With improving corporate confidence, increasing political certainty, and strengthened balance sheets, conditions appear to be ripe for increased merger and acquisition (M&A) activity in 2013. After a few years of stockpiling cash to guard against economic challenges, some executives are starting to loosen their purse strings and consider strategic investments, including acquisitions, which can help them achieve their growth objectives. As a result, this could be an opportune time for S corporation owners who are contemplating selling their businesses. However, the timing and tax structure of the sale transaction could significantly influence the value derived by owners and other shareholders of the company.

Another important change authorized by the 2012 tax act is an extension of the reduced built-in gains recognition period from 10 years for certain sales during calendar years 2012 and 2013. Absent any additional tax law changes, the recognition period for built-in gains tax will revert back to 10 years after 2013, which may make it more advantageous, from a tax perspective, to complete the sale of an S corporation before December 31, 2013. Several S corporation disposition alternatives are available that shareholders should consider when planning for the sale of the S corporation. Alternatives include a “deemed asset sale” — technically known as a section 338(h)(10) election — the sale of personal goodwill, a “direct asset” transaction, and a “direct stock transaction without a section 338(h)(10) election.”

Which transaction is in a shareholder’s best interest? Are all shareholders treated the same? What are possible deadlines for executing transactions? And what are the potential consequences of waiting too long?

S corporation owners should carefully evaluate these options to understand their potential impact on the economics of the transaction, tax results, and their individual financial objectives. Critical to this effort is the ability to compare the various options available so that the potential tax impacts and other implications can be analyzed.

1 Unless otherwise indicated, all “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Treas. Reg §” references are to the Treasury Regulations promulgated under the Code, all as in effect on the date of this publication.
Benefits and risks of a section 338(h)(10) election

The U.S. Tax Code allows buyers and sellers of the stock of an S corporation to make a section 338(h)(10) election so that a qualified stock purchase will be treated as a deemed asset purchase for federal income tax purposes. A section 338(h)(10) election is a joint election that requires agreement between and among all of the selling shareholders and the prospective buyer. As a result of this election, a stock sale, for legal purposes will be treated as an asset sale for tax purposes, resulting in different tax consequences for both the buyer and seller. Selling shareholders need to understand these tax consequences. Importantly, a section 338(h)(10) election will adjust the tax basis of the S corporation’s assets in the hands of the buyer to fair market value. As a result, the buyer may enjoy incremental tax benefits, including amortization and depreciation of the assets’ purchase price for federal income tax purposes, along with resulting future tax deductions — for the amount paid — over the tax life of the acquired assets.

The deemed asset sale treatment may have negative tax consequences that selling shareholders need to consider. By agreeing to make a section 338(h)(10) election, selling shareholders may subject themselves to various federal and state taxes that a straight stock sale — one without a section 338(h)(10) election — would not generate.

- Some of the gains from a deemed asset sale may be taxed at ordinary rates. For example, purchase price allocated to fixed assets may result in ordinary gain due to depreciation recapture and gains associated with the difference between the fair market value of inventory and the tax basis may also be taxed at ordinary rates. On the other hand, assumption of certain liabilities might result in additional ordinary deductions to the S corporation today that were disallowed in prior years under the economic substance rules. It is important for selling shareholders to understand these tax implications, both for themselves and the buyer, before agreeing to make the election.

- A straight stock sale may result in no state income taxes owed if the selling shareholders reside in states without an income tax, whereas a deemed asset sale may result in state taxes owed in the states where the S corporation operates.

Selling shareholders will want to understand both the costs associated with making a section 338(h)(10) election and the tax benefits in the hands of the buyer. It is possible that the tax benefits may substantially outweigh the costs. As a result, buyers may be willing to reimburse selling shareholders for any incremental costs incurred. Sellers who understand the potential benefits resulting from the step-up transaction may also be in a position to negotiate a higher purchase price by clearly articulating those benefits to potential buyers.

