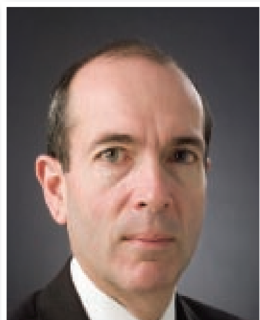
Avoid Tax Traps When Structuring an S Corporation Acquisition



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Stock Purchase vs. Asset Purchase.

Parties often desire to structure the acquisition of an S corporation target as a stock purchase. One advantage of a stock purchase is that all known and unknown liabilities of the target stay with the corporation unless otherwise allocated by contract. Another advantage of a stock purchase is that it usually avoids the need to get consent from third parties to transfer key contracts (as would normally be required in an asset purchase).

For tax purposes, the acquirer typically desires the tax basis step-up benefit that it would obtain in an asset purchase. An election under Internal Revenue Code section 338(h)(10) provides the acquirer the benefit of asset purchase treatment for tax purposes, even though the transaction takes the form of a stock purchase for legal purposes. This article addresses several "tax traps" in making an effective 338(h)(10) election.

Section 338(h)(10) Election.

In a transaction involving a stock purchase of an S corporation, for tax purposes, the parties often agree to make an election under Code section 338(h)(10). A "338(h)(10) election" treats a stock purchase as an asset purchase for tax purposes. As a result of the election, the acquirer receives the benefit of a tax basis "step-up" in each asset held by the target. The new tax basis is equal to the asset's fair market value at the time of the transaction. Both tangible assets and intangible assets, such as goodwill and going concern value of the target, are eligible for the tax basis step-up.

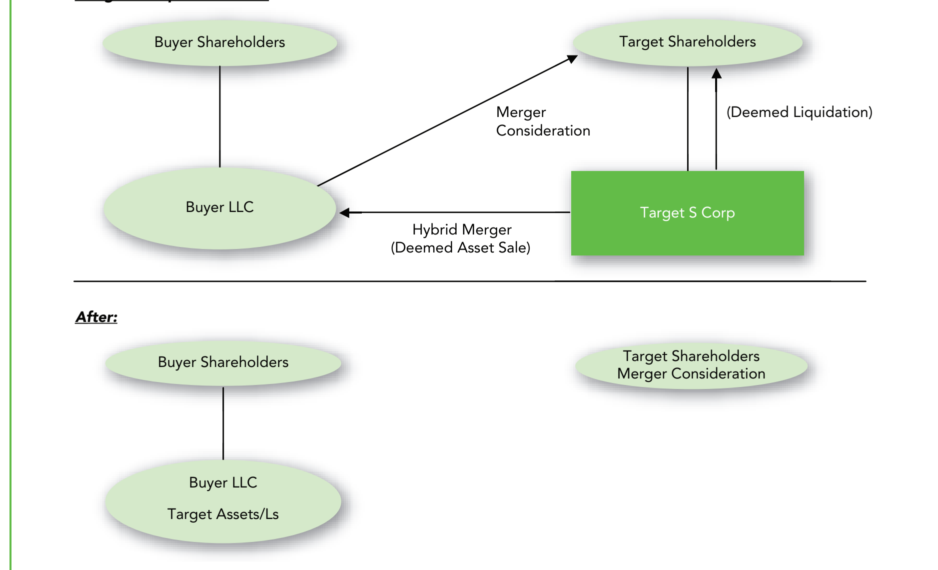
In order for the acquisition of an S corporation target to qualify for a 338(h)(10) election, the acquirer:

(1) must be a corporation for tax purposes;

(2) must acquire 80% of the target's voting power and 80% of the target's equity value; and

(3) must be treated as acquiring the amount of stock described in (2) by "purchase."

The target's shareholders often incur additional taxes as a result of making a 338(h)(10) election. However, the tax benefit to the acquirer is usually sufficient to justify a tax gross-up payment to the target's shareholders to induce them to agree to the election.



Tax Trap #1: Ineligible Acquirer.

Problem. As noted above, the acquirer must be a corporation in order for the transaction to qualify for a 338(h)(10) election. In some cases, an investment group comprising common and preferred investors will form an investment entity to acquire the target's stock. These investors will often want the investment entity to be a pass-through entity for tax purposes, so that future operating and liquidation profits will be subject to only one level of tax, rather than two.

