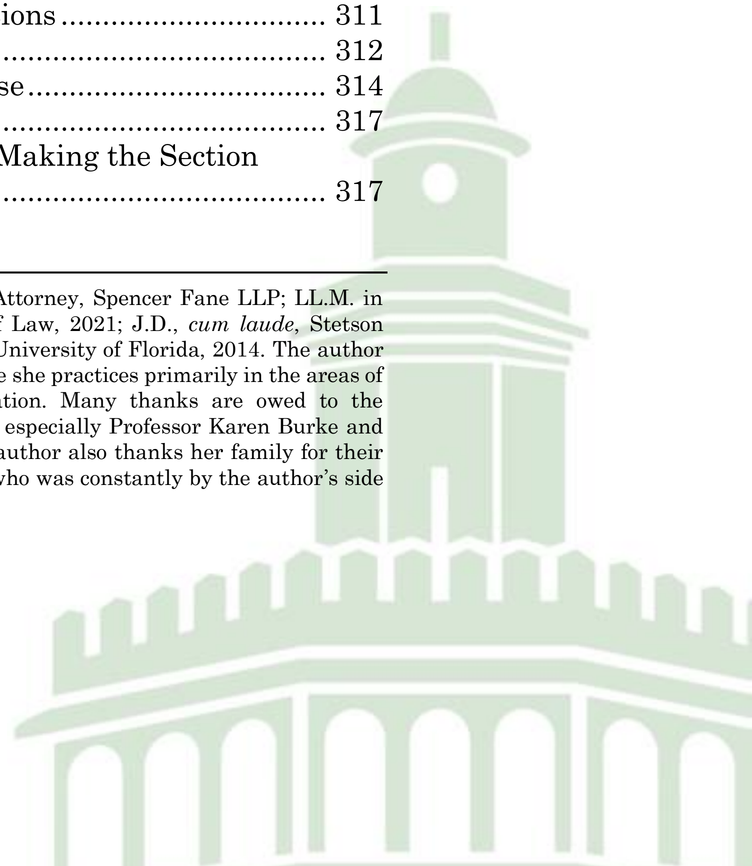
STETSON BUSINESS LAW REVIEW

TAX CONSIDERATIONS AND CONSEQUENCES OF SECTION 338(H)(10) AND SECTION 336(E) ELECTIONS IN THE SALE OF S CORPORATIONS

Nicole Zaworska[a1]

TABLE OF CONTENTS

Introduction 299
I. Qualification as an S Corporation 300
A. S Corporations 300
B. Availability of and Limitations to an S Corporation Election 301
C. Taxation of S Corporations 301
II. Considerations Regarding Choice of Acquisition Structure 301
A. Preferences of C Corporation Seller and the Double Tax on Sale of Assets 302
B. Preferences of S Corporation Seller 304
C. Preferences of Purchaser 306
D. Other Acquisition Considerations 309
III. Purchase and Sale of S Corporations Transaction Structure 311
A. Choice of Entity Statistics 311
B. S Corporations and the Elections 311
C. Section 338(h)(10) Election 312
1. Qualified Stock Purchase 314
2. Consent Requirements 317
3. Manner and Timing of Making the Section 338(h)(10) Election 317



a1 © 2023, Nicole Zaworska. All Rights Reserved. Attorney, Spencer Fane LLP; LL.M. in Taxation, University of Florida – Levin College of Law, 2021; J.D., *cum laude*, Stetson University College of Law, 2017; B.A., *cum laude*, University of Florida, 2014. The author serves as an attorney with Spencer Fane LLP, where she practices primarily in the areas of corporate law, mergers & acquisitions, and taxation. Many thanks are owed to the individuals that helped make this article a reality, especially Professor Karen Burke and the staff of the *Stetson Business Law Review*. The author also thanks her family for their endless support. This article is dedicated to Sochi, who was constantly by the author's side during the writing process.

D. Section 336(e) Election 318
1. Qualified Stock Disposition 320
2. Consent Requirements 322
3. Manner and Timing of Making a Section 336(e) Election 323
E. Comparison of Section 338(h)(10) Election to Section 336(e) Election 323
IV. Decision to Make Decision to Make Section 338(H)(10) or Section 336(E) Election 324
A. Due Diligence of Valid S Corporation Status 324
B. Evaluation of Fair Market Value and Tax Basis 324
C. Comparison of Inside Basis Versus Outside Basis 325
D. Character of Gain Differential Between Stock Sale and Asset Sale 325
E. Corporate Level Tax Triggered in Deemed Asset Sale 326
F. Purchase Price Considerations 328
V. Effect of Section 338(H)(10) and Section 336(E) Elections 329
A. Deemed Asset Purchase Price Allocation 330
B. Deemed Asset Sale Tax Treatment for S Corporation and Shareholders 331
C. Tax Treatment on Liquidation of S Corporation 334
D. Tax Treatment to Purchaser of Assets 335
1. 100 Percent Bonus Depreciation 335
2. Section 179 Expensing 336
E. Impact of Election on Purchase Agreement 337
1. Purchase Agreement from Purchaser's Perspective 337
2. Purchase Agreement from Seller's Perspective .. 338
VI. Effects of Biden Administration Proposed Tax Changes ... 338
VII. Conclusion 340

INTRODUCTION

Striking a balance between the tax concerns of purchasers and sellers during a business acquisition can involve intricate negotiations. Purchasers typically prefer an asset acquisition to steer clear of taking on undisclosed liabilities and to recoup costs through depreciation. On the other hand, sellers often favor a stock sale to completely divest from all facets of a business and to attain advantageous tax rates on capital gains. Nonetheless, in most circumstances, a stock acquisition remains the most expedient transaction structure from a business perspective.

When an acquisition involves a corporation as the target entity, the natural tension between purchasers and sellers is partly alleviated by the elections available under Section 338(h)(10) and Section 336(e) of the Internal Revenue Code of 1986, as amended ("I.R.C."), and the applicable treasury regulations promulgated thereunder ("Treas. Reg." or "Regulations"). Both provisions allow taxpayers to elect to treat certain sales, exchanges, or distributions of certain domestic corporations as a deemed sale of that corporation's assets for tax purposes.

Because S corporations are the most popular type of business entity, the availability of the deemed asset acquisition structure pursuant to the Section 338(h)(10) and Section 336(e) elections makes the S corporation a valuable and advantageous target entity in the world of mergers and acquisitions. If a deemed asset acquisition structure benefits the potential purchaser from a tax perspective, the pass-through taxation of the S corporation, which avoids double taxation, makes the shareholders of an S corporation target more likely to agree to structure the acquisition as a stock sale with either a Section 338(h)(10) or Section 336(e) election.

This Article focuses on the interaction of Section 338(h)(10) and Section 336(e) and the most common tax and other business issues considered by purchasers and sellers when an acquisition transaction involves an S corporation target. Part I of this Article outlines the qualifications, limitations, and taxation of S corporations. Part II explores various considerations of the parties involved in a transaction when determining acquisition structure, including the general preference of sellers for stock sales and purchasers for asset acquisitions, as well as the benefits of having an S corporation as the target entity in comparison to a C

corporation. Part III details the requirements for making an election under Section 338(h)(10) and Section 336(e), as well as the intersection of these two available elections with respect to the purchase and sale of S corporations. Part IV of this Article identifies various considerations involved in deciding whether to structure a transaction as an asset or stock acquisition, including whether to consider making a Section 338(h)(10) or Section 336(e) election, such as the qualification of the target entity as an S corporation, the tax basis of the target corporation, and the character of the gain or loss from the sale. Part V discusses the tax treatment and consequences of a Section 338(h)(10) and Section 336(e) election at various stages of the transaction and from the perspective of each party involved. Part VI highlights some of the proposed changes to the U.S tax code and the resulting effects on the popularity of the S corporation target in future business acquisition transactions. Finally, Part VII concludes that the S corporation is a preferable and beneficial target entity—particularly in a stock sale structured as a deemed asset acquisition using a Section 338(h)(10) or Section 336(e) election. Even considering potential tax rate increases under the U.S tax code, the availability of the Section 338(h)(10) and Section 336(e) elections will remain a valuable tax planning tool for potential purchasers in corporate acquisition transactions.