Early planning is another important consideration. S corporation shareholders should begin to weigh the benefits and risks of a section 338(h)(10) election at the earliest possible stages of a transaction, in most cases before a letter of intent is signed with a prospective buyer. The letter of intent often contains specific terms that address the transaction structure. Both sellers and the prospective buyer can save time, money, and resources by making an informed decision regarding the section 338(h)(10) election before the letter of intent is signed.

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2 Generally the acquisition of 80% or more of the stock of a corporation in a 12-month period.
Alternatives to a deemed asset sale

With so many complex issues to consider, a section 338(h)(10) election can be a complex transaction that may not be appropriate for all S corporation sellers or buyers. For deal participants that are not positioned to make the section 338(h)(10) election — or simply prefer not to — other options include:

- The sale of personal goodwill allows the buyer(s) of the S corporation to receive tax benefits without negatively impacting the seller’s tax position. In this type of transaction, the portion of an S corporation’s asset value that can be attributed to the “personal goodwill” of the company’s owners or executives is allocated and segregated from the total asset value. The proceeds of that goodwill are reported as a gain to the shareholder to whom the goodwill relates and are treated as long-term capital gains. For S corporations with built-in gains, shifting purchase price to a shareholder’s personal goodwill may limit the double taxation that results from the built-in gains tax. The buyer benefits because it can deduct the purchase price associated with personal goodwill over 15 years. Again, many factors influence whether or not personal goodwill actually exists and how much asset value can be allocated to a selling shareholder’s personal goodwill, so it helps the shareholders of the S Corporation to compare various scenarios and understand the potential consequences of the transaction.

- A direct asset transaction involves the transfer of the S corporation’s assets to the buyer. From a tax perspective, this type of transaction is usually more advantageous for the buyer than the seller because, similar to a section 338(h)(10) transaction, the buyer will receive a step-up in the tax basis of the acquired assets, but unlike a section 338(h)(10) transaction, historical income tax risks associated with the business, including built-in gains taxes, will remain with the selling shareholders. As such, it is important for the seller to understand all the implications of the transaction (see “Scenario analysis — the foundation of an informed decision”) and use that knowledge to negotiate either favorable terms or an alternate approach to the deal. Straight asset purchases, however, may be complicated by non-tax factors, such as the need to obtain consent to transfer certain assets — for example, contracts. These non-tax factors need to be evaluated in connection with the tax objectives of the parties.

- A stock transaction without a section 338(h)(10) election may be an appropriate alternative when the costs associated with a deemed asset sale clearly outweigh the tax benefits associated with a step-up transaction. It will be important for buyers and sellers to understand the potential costs and benefits — or lack thereof — of a straight stock transaction.

- A direct asset transaction involves the transfer of the S corporation’s assets to the buyer. From a tax perspective, this type of transaction is usually more advantageous for the buyer than the seller because, similar to a section 338(h)(10) transaction, the buyer will receive a step-up in the tax basis of the acquired assets, but unlike a section 338(h)(10) transaction, historical income tax risks associated with the business, including built-in gains taxes, will remain with the selling shareholders. As such, it is important for the seller to understand all the implications of the transaction (see “Scenario analysis — the foundation of an informed decision”) and use that knowledge to negotiate either favorable terms or an alternate approach to the deal. Straight asset purchases, however, may be complicated by non-tax factors, such as the need to obtain consent to transfer certain assets — for example, contracts. These non-tax factors need to be evaluated in connection with the tax objectives of the parties.

- The transactions noted above, including a stock sale with a section 338(h)(10) election, can also be completed pursuant to installment sale rules. An installment sale involves disposition of property at a gain, where at least one payment is to be received after the tax year in which the sale occurs. This option, under section 453, offers the advantage to the seller of receiving payments over time and only including in income each year the part of the gain received that year. There are many details associated with this type of transaction that should be considered, including rules for how to treat losses, inventory, securities, and interest on the installment amounts. In light of the potential tax rate changes referenced above, selling shareholders should consider whether installment sale treatment makes sense for their transaction.
Scenario analysis — the foundation of an informed decision

Scenario analysis is essential to helping S corporation owners and shareholders make informed decisions about which type of disposition structure provides the greater value. An effective scenario analysis clearly outlines the costs and benefits of each approach and provides insights into the potential consequences of the decision based on a variety of factors, including:

