acquisitions of MCI by British Telecom, GTE and WorldCom," in *Cases In Tax Strategy*, edited by M. Erickson. Upper Saddle River, NJ: Pearson Prentice Hall.

Robinson, J. 2003. "Barry Diller and Vivendi's Mixing Bowl Partnership," in *Cases In Tax Strategy*, edited by M. Erickson. Upper Saddle River, NJ: Pearson Prentice Hall.  
See list at the end of Chapter 13.