I. *QUALIFICATION AS AN S CORPORATION*

A. S Corporations

"[T]he term 'S corporation' means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year."[1] Per Section 1361(b)(1), the term "small business corporation" means an eligible domestic corporation, having no more than 100 shareholders, which shareholders are only individuals[2] who are either resident aliens or citizens of the United States, and which only has one class of stock.[3]

1. I.R.C. § 1361(a)(1).

2. The requirement that shareholders be individuals is subject to exceptions for an estate, a trust described in I.R.C. § 1361(c)(2), or an organization described in I.R.C. § 1361(c)(6). *See* I.R.C. § 1361(b)(1).

3. I.R.C. § 1361(b)(1). An eligible corporation is any corporation which is not deemed to be ineligible per I.R.C. § 1331(b)(2) (ineligible corporation means any corporation that is

B. Availability of and Limitations to an S Corporation Election

To be treated as an S corporation for tax purposes, an eligible corporation must affirmatively make an effective election under Section 1362.[4] The election is made by the corporation and there are several technical requirements that must be met to make a valid election, including the consent to such an election by all persons who are shareholders in such corporation on the day on which such election is made.[5] An S corporation election is effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until the election is terminated under I.R.C. Section 1362(d).[6]

C. Taxation of S Corporations

Unlike C corporations, S corporations are normally not subject to taxation at the entity level; rather, an S corporation is generally taxed in the same manner as an individual. Profits and losses of an S corporation generally pass-through to its shareholders, and such shareholders include their respective share of those items on their U.S. federal income tax returns. This avoids double taxation of the S corporation's corporate income.

II. CONSIDERATIONS REGARDING CHOICE OF ACQUISITION STRUCTURE

Purchasers and sellers are often at odds over whether a transaction should be structured as a purchase of assets or a purchase of stock of the target corporation. The acquisition structure selection can greatly alter the tax consequences of the transaction for the parties, with sellers typically deriving the most favorable tax consequences from a stock sale and purchasers typically deriving the most favorable tax consequences from an asset acquisition. Thus, seller and purchaser have diverging interests from the very initial stages of negotiation. Generalities

---

a financial institutional using the reserve method of accounting for bad debts described in Section 585, an insurance company subject to tax under subchapter L, or a domestic international sales corporation ("DISC") or former DISC).

4. I.R.C. § 1362(a)(1)–(2).
5. *Id.*
6. I.R.C. § 1362(c).

aside, there are multiple tax and other factors that seller and purchaser must (or should) consider before agreeing on final acquisition structure, including, the target company entity type, the different types of relevant assets, the aggregate basis of the target entity's assets, the fair market value of such assets, the target shareholders' basis in their target shares, the character of potential gains and losses, the right to transfer or assign various assets, and purchase price calculations and determinations.

Each of these factors needs to be considered against the expectations of the parties, as well as the history, operations, and other information relevant to the target entity. Although tax consequences are not always the primary factor driving acquisition structuring, having an S corporation as the target entity improves the possibility of the parties coming to a swift consensus on a transaction structure that is mutually advantageous to the parties from both a taxation and legal perspective. Assuming all gain is characterized as long-term capital gain, the S corporation shareholders will be impartial for federal tax purposes as between an asset or stock sale. However, certain commercial and legal considerations can cause the purchaser and the S corporation sellers to prefer a stock acquisition. As explained in more detail below, the interests of the sellers and the purchaser of an S corporation target converge when applying the specific acquisition structure that is the topic of this Article—a stock sale treated like an asset sale for tax purposes using an election under I.R.C. Section 338(h)(10) or Section 336(e).

A. Preferences of C Corporation Seller and the Double Tax on Sale of Assets

Sellers generally prefer to structure a transaction as a sale of stock (rather than an asset sale) because a purchaser of stock acquires all assets and liabilities of the corporation, leaving sellers without any contingent liabilities with respect to the corporation post-closing.[7] The preference for stock sales is further strengthened by the fact that sellers typically receive better tax treatment when selling stock as opposed to assets of the

7. *See* William W. Potter, *Section 338(h)(10) Elections Section 338 (h)(10) Elections of S Corporations, Incremental Costs, and Considerations Following Tax Reform*, 45 WGL-CTAX 03, at *5 (Nov./Dec. 2018).

corporation.[8] In the case of a C corporation, its shareholders will generally prefer a traditional stock sale because it avoids the double taxation that is characteristic to C corporations. In a traditional asset sale, the C corporation shareholders are subject to two levels of taxation—the 21 percent flat tax applicable to C corporations and paid at the entity level on the sale of assets and a second level of tax at the shareholder level from the distribution of proceeds resulting from the asset sale. This double taxation regime on C corporations makes stock sales preferable for C corporation shareholders because the stock sale imposes only one level of taxation at the shareholder level, which is generally taxed at the preferential long-term capital gain tax rate.

Example 1: Suncoast Inc., a C corporation, sells its assets for cash consideration of $1,000,000. Assuming Suncoast Inc. has a zero-tax basis in the assets, Suncoast Inc. recognizes a gain of $1,000,000 from the asset sale. Suncoast Inc. is taxed on the $1,000,000 of gain at the corporate tax rate of 21 percent. After Suncoast Inc. pays the $210,000 in corporate-level taxes, there is $790,000 of cash remaining for a dividend to the shareholders. A $790,000 dividend paid to the shareholders will be subject to a second level of tax imposed on the shareholders of Suncoast Inc. Assuming the distribution is a qualified dividend, the highest income tax rate applicable would be 20 percent (or 23.8 percent if net investment income tax ("NIIT") is applicable).[9] Thus, the total tax to be paid by the shareholders on receipt of the distribution would be $158,000 (or $188,020 if NIIT applies), resulting in $632,000 net cash to the Suncoast Inc. shareholders (or $601,980 if NIIT applies).[10] The total tax on the distributed corporate income

8. *See id.*

9. *See* KAREN C. BURKE, FEDERAL INCOME TAXATION OF CORPORATIONS AND STOCKHOLDERS IN A NUTSHELL 2 (8th ed. 2019). "Thus, under current law the maximum combined burden on distributed corporate earnings is 36.8%, or slightly less than the maximum individual rate (37%). The combined burden is actually somewhat higher because dividends are subject to the 3.8% tax on net investment income under § 1411, which is intended to mirror the Medicare tax on "earned income." For high-income individuals, the overall tax rate for qualifying dividends and long-term capital gain is 23.8% (20% plus 3.8%). As a result, the combined tax burden is 39.8% for such individuals." *Id.*

10. Jerald D. August, *Understanding the 199A Deduction After the New Final Regulations: An IRS Perspective*, Aug. 25, 2023, VCAG0416 ALI-CLE 1 (West). ("This should be contrasted to a top marginal tax rate of 37% on the income of a pass-through entity or sole proprietorship even if the taxpayer derives no benefit whatsoever from the deduction available under Section 199A, or a top marginal tax rate of 29.6% on the QBI of a pass-through entity or sole proprietorship where the taxpayer receives the full benefit of Section 199A without being subject to the wage and capital limitations.").

would be $368,000 ($210,000 plus $158,000) (or $398,020 considering NIIT ($210,000 plus $188,0200)). Overall, the maximum combined effective double-tax rate for Suncoast Inc. is 36.8 percent ($368,000 divided by $1,000,000 income) (or 39.8 percent with NIIT).

B. Preferences of S Corporation Seller

In the case of an S corporation, there is generally no taxation at the entity level but rather there is only a single level of taxation imposed on corporate income—at the shareholder level.[11] In the case of either an asset sale or a stock sale, S corporation shareholders are subject to only one level of tax.[12] Thus, a stock sale of an S corporation results in the same general federal tax consequences as the stock sale of a C corporation. However, an asset sale in an S corporation results in vastly different tax results as compared to an asset sale in a C corporation. The gain from the sale of assets in an S corporation avoids the entity level tax and instead such gain is passed through to the shareholders, to be taxed on the shareholders' tax returns.[13] With the exception of gains associated with a sale or other disposition of certain items that are taxable as ordinary income, such as inventory, depreciation recapture, and other ordinary income items,[14] "the gain passed out to the S corporation shareholder is taxed as a capital gain to the individual."[15] Following the asset sale in an S corporation, a "subsequent liquidating distribution, unlike the case of a Subchapter C–Corporation, escapes taxation as a return of capital."[16] Thus, with S corporation asset sales, the selling shareholders are taxed a single level of tax at the maximum capital gains rate of 20 percent,[17] resulting in a lower tax burden and more cash on an after-tax basis as compared to C corporation asset sales. Consider the following example:

---

11. *New Tax Structuring Tool in the Acquisition of S-Corporations*, WINDES (Sept. 26, 2017), https://windes.com/tax_alerts/new-tax-structuring-tool-acquisition-s-corporations/.
12. *Id.*
13. *See* Samuel T. Greenberg & Andrew T. Davis, *Acquisition Structures*, 74 N.Y.U. ANN. INST. FED. TAX'N § 4.03(6)(c)(ii) (2021).
14. *See id.* § 4.03(3)(a).
15. WINDES, *supra* note 11.
16. *Id.* This is unlike the case of a Subchapter C corporation, which imposes the second layer of shareholder tax on subsequent liquidating distributions.
17. *Id.*

Example 2: RIZ Inc., an S corporation, sells its assets for cash consideration of $1,000,000. Assuming RIZ Inc. has a zero-tax basis in the assets, RIZ Inc. recognizes income of $1,000,000 from the asset sale. RIZ Inc. has a basis of $1,000,000 in the cash received. The $1,000,000 of income retains its character as it "flows through" to RIZ Inc.'s shareholders, who report and are taxed on their pro rata share of such $1,000,000 of income (irrespective of RIZ Inc. paying actual distributions to such shareholders). So, assuming the assets sold were all long-term capital assets in the hands of RIZ Inc., the capital gain character is passed through to the $1,000,000 of income, which then flows through to the RIZ Inc. shareholders, who must each pay their pro rata share of tax on such income at the applicable capital gains rate.[18] At the maximum capital gains tax rate of 20 percent (or 23.8 percent if adding the 3.8 percent NIIT),[19] this, will result in $200,000 of taxes due (or $238,000 if taxed at 23.8 percent) in the aggregate from the RIZ Inc. shareholders. The $1,000,000 of income also increases the RIZ Inc. shareholders' basis in their RIZ Inc. shares by the same amount (respectively, by each shareholders' pro rata share of such income), bringing their collective basis to $1,000,000. A subsequent distribution by RIZ Inc. of the $1,000,000 of income to its shareholders will reduce the shareholders' collective basis in their RIZ Inc. shares by the amount of the distribution (with each shareholder's basis in her respective RIZ Inc. shares reduced by her pro rata share of such distribution received). Thus, absent any other transaction or character difference in the gain, when the $1,000,000 of income is distributed, no shareholder recognizes any

18. The character of income (or loss) earned by the S corporation (as determined at the corporate level) passes through to its shareholders and remains (and is taxed) the same in the shareholders' hands. I.R.C. § 1366(b). Accordingly, if the assets sold were instead RIZ Inc.'s inventory, the ordinary income character would pass through to the shareholders and be taxed at the *individual* rate applicable to each such shareholder, which is currently at a top rate of 37 percent (or 40.8 percent if adding 3.8 percent NIIT).

19. "This should be contrasted with the sale of assets by an S corporation, partnership or LLC taxed as partnership, or a sole proprietorship, where typically the bulk of the sales price is allocated to capital assets (such as goodwill), so that the maximum marginal rate to which the gain on the sale of the assets will be subject will either be 20% (the maximum capital gains tax), or, if the taxpayer does not materially participate in the trade or business carried on by the entity, 23.8% with the addition of the Net Investment Tax." August, *supra* note 10. NIIT applies to passive types of income, such as interest, dividends, capital gains, royalties, and rents, as well as pass-through income from a passive business like an S corporation. If the shareholder-taxpayer materially participates in the trade or business of the S corporation, the pass-through income is not treated as passive and is not subject to NIIT.

additional gain or loss because their respective pro rata share of such $1,000,000 distribution equals such shareholder's basis in her shares of RIZ Inc.[20] Thus, the RIZ Inc. shareholders end up with an aggregate net cash amount of $800,000 (or $762,000 if taxed at 23.8 percent).

C. Preferences of Purchaser

On the other hand, potential purchasers generally prefer to purchase the assets of a corporation for several reasons. From a tax perspective, a buyer who purchases assets of a business can receive a stepup in basis, which generates post-transaction tax benefits and increases cash flow through the use of amortization and other deductions.[21] In an asset sale, the purchaser takes a basis in the acquired assets equal to the fair market value at the time of transfer;[22] thus creating a "step-up" in basis if the transferors basis in the assets was less than the fair market value at the time of sale.[23] In light of the 2017 Tax Cuts and Jobs Act, an asset acquisition became even more favorable to a purchaser because it could immediately expense the cost of tangible personal property with a recovery period of 20 years or less.[24] This is otherwise known as bonus depreciation—available at a rate of 100 percent of the purchase price for assets acquired and placed into service after September 27, 2017, but before January 1, 2023, with sunsetting bonus depreciation percentages through 2026.[25] Another form of immediate expense deduction available to a purchaser acquiring depreciable business equipment (such as office equipment, business machinery, computers, vehicles, or software) is Section 179 expensing.[26] In essence, the purchaser's investment begins immediately paying for itself in the form of tax

---

20. *See* Potter, *supra* note 7, at *3. If the S corporation makes later distributions of its income, such distributions are generally tax free to the shareholders to the extent they reflect income that has already been taxed to the shareholders. I.R.C. § 1368.

21. *See* Potter, *supra* note 7, at *3.

22. I.R.C. § 1012.

23. There is a step-down in basis if the target company's basis in its assets exceeds its fair market value.

24. I.R.C. § 168(k).

25. *See infra* Section 0.0.1 (discussing bonus depreciation as an immediate expense deduction).

26. *See infra* Section 0.0.2 (discussing Section 179 expensing as an immediate expense deduction).

benefits.[27] In contrast, in a stock purchase, the purchaser takes a transferred basis in the target corporation's assets, which leaves the purchaser without amortizable intangible assets (such as goodwill), and generally, assuming the fair market value is greater than its basis and the value of assets continue to appreciate, the purchaser is subject to taxation on a greater amount of gain realized on a subsequent sale of the acquired assets in target corporation. Consider the following examples.

Example 3: Izabella, an individual, owns all the stock of RIZ Inc., an S Corporation. Her basis for the stock is $100,000. RIZ Inc. has only two assets, equipment and land. The equipment has a basis of $120,000 (with $150,000 depreciation) and a fair market value of $400,000, and the land has a basis of $180,000 and a fair market value of $600,000.

Example 3(a): Lekko Corporation, a C corporation, purchases all the assets of RIZ Inc. for cash consideration of $1,000,000. Lekko Corporation takes a cost basis in the acquired assets of $1,000,000. Under Section 1060, the purchase price is allocated among the acquired assets up to their fair market value. Thus, Lekko Corporation takes a cost basis of $400,000 in the equipment and $600,000 in the land. Although the land is not depreciable, Lekko Corporation will be able to immediately begin depreciating the equipment using the stepped-up basis of $400,000. Upon subsequent sale of the land for $750,000, Lekko Corporation uses the $600,000 basis and is subject to tax on $150,000 of gain.

Example 3(b): Lekko Corporation purchases all the stock of RIZ Inc. for cash consideration of $1,000,000. Lekko Corporation takes a cost basis in RIZ Inc. stock of $1,000,000. The RIZ Inc. stock is neither depreciable nor amortizable. Thus, Lekko Corporation simply retains the $1 million basis in the stock until Lekko Corporation eventually sells the shares, at which point the basis will be available to offset the sales proceeds. Lekko Corporation acquires the equipment and the land without taking it out of RIZ Inc., so the basis in the assets does not change. Thus, Lekko Corporation has a transferred basis of $120,000 in the equipment and $180,000 in the land. The basis in assets does not change because this was a stock sale. When stock is purchased, nothing changes inside the target. Thus, even though Lekko Corporation

27. Essentially, it is a return on purchaser's investment in the form of immediate tax deductions.

paid $1,000,000 for RIZ Inc., the basis RIZ Inc. held in its assets remains unchanged in the hands of Lekko Corporation. As a result, Lekko Corporation is left depreciating the equipment using the remaining $120,000 of tax basis. Upon subsequent sale of the land for $750,000, Lekko Corporation uses the $180,000 basis and is subject to tax on $570,000 of gain.

In comparing the tax results to Lekko Corporation, the purchaser, in the asset purchase in Example 3(a) versus the stock purchase in Example 3(b), it is evident that Lekko Corporation is not receiving the same results even though in both cases Lekko Corporation is paying the same amount to acquire all of RIZ Inc. In the asset sale, Lekko Corporation has the added tax benefit of an additional $160,000 in depreciation deductions in the equipment ($400,000 basis following the asset sale – $120,000 basis following a stock sale), and Lekko Corporation also has less taxable gain on a future sale of land ($150,000 taxable gain if the land were acquired in an asset sale as compared to $570,000 taxable gain in a stock sale). The purchaser, in this case Lekko Corporation, would likely discount the purchase price.

Should Lekko Corporation pay the same amount ($1,000,000) for the RIZ Inc. stock as it would for the assets of RIZ Inc.? If the equipment is worth $400,000 and the land is worth $600,000 and Lekko Corporation is taking a basis of $1,000,000 in the stock of RIZ Inc. (which is not depreciable), Lekko Corporation is not getting the same value for its money because following the stock purchase Lekko Corporation has assets with built-in gain. Whereas, in the asset purchase, the basis in the assets acquired is stepped-up to match the fair market value resulting in no built-in gain or loss to Lekko Corporation in the acquired assets. In a stock purchase, Lekko Corporation acquires the land with a built-in gain of $420,000 ($600,000 fair market value – $180,000 basis) and the equipment with a built-in gain of $280,000 ($400,000 fair market value – $120,000 basis). Lekko Corporation also cannot amortize the basis in the RIZ Inc. stock acquired. Based on such after-tax results, Lekko Corporation would definitely not pay the same amount in a stock acquisition as it may in an asset acquisition because the parties will take into account the after-tax consequences of the transaction when they are setting the purchase price. Here, the built-in tax liabilities of a stock acquisition of RIZ Inc. would prompt a lower purchase price. The purchaser, in this case Lekko Corporation, would discount the

purchase price in a stock acquisition because it is not receiving a corresponding basis step-up.

If the purchase price in Example 3(b) was $800,000 (instead of $1,000,000), the $700,000 of income ($800,000 amount realized – $100,000 basis in stock) would be passed through to the RIZ Inc. shareholder, who is taxed on that $700,000 of income at the maximum individual capital gains tax rate of 20 percent, resulting in $140,000 taxes owed. RIZ Inc. shareholder has $560,000 cash after tax. In this scenario, Lekko Corporation takes a $800,000 cost basis in the stock. Lekko Corporation's basis in the equipment and land still does not change (stays at $120,000 and $180,000, respectively). But in this scenario, the purchase price better reflects the built-in tax onthe assets acquired, as well as the fact that Lekko Corporation is not able to amortize the purchase price of the RIZ Inc. stock.

This pursuit of the "stepped-up" tax basis (in addition to avoiding hidden liabilities) is a primary incentive driving purchasers' preference to pursue an asset acquisition rather than a stock acquisition.[28]

D. Other Acquisition Considerations

In addition to the tax consequence considerations, purchasers are further enticed to structure a transaction as an asset sale because an asset sale provides purchasers with the ability to select specific assets and liabilities of the target corporation that it actually wants to assume; thereby avoiding wasting money on unwanted assets, as well as any additional risk of assuming unknown or undisclosed liabilities.[29] Asset sales grant purchasers this type of flexibility, while stock sales, on the other hand, require the purchaser to assume all of the assets and liabilities of target corporation.[30]

Although purchasers may prefer to purchase the assets of an S corporation, certain non-tax factors may require the transaction to be structured otherwise. Due in part to the restrictive

28. Tony Nitti, *Tax Geek Tuesday: A Buyer's Best Friend – Understanding The Section 338(h)(10) Election*, FORBES (Oct. 5, 2015, 6:34 PM), https://www.forbes.com/sites/anthonynitti/2015/10/05/tax-geek-tuesday-a-buyers-best-friend-understanding-the-section-338h10-election/?sh=8edcc644fa0d.

29. James R. Hamill, *Purchases and Sales Involving S Corporations*, 92 TAXES 65 (2014).

30. *See* Potter, *supra* note 7, at *5.

qualification requirements of S corporations, the physical transfer of S corporation assets and contracts can become incredibly time-consuming, problematic, and in certain situations, even impossible, which in turn might cause the purchaser to have no choice other than acquiring the stock of the target corporation and thus potentially losing the tax step-up and other tax benefits afforded to purchasers in an asset acquisition.[31] For example, this can occur when the target has key contracts that are not freely transferable or assignable to purchaser. When this is the case, the only way to acquire the contracts might require target corporation to remain a party to such contracts, requiring the preservation of target corporation's separate legal existence so that the key contracts remain valid and effective.[32]

On the other hand, sellers of an S corporation will still generally prefer a stock sale as compared to an asset sale due to other non-tax considerations. Sellers generally prefer to structure an acquisition as a stock sale because in a stock sale, the purchaser assumes *all* liabilities of the target company as a matter of law.[33] As compared to an asset sale, in which case the sellers are left with known and unknown liabilities of the target company, which the purchaser does not expressly assume.[34] Asset acquisitions are generally also more complex and time consuming than stock acquisitions, which may involve "the retitling of assets and renegotiation of certain contracts and governmental permits."[35] As a result, it is common for parties to structure an acquisition of the target company as a stock sale with a Section 338(h)(10) election or a Section 336(e) election, which will allow for many of the tax benefits of an asset sale.[36]

31. WINDES, *supra* note 11.

32. Nitti, *supra* note 9. Other situations that may require the transaction to be structured as a stock sale include state and federal regulatory restrictions, as well as required retention of target company's Employer Identification Number.

33. Potter, *supra* note 7, at *3.

34. Bryan F. Egan, *Asset Acquisitions: Assuming and Avoiding Liabilities*, 116 PENN ST. L. REV. 913, 917 (2012).

35. Potter, *supra* note 7, at *4.

36. *Id.*

III. PURCHASE AND SALE OF S CORPORATIONS TRANSACTION STRUCTURE

In the case of S corporation target entities, many of the concerns relating to asset versus stock acquisition structure have been eliminated because of the Section 338(h)(10) election and the Section 336(e) election (hereinafter, the "Elections"). The Elections allow the parties to treat an acquisition transaction as a sale of assets for tax purposes, though, legally transferring the stock of the S corporation.[37] This allows the parties to proceed with the ease of transferability inherent in a stock sale, while still benefitting from the favorable tax consequences of an asset sale.

A. CHOICE OF ENTITY STATISTICS

Despite the popularity of LLCs in the last 20 years, the number of entities filing S corporation returns exceeds the number of entities filing partnership returns and it is projected to stay that way for the foreseeable future. S corporations continue to be the most prevalent type of corporation, making S corporations a prevailing target entity in the world of mergers and acquisitions, due to both number and advantage.[38] For Tax Year 2019, there were 5,186,557 returns filed by S corporations (filing a Form 1120-S), translating to approximately 70.7 percent of all corporations in the U.S. classified as S corporations.[39] As discussed in Part II, the pass-through taxation of S corporations, which avoids double taxation,[40] makes S corporations advantageous target entities for potential purchasers because S corporation shareholders are generally indifferent as to whether the purchaser wants to structure an acquisition as either an asset or a stock sale.

B. S Corporations and the Elections

When comparing a C corporation with a similarly situated S corporation, the S corporation will generally be a more appealing

---

37. WINDES, *supra* note 11.

38. Total of 7,333,461 returns filed by all corporations, of which 2,146,904 returns filed by C corporations or other corporations and 5,186,557 returns filed by S corporations, per form 1120-S. *See* SOI Tax Stats - IRS Data Book, *available at* https://www.irs.gov/pub/irs-pdf/p55b.pdf.

39. *Id.*

40. With the exception of built-in gain tax under I.R.C. § 1374.

target company from both a business and tax perspective because of the availability of the deemed asset acquisition elections under Section 336(e) and Section 338(h)(10) while avoiding the double taxation inherent in C corporations. In a deemed asset acquisition, the S corporation stock is "sold without the complexity of disposing of individual assets, but with the tax advantage of a step-up in the [S] corporation's asset basis for the purchaser."[41] To achieve this desired stepped-up basis, a Section 338(h)(10) election or a Section 336(e) election must be made.[42]

C. Section 338(h)(10) Election

A Section 338(h)(10) election is available only in limited situations. To be eligible to make the Section 338(h)(10) election, the parties involved in the transaction must meet specific statutory and regulatory requirements. If a valid Section 338(h)(10) election is made, even though the purchaser acquired the target company's stock, for tax purposes only, the transaction is treated as if the purchaser acquired only the target company's assets.[43]

The availability of a Section 338(h)(10) election is restricted to only the types of entities and organization structures specifically identified in the Regulations.[44] Generally, a Section 338(h)(10) election may be made when one *corporation* purchases the stock of another *corporation*.[45] In other words, the Section 338(h)(10) election can only be made if both the purchaser and the target are corporations, whether a C corporation or an S corporation. Thus, if either the purchaser or target is a partnership, an LLC not treated as an S corporation for tax purposes, or any type of entity other than a corporation, the Section 338(h)(10) election is unavailable.

41. Horacio et al., *Section 336(e) Deemed Asset Acquisitions and S Corporations*, DAILY BLOOMBERG BNA - TAX REPORT (March 31, 2014).

42. Jerald D. August & Stephen R. Looney, *Tax Planning for S Corporations: Mergers and Acquisitions Involving S Corporations (Part 1)*, 30 Prac. Tax Law. 19, 37 (Winter 2016)[hereinafter Looney]. The transaction can also be structured as an F reorganization/Qsub deemed sale of assets. Jerald D. August & Stephen R. Looney, *Tax Planning for S Corporations: Mergers and Acquisitions Involving S Corporations (Part 3)*, 30 Prac. Tax Law. 42, 53 (Summer 2016).

43. The purchaser can also make an election under I.R.C. Section 338(g) (a Section 338(g) election) but this election is less common because it often results in adverse tax consequences for the seller.

44. Nitti, *supra* note 28; *see* Treas. Reg. §§ 1.338–2, 1.338–2, 1.338(h)(10)–1.

45. *See* I.R.C. §§ 338(d)(1)–(2), 338(h)(2)(d)(1), (2) (identifying and defining purchasing corporation and target corporation as only a "corporation").

This also means that the Section 338(h)(10) election is unavailable to purchasers who are individuals.[46] Further, the purchaser can only be a single corporation, which means that there cannot be more than one purchaser of the target entity in the transaction.[47]

To qualify for the Section 338(h)(10) election, the seller of the target company must be one of the following:[48] (1) a domestic subsidiary corporation in the same consolidated group as the target company, and which group meets the Section 1504 control requirement ("selling consolidated group");[49] (2) a domestic subsidiary corporation that has Section 1504 control of a domestic target company and that is *eligible* to file a consolidated return with target, but chooses not to ("selling affiliate");[50] or (3) one or more S corporation shareholders.[51]

Per Section 1504, a selling consolidated group or selling affiliate must be part of a chain of corporations connected through ownership by at least 80 percent of total voting stock and 80 percent of total value of stock owned by the common parent corporation and at least one other corporation in the group.[52]

Example 4(a): Consider the same facts as in Example 3 and Example 3(b), with the parties desiring to make a Section 338(h)(10) election. Because RIZ Inc. is an S corporation, Izabella meets the definition of a seller under Reg. Section 1.338(h)(10)–1(c) as an S corporation shareholder. Lekko Corporation is a C corporation, which satisfies the corporate purchaser requirement under Section 338. Thus, the Section 338(h)(10) election is available to Lekko Corporation and Izabella in a qualified stock purchase of RIZ Inc.

Example 4(b): Vanessa, an individual, owns 100% of Nismo Inc., which is a C corporation. Vanessa sells 90 percent of her Nismo Inc. stock to Cars Corp., which is also a C corporation. Cars Corp., Vanessa, and Nismo Inc. may not make a Section 338(h)(10) election because the seller, Vanessa, does not meet the definition

---

46. I.R.C. § 338(d)(3); Treas. Reg. § 1.338–3(b) (2006) ("an individual cannot make a qualified stock purchase of target").

47. *See* I.R.C. § 338(d)(3) (qualifying transactions require the stock of "1 corporation" acquired by "another corporation").

48. Treas. Reg. § 1.338(h)(10)–1(c) (2010).

49. I.R.C. § 338(h)(10)(B).

50. *Id.*

51. Nitti, *supra* note 8. "By limiting the eligible types of targets in a Section 338(h)(10) transaction to the three types of corporations listed above, it is ensured that the deemed liquidation will not result in a second taxable transaction." *Id.*

52. I.R.C. § 1504(a)(1)–(2).

of a seller under Reg. Section 1.338(h)(10)–1(c). Nismo Inc. is a C corporation, which means that to qualify for the § 338(h)(10) election, the seller must be another corporation that has Section 1504 control of Nismo Inc. Here, Nismo Inc. is owned by Vanessa, an individual, so this will not meet the requirements for a 338(h)(10) election.

1. Qualified Stock Purchase

A Section 338(h)(10) election applies in the case of a stock purchase; however, the rules require something more specific. The stock purchase must be a "qualified stock purchase" ("QSP"). The term qualified stock purchase is defined as "any transaction or series of transactions in which stock (meeting the requirements of section 1504(a)(2)) of 1 corporation is acquired by another corporation by purchase during the 12-month acquisition period."[53]

Per this definition, the stock purchase must satisfy each of the following three elements of a qualified stock purchase: (1) purchaser must "purchase" the stock; (2) purchaser must purchase a sufficient amount of stock to meet the control requirements under Section 1504(a)(2); and (3) the purchase must be made within a period of 12 months.[54] Each element is subject to the specific rules and limitations discussed below.

a. Must "Purchase" the Stock

Section 338(h)(3)(A) sets forth definitions and special rules applicable in determining whether a transaction is a qualifying stock purchase for purposes of an election. A "purchase" is defined as:

> [A]ny acquisition of stock, but only if—(i) the basis of the stock in the hands of the purchasing corporation is not determined (I) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (II) under section 1014(a) (relating to property acquired from a decedent), (ii) the stock is not acquired in an exchange to which section 351, 354, 355, or 356 applies and is not acquired in any

53. I.R.C. § 338(d)(3) (requiring a taxable purchase of at least 80 percent of a US target corporation within a 12-month period).

54. *Id.*

> other transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized on the transaction, and (iii) the stock is not acquired from a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) thereof), be attributed to the person acquiring such stock.[55]

The definition of the term "purchase" is exclusive and exhaustive in the sense that a purchase is any transaction whatsoever, except for the three types of transactions described in subsections (i) through (iii) of Section 338(h)(3)(A). The three exclusions are: (1) if the purchaser's basis in the target stock is determined with respect to the basis of the stock in the hands of the transferor; (2) the stock is acquired in a transaction described in Sections 351, 354, 355, or 356; and (3) the stock is acquired in a related party transaction.[56]

Essentially, this means purchaser must acquire at least 80 percent of the target company stock in a *taxable* acquisition.[57] If the stock is purchased in any of the excluded transactions described above, Section 338(h)(3)(A) disqualifies it, and it is not a qualified stock purchase.

b. Purchase Meeting Section 1504(a)(2) Control

The term qualified stock purchase is defined through a cross reference to Section 1504(a)(2), which requires ownership of stock of "at least 80 percent of the total voting power of the stock" and "a value equal to at least 80 percent of the total value of the stock" of the target corporation.[58] Nonvoting, nonconvertible preferred stock is excluded from stock considered in calculating the 80 percent threshold requirement.[59] As the rules are applied to S corporations, the purchaser must acquire at least 80 percent of the S corporation's outstanding stock in order to be sufficient as a qualified stock purchase.

---

55. I.R.C. § 338(h)(3)(A).
56. *Id.*
57. Nitti, *supra* note 28.
58. I.R.C. § 1504(a)(2).
59. *See* I.R.C. § 1504(a)(4). This requirement is moot in the case of a stock acquisition of an S corporation because S corporations are only permitted to have one class of stock.

c. Within a 12-Month Period

The 80 percent threshold can be satisfied in "any transaction or series of transactions" so long as they occur within the 12-month acquisition period (also known as a creeping stock purchase). "The term '12-month acquisition period' means the 12-month period beginning with the date of the first acquisition by purchase of stock included in a qualified stock purchase."[60] Essentially, this is the 12-month period prior to the date that purchaser acquires 80 percent ownership in the target corporation. Thus, to be considered a qualified stock purchase, the purchaser must acquire control (*i.e.*, 80 percent of stock by vote and value) of the target corporation and this can take place in a series of transactions, over time, but it must be within a 12-month period. "[T]he first day on which there is a qualified stock purchase with respect to the stock of such corporation" is the "acquisition date."[61] Although the Section 338 Regulations provide that a so-called creeping stock purchase may satisfy the requirements of a qualified stock purchase, a creeping QSP of an S corporation is not possible.[62]

In the case of a corporate purchaser buying the stock of an S corporation target, the stock purchase can only be a "qualified stock purchase" if the purchaser purchases at least 80 percent of the stock of the S corporation in a single transaction, *i.e.*, on the "acquisition date" only. The Section 338(h)(10) election is only available if the target S corporation holds valid S corporation status on the acquisition date. S corporation status will be invalid if any of the owners of the S corporation become ineligible shareholders before that date.[63] Keeping in mind that a corporation is an ineligible shareholder of an S corporation if, for example, a corporate purchaser were to purchase any of the S corporation's stock prior to the acquisition date, the target's S corporation election would terminate upon the first stock purchase, before the purchaser could make it to the "acquisition date," at which point in time the Section 338(h)(10) election would already be unavailable due to the earlier termination of the S corporation election. Since the Section 338(h)(10) election may only be

---

60. I.R.C. § 338(h)(1).
61. I.R.C. § 338(h)(2).
62. Nitti, *supra* note 28.
63. Phillip Elefonte, *Inadvertent S Corp. Terminations*, THE TAX ADVISER (Oct. 1, 2012), https://www.thetaxadviser.com/issues/2012/oct/clinic-story-11.html.

entertained by a purchaser who is a corporation, the acquisition of S corporation stock using the Section 338(h)(10) election can never be structured as a series of transactions occurring on different dates because the S corporation election will always bust as of the consummation of the first stock acquisition.[64]

As a result, the 12-month period requirement becomes somewhat irrelevant when the target is an S corporation. If a purchaser wants to acquire an S corporation target using the Section 338(h)(10) election, the qualified stock purchase must simply occur in a single transaction, on the acquisition date.

2. Consent Requirements

The Section 338(h)(10) election must be made jointly by the purchaser and the seller (or sellers). In the case of an S corporation target, the sellers are the S corporation shareholders. The Regulations provide that *all* shareholders of the S corporation must consent to the election including shareholders who do not sell their target stock in the qualified stock purchase.[65]

3. Manner and Timing of Making the Section 338(h)(10) Election

The Section 338(h)(10) election must be made no later than the 15th day of the ninth month beginning after the end of the month in which the qualified stock purchase is completed (*i.e.*, counting from the month immediately following the acquisition date).[66] The election is made jointly by purchaser and seller on Form 8023, and on behalf of the target corporation.[67] Once the Section 338(h)(10) election is made, it becomes irrevocable.[68] In the case of an S corporation target, the target's S corporation status continues in effect through the close of the acquisition date.[69]

Example 5: Consider the same facts as in Example 4(a). If the qualified stock purchase is completed on January 20, 2023, Lekko

64. Nitti, *supra* note 28.
65. Treas. Reg. § 1.338(h)(10)–1(c)(3).
66. *Id.*
67. *Id.* If target is an S corporation, the principles of §§ 1.338–2(c)(10) and 1.338–10(a)(1), (5), and (6)(i) apply to the return on which the deemed sale tax consequences are reported. *Id.*
68. Treas. Reg. § 1.338(h)(10)–1(c)(4).
69. Treas. Reg. § 1.338(h)(10)–1(d)(3) (including the time of the deemed asset sale and the deemed liquidation).

Corporation and RIZ Inc. must jointly file Form 8023 by October 15, 2023, based on the January 20 acquisition date.

In addition to filing Form 8023 by October 15, RIZ Inc. must also attach Form 8883, Asset Allocation Statement Under Section 338,[70] to its final Form 1120-S (U.S. Income Tax Return for an S Corporation), which is due by April 15 (the 15th day of the third month following January 20, the date of the stock purchase). Under these facts, RIZ Inc.'s final Form 1120-S (and any applicable built-in gains tax paid with that return) is due *before* Form 8023 on which the Section 338(h)(10) election is made. If Lekko Corporation files a consolidated return with RIZ Inc., Form 8883 is attached to the consolidated return that includes the first day after the acquisition date. Otherwise, Form 8883 is attached to RIZ Inc.'s first Form 1120-S and to Lekko Corporation's Form 1120. Because RIZ Inc.'s final Form 1120-S is due before Form 8023, RIZ Inc. would normally file its final Form 1120-S and, if required, pay any applicable built-in gains tax before the due date of the Form 8023 on which the Section 338(h)(10) election is made. Even if RIZ Inc. extends the due date of its final Form 1120-S, both forms would be due at the same time. However, the extension to file does not extend the time to pay any applicable built-in gains tax.

D. Section 336(e) Election

Under Section 336(e), if

> (1) a corporation owns stock in another corporation meeting the requirements of section 1504(a)(2), and (2) such corporation sells, exchanges, or distributes all of such stock, an election may be made to treat such sale, exchange, or distribution as a disposition of all of the assets of such other corporation, and no gain or loss shall be recognized on the sale, exchange, or distribution of such stock.[71]

The Section 336(e) election is similar to a Section 338(h)(10) election, but it applies in situations when Section 338(h)(10) would not apply. A stock sale can qualify for the Section 336(e) election if

70. Form 8883 is used to report information about transactions involving the deemed sale of corporate assets under I.R.C. Section 338. This includes information previously reported on Form 8023, which is used for elections under I.R.C. Section 338 for corporations making qualified stock purchases.

71. I.R.C. § 336(e).

it satisfies the requirements of a "qualified stock disposition", which is similar to a qualified stock purchase under Section 338 because both require the disposal of 80 percent of target stock within a 12-month period, but it is broader because the Regulations under Section 336 have a broader definition of what applies as a qualified stock disposition. Additionally, the Section 336(e) election is more expansive because the identity of the purchaser is not restricted, nor is the number of purchasers.[72] Thus, the seller and the target corporation may be able to make an election under Section 336(e) if the Section 338(h)(10) or Section 338(g) elections are unavailable.[73]

On May 10, 2013, the U.S. Treasury Department promulgated final Regulations under Section 336(e). The proposed Regulations under Section 336 did not make the Section 336(e) election available with respect to the sale of stock of an S corporation. Due in large part to the fact that the Section 336(e) regime was modeled on Section 338(h)(10), the final Regulations effectively extended the Section 336(e) election to S corporations.[74] The final Regulations are generally effective for "qualified stock dispositions" taking place on or after May 15, 2013. Just as a corporation can make the Section 338(h)(10) election in conjunction with a qualified stock purchase of an S corporation, the Section 336 final Regulations authorize a Section 336(e) election in the case of a stock sale that is a qualified stock disposition involving an S corporation as the target.[75]

Although a Section 336(e) election is broader than its Section 338(h)(10) counterpart, many of the same principles, rules, and regulations apply. Generally, the final Regulations under Section 336 are drafted to coincide with Section 338 and in most cases adopt a Section 338(h)(10) model.[76] Thus, a valid Section 336(e) election has the same effect as the Section 338(h)(10) election in that both cause certain stock acquisitions of a target corporation to be treated as a deemed asset acquisition for tax purposes.

72. Hamill, *supra* note 29, at 75.

73. For example, if there is a non-corporate buyer or multiple buyers.

74. Regulations Enabling Elections for Certain Transactions Under Section 336(e), 78 Fed. Reg. 28467-01, 28471 (May 15, 2023) (to be codified at 26 C.F.R. part 1).

75. Under Treas. Reg. § 1.336-1(b)(3), the definition of target includes S corporations.

76. Treas. Reg. § 1.336–1(a) ("[T]o the extent not inconsistent with section 336(e) or these regulations, the principles of section 338 and the regulations under section 338 apply for purposes of these regulations.").

To be eligible for the Section 336(e) election, the target company must be either a domestic C corporation or a domestic S corporation.[77] The seller must be either a domestic C corporation or, if the target is an S corporation, all of the stockholders of an S corporation.[78] Similarly to the Section 338(h)(10) election, in the case of a Section 336(e) election with an S corporation target, the S corporation shareholder sellers include not only those shareholders that sell their stock in the transaction, but *all* of the S corporation shareholders, even those that do not sell their S corporation target stock in the transaction.[79]

The Section 336(e) election enlarges the categories of stock transactions that can be structured as asset acquisitions for tax purposes. In particular, a Section 336(e) election can apply to stock sales to non-corporate purchasers and stock transactions with multiple purchasers.[80] Essentially, the purchaser or purchasers can be corporations, partnerships, LLCs, individuals, or any combination of the foregoing.

1. *Qualified Stock Disposition*

A Section 336(e) election requires a qualified stock disposition, which is defined as "any transaction or series of transactions in which stock meeting the requirements of section 1504(a)(2) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation or by the S corporation shareholders in a disposition . . . during the 12-month disposition period."[81]

Per this definition, the stock sale must satisfy each of the following three elements of a qualified stock disposition: (1) the stock is transferred in a disposition; (2) a disposition of stock in an amount meeting the 80 percent control requirements under Section 1504(a)(2); and (3) the disposition must be made within a

77. *See* Treas. Reg. § 1.336–1(b)(3).

78. *See* Treas. Reg. § 1.336–1(b)(1) (Generally, all members of a consolidated group that dispose of target stock are treated as a single seller."); *see* Treas. Reg. § 1.336–2(g)(2).

79. *See* Treas. Reg. § 1.336–2(h)(3)(i).

80. *See* Treas. Reg. § 1.336–1(b)(2) (The Section 336 election is available to "one or more persons that acquire or receive the stock of another corporation in a qualified stock disposition.").

81. Treas. Reg. § 1.336-1(b)(6).

period of 12 months. Each element is subject to the specific rules and limitations discussed below.[82]

a. A "Disposition" of the Stock

The term disposition is defined as "any sale, exchange, or distribution of stock, but only if:" (1) the purchaser's basis in the target stock is not determined with respect to the basis of the stock in the hands of the transferor; (2) the stock is not transferred in a transaction covered by Sections 351, 354, 355, or 356; and (3) the stock is not transferred to a related person.[83] Generally, this requires a *taxable* sale, exchange, or distribution of the target stock to an unrelated party. A qualified stock disposition under Section 336(e) is broader than a qualified stock purchase under Section 338(h)(10) because a qualified stock disposition can be a combination of stock distributions, stock exchanges, *and* stock sales. Notably, if a stock disposition meets the definition of both a qualified stock disposition and a qualified stock purchase, the overlap rule in Treas. Reg. Section 1.336-1(b)(6)(ii)(A) provides that it will not be treated as a qualified stock disposition, and the Section 338(h)(10) election would be made in lieu of the Section 336(e) election.[84] In other words, Section 338(h)(10) and the qualified stock purchase rules take precedence over Section 336(e) and qualified stock dispositions. If a transaction qualifies for both elections, the Section 336(e) election becomes unavailable, and Section 338 and the corresponding Regulations are used to determine the tax effect of the transaction.[85]

b. Disposition Meeting Section 1504(a)(2) Control

The term qualified stock disposition is defined through a cross-reference to Section 1504(a)(2), which requires ownership of stock of "at least 80 percent of the total voting power of the stock" and "a value equal to at least 80 percent of the total value of the stock" of

82. *Id.;* Treas. Reg. § 1.336–1(b)(5).
83. Treas. Reg. § 1.336–1(b)(5).
84. Treas. Reg. § 1.336-1(b)(6)(ii)(A) (providing that if a transaction qualifies as a Section 338(h)(10) transaction, then it cannot be a qualified stock disposition under Section 336(e)); *see* Matthew J. Mittman, CPA, Oak Brook, Ill., *Final Sec. 336(e) Regulations: Election for Qualified Stock Dispositions*, THE TAX ADVISER (September 1, 2013), https://www.thetaxadviser.com/issues/2013/sep/clinic-story-01.html.
85. *See infra* Section 0.0. (comparing the Section 338(h)(10) election to the Section 336(e) election).

the target corporation.[86] Nonvoting, nonconvertible preferred stock is excluded from stock considered in calculating the 80 percent threshold requirement.[87] As the rules are applied to S corporations, the S corporation shareholders must dispose of at least 80 percent of the S corporation's outstanding stock in order to be sufficient for a qualified stock disposition.

c. Within a 12-Month Period

A qualified stock disposition can occur in several transactions with different purchasers on different dates. A fundamental difference between the Regulations under Section 338(h)(10) and the Regulations under Section 336(e) for S corporations is that only Section 336(e) creates the possibility of a deemed sale election as a result of multiple dispositions of S corporation stock occurring on more than one day during the disposition period.[88]

2. Consent Requirements

The Section 336(e) election is, in a sense, a unilateral election because it is made by the selling group, yet without the purchaser's consent; however, it is a joint election because it must be elected jointly by the members of the selling group (*i.e.*, the seller and the target corporation).[89] Thus, in the sale of an S corporation, the Section 336(e) election must be made jointly by the target S corporation and *all* of the shareholders of the S corporation. Even the S corporation shareholders who are not participating in the qualified stock disposition must consent to the election. "The fact that all the shareholders, including those that did not sell stock, must approve the Sec. 336(e) election is reasonable and prevents a tax burden from being assessed on a nonparticipating shareholder."[90]

---

86. I.R.C. § 1504(a)(2).
87. *See* I.R.C. § 1504(a)(4).
88. I.R.C. § 336(e); Treas. Reg. § 1.338(h)(10).
89. Treas. Reg. § 1.336–1(h).
90. Edward J. Schnee & W. Eugene Seago, *Maintaining Single Taxation: Sec. 336(e) and S Corporations*, THE TAX ADVISER (Mar. 1, 2014), https://www.thetaxadviser.com/issues/2014/mar/schnee-mar2014.html.

3. Manner and Timing of Making a Section 336(e) Election

The seller shareholders and target S corporation must enter into a binding, written agreement to make a Section 336(e) election on or before the due date of the U.S. federal income tax return of the S corporation target for the taxable year that includes the disposition date.[91]

E. Comparison of Section 338(h)(10) Election to Section 336(e) Election

Like a Section 338(h)(10) election, a Section 336(e) election can be beneficial when an asset sale would be preferable but other factors require a stock transaction. Sections 336(e) and 338(h)(10) both allow taxpayers to elect to treat the sale of a target company's stock as the sale by the target company of its assets followed by a liquidation of the target.

A Section 336(e) election generally cannot be made if a Section 338(h)(10) or Section 338(g) election could be made.[92] As a result, the Section 336(e) election expands the categories of stock transactions that can be structured as asset acquisitions for tax purposes. Section 336(e) is broader and more expansive than Section 338(h)(10) because a Section 338 election only applies to a *purchase* of stock; whereas the Section 336(e) election applies to sales, exchanges, and dispositions of stock. Although both Section 336(e) and Section 338 look to the same 80 percent of target stock standard, a "qualified stock disposition" looks to the transferor while a "qualified stock purchase" looks to the purchaser. Another major difference between these sections is that Section 338(h)(10) requires the stock sale to be to another corporation, while Section 336(e) does not restrict the entity of the purchaser. Under Section 336(e), purchasers can be corporations, partnerships, LLCs, trusts, individuals, or any combination of the foregoing. Additionally, a Section 336(e) election can apply to transactions with multiple purchasers.[93]

Generally, if a transaction is a Section 336(e) "qualified stock disposition" as well as a Section 338 "qualified stock purchase," the

---

91. Treas. Reg. § 1.336–1(h)(3).
92. Treas. Reg. § 1.336-1(b)(6)(ii); Treas. Reg. § 1.336-1(b)(6)(ii)(A).
93. The Section 336 election is available to "one or more persons that acquire or receive the stock of another corporation in a qualified stock disposition." Treas. Reg. § 1.336–1(b)(2).

transaction is not a qualified stock disposition, and the Section 336 Regulations indicate that only the Section 338 election is available. Thus, the parties cannot bypass Section 338 by using a Section 336(e) election instead.

Example 6: Consider the facts from Example 4(a). Since Lekko Corporation is a corporation (rather than a partnership), Lekko Corporation cannot tell Izabella to make a Section 336(e) election instead of a Section 338 election because Lekko Corporation would have to go with the Section 338 election.

IV. DECISION TO MAKE SECTION 338(H)(10) OR SECTION 336(E) ELECTION

The decision of whether it is more advantageous and to what extent an S corporation should sell its assets or its stock, and in the case of a stock sale whether to make an Election, will require the consideration of the following tax issues:

A. Due Diligence of Valid S Corporation Status

The purchaser of stock in an S corporation should ensure the initial and continuing qualification of the target entity as an S corporation. This may require that the S corporation sellers produce documentation evidencing a valid S corporation election and continuing status. The S corporation sellers may also be asked to make several representations and warranties in the purchase agreement as to the target entity's S corporation status.[94]

B. Evaluation of Fair Market Value and Tax Basis

A Section 338(h)(10) or Section 336(e) election only makes sense if the fair market value of the target corporation's assets exceeds the target corporation's aggregate tax basis in such assets. This is because the purchaser should only pursue the deemed asset acquisition if the purchaser obtains a corresponding stepped-up basis in the target corporation's assets. If the purchaser acquires assets from target corporation at a time when the target corporation's basis in its assets exceeds the fair market value of the assets, a stock purchase with a Section 338(h)(10) or Section 336(e) election results in adverse tax consequences to the

94. Hamill, *supra* note 29.

purchaser in the form a "stepped-down" basis in the acquired assets.[95] Thus, in an economic downturn, a purchaser may prefer to structure an acquisition as a stock acquisition without a Section 338(h)(10) or Section 336(e) election.

C. Comparison of Inside Basis Versus Outside Basis

The relative attractiveness of either a Section 336(e) or Section 338(h)(10) election depends on whether the S corporation shareholders' basis in the target S corporation stock is significantly lower than target S corporation's basis in its assets. S corporation target shareholders will be disinclined to agree to an asset acquisition if the S corporation holds ordinary income assets and the shareholders have a higher outside stock basis in the S corporation shares as compared to the aggregate inside basis the S corporation has in its assets. This would result in ordinary income and capital loss to the S corporation shareholders in a transaction structured as an asset acquisition—an undesirable result for the S corporation shareholders, who would be taxed a higher tax rate on their ordinary income and also might not have capital gains to offset the capital losses.[96] In such a case, the S corporation shareholders would insist on a stock acquisition without an Election.

D. Character of Gain Differential Between Stock Sale and Asset Sale

An asset acquisition and a stock acquisition generally result in the same aggregate gain to an S corporation's target shareholder. However, the amount of tax on such gain will depend on the type of assets being sold and the resulting character of gain or loss on a sale of assets.

If a substantial amount of the assets held by an S corporation would be subject to ordinary income characterization, an asset acquisition would result in both ordinary income and capital gains to the S corporation shareholders, while a comparable stock acquisition would result in only capital gain to the S corporation shareholders.[97] Thus, in this case, the S corporation shareholders

95. *See* Greenberg & Davis, *supra* note 13.
96. *Id.*
97. *Id.*

would likely prefer a stock acquisition because the long-term capital gains are subject to preferential tax rates, and an S corporation shareholder would want to ensure that *all* (instead of just some) of its gains on sale are eligible for preferential tax treatment.[98]

For example, suppose an S corporation, who is a cash method taxpayer, has the following assets: inventory with a basis of $50 and a fair market value of $150, and accounts receivable with a $0 basis and value of $100. If the S corporation shareholder sold its stock for a purchase price of $250 and a valid Election were made to treat the stock sale as an asset sale, the S corporation shareholder would recognize $200 of gain, all of which would be ordinary income, taxable at a rate of 39.6 percent (if the QBI deduction does not apply), resulting in $79.20 of tax. On the other hand, if the S corporation's only assets were capital assets, such as two tracts of land with the same basis and fair market value as above, the asset sale would result in the same $200 of gain, but it would be taxable at the capital gain rate of 20 percent, resulting in only $40 of tax.

E. Corporate Level Tax Triggered in Deemed Asset Sale

S corporations are pass-through entities, which are not usually subject to corporate-level taxes.[99] However, in certain circumstances, corporate level taxes may be imposed upon an S corporation under I.R.C. Section 1374. Section 1374 imposes a corporate level tax upon the disposition of built-in gain assets by an S corporation in the following situations: (i) if the S corporation was previously a C corporation that elected S corporation status after formation (*i.e.*, a converted S corporation) and it retained assets from the time it was a C corporation;[100] or (ii) if the S corporation acquired built-in gain assets from a C corporation in a tax-free, transferred basis transaction.[101]

The Section 1374 built-in gain tax is applicable for