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<tr>
<th>Built-in gains tax</th>
<th>State taxes</th>
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<td>Owners of an S corporation need to consider in advance the impact of built-in gains tax associated with their transaction. Built-in gains are amounts of unrecognized appreciation that existed when the S election was first made that are subject to corporate-level taxation. Among the issues associated with built-in gains are:</td>
<td>Where the shareholders of an S corporation live and where the company has operations can significantly impact state taxes consequences for both the company and its shareholders. For example:</td>
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<tr>
<td>• A company’s built-in gain may not be static over time, so planning opportunities may be missed if this calculation isn’t considered.</td>
<td>• Whether the state in which a shareholder lives has an income tax — for instance, Florida, Nevada, or Texas do not — can impact the decision of how to structure the deal, especially if the corporation itself has operations in other states.</td>
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<tr>
<td>• It is important to understand and apply proper accounting and valuation principles to document the effects of changes to the built-in gains tax law and to calculate the amount of the tax. If a company does not have a built-in gain calculation from the date of the S election, this analysis may require the use of financial information available as of the date of the election and market trends to estimate the amount of the company’s existing built-in gain.</td>
<td>• Certain states also have entity-level taxes for S corporations. In such states, the decision about whether to undertake a stock or asset sale can significantly impact capital gains taxes paid by the S corporation, both at the federal and state level.</td>
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<td>• The American Taxpayer Relief Act of 2012 lowered the recognition period for S corporations from 10 to five years, for certain sales during the 2012 and 2013 tax years. Therefore, owners who want to take advantage of the reduced window need to take action in 2013.</td>
<td>• Different states, of course, have very different tax rates for the same types of taxes. It’s important to factor these various rates in to the overall picture so the S corporation shareholders fully understand their tax exposure when the sale transaction is executed.</td>
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Scenario analysis can help both seller and buyer understand the implications of purchase price allocation under various deal structures, including:

- Potential tax benefits the buyer could obtain through a section 338(h)(10) election or straight asset deal, including the timing of those benefits.
- Whether purchase price can be allocated to shorter-lived assets, such as inventory or machinery and equipment, which may result in a quicker recovery of tax benefits in a step-up transaction.
- The impact that the S corporation’s contingent liabilities, such as warranty claims, pending lawsuits and deferred revenue, may have on the deal economics for the seller and the buyer. It will be important to consider the tax implications of seller contingent liabilities as well as subsequent payment of those liabilities by the buyer.
- How potential benefits to the buyer can be factored into the deal equation for the benefit of the seller in terms of the overall deal valuation.

Another important calculation is the net present value of the buyer’s tax benefits from a section 338(h)(10) election based upon receiving a step-up for tax purposes. As noted above, a section 338(h)(10) election will result in a step-up in the tax basis of the acquired assets to fair market value (i.e. purchase price). The buyer may realize tax benefits of the step-up in years one through 15 following the transaction. For example, the buyer may benefit from increased depreciation deductions over the tax life of the acquired fixed assets or from amortization deductions related to the portion of purchase price that is allocated to goodwill. By taking the time to project the buyer’s tax benefits resulting from a section 338(h)(10) election, sellers are likely to be in a better position to make informed decisions regarding the transaction, including but not limited to the right deal structure and purchase price.

- In all of these areas — from built-in gains taxes to buyer’s tax benefits — the scenario analysis tools and technique are important. However, equally relevant is the experience of the people utilizing those tools. Specific knowledge of finance, valuation, estate planning, tax law, and tax accounting are important if deal participants are to understand the many intricacies and nuances of the transaction.

**Look before you leap**

With the M&A environment heating up and tax laws that continue to change, S corporation owners who are considering the sale of their business should carefully weigh the tax implications of a potential transaction. Because the structure of the deal has such a potentially big impact on rewards for the sellers and buyers, both parties can benefit from thorough scenario analysis. Scenario analysis that incorporates a variety of disciplines and considerations can help make the sale of an S corporation tax efficient and clearly identify areas of deal value for the owners, both immediately and in the long term.
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