This presents a tax problem. The investment entity will not qualify as an S corporation due to the existence of preferred investors. An S corporation may not issue preferred stock without losing its S election.

In order to issue preferred equity and obtain pass-through treatment for tax purposes, the investment entity should be a limited liability company taxed as a partnership, which facilitates both common and preferred equity and provides flow-through tax treatment. However, an LLC taxed as a partnership is not eligible to make a 338(h)(10) election.

Solution. Many states' statutes now allow a corporation to merge into an LLC, and vice versa. The parties could agree to merge the target S corporation into a new LLC to be formed by the investment group. For tax purposes, the merger is treated as an asset sale followed by a liquidation of the target corporation, which produces the same income tax results that a 338(h)(10) election would have produced.

If the target is a party to contracts that would require a third party's consent as a result of the merger, the parties could utilize a slightly more complicated acquisition structure that produces the desired tax results. Under the alternative structure, the target's shareholders would reorganize the S corporation prior to the acquisition by: (1) transferring the target's stock to a newly formed S corporation holding company; (2) making a QSUB tax election for the target; (3) converting the target from a corporation into an LLC; and (4) causing the S corporation holding company to sell the target LLC's units to the investors' acquiring LLC.

NOTE: The conversion from a corporation to an LLC may require contract approval, depending on the terms of the contract.

Tax Trap #2: Tax-Free Management Rollover.

Problem. Often, several key executives at the target company will be asked to (and/or will desire to) convert a portion of their shares into acquirer shares in the transaction. If management holds shares that account for more than 20% of the target's voting rights or equity value, the transaction may not qualify for a 338(h)(10) election because the IRS could argue that the target executives' stock will not be acquired by "purchase" for tax purposes. Rather, management of the target company would be treated as participating in a partially tax-free contribution of property, contributing property (their shares) to the acquirer in exchange for a mix of acquirer shares and cash. This type of contribution is not treated as a "purchase" for tax purposes.

Solution. The acquirer's parent corporation can form a subsidiary corporation to acquire the target company shares in exchange for the cash portion of the transaction consideration. Target management can transfer the rollover shares to the acquirer parent in exchange for the acquirer parent stock prior to the cash sale. If the acquirer subsidiary acquires 80% of the target company's shares measured by vote or value for cash, the transaction should qualify for a 338(h)(10) election without violating the "purchase" requirement.

Tax Trap #3: Anti-Churning Rules.

Problem. Internal Revenue Code section 197 provides that certain intangible assets may be amortized over a 15-year period. Eligible intangible assets include acquired goodwill and going concern value. Thus, amounts allocated to the target's goodwill and going concern value as the result of a 338(h)(10) election are generally eligible for amortization over a 15-year period after the transaction.

However, a special "anti-churning" rule, denies amortization deductions for acquired goodwill and going concern value held between July 25, 1991, and Aug. 10, 1993, in certain situations. The anti-churning rule can apply if a group of shareholders collectively owns more than 20% of both the target's stock and the acquirer's stock, and the target conducted business operations prior to Aug. 10, 1993. The anti-churning rules often threaten to deny amortization when management of the target company with a greater than 20% interest roll over their equity into the acquirer and cross the 20% threshold in the acquirer.

Solution. The parties could agree to limit target management's acquirer equity to 20% and provide target management with phantom stock rights. Phantom stock rights, which typically provide bonus payments in the event of a future change in control transaction or separation of service, constitute contract rights and should not be included in determining whether management's equity exceeds 20% after the transaction. Of course, the phantom stock rights must constitute reasonable compensation for services to be rendered to the acquirer after the transaction. Management of the target company may request an additional cash bonus due to the fact that the bonus payment will be taxed at ordinary tax rates, rather than capital gain rates.

Conclusion. When the parties to an S corporation stock purchase make a Code section 338(h)(10) election, they can combine the tax benefits of an asset purchase with the legal and contract benefits of a stock purchase. However, there are several tax traps that can prevent the transaction from qualifying for the special tax benefits. With proper planning, the parties can avoid these traps and a post-closing confrontation with the Internal Revenue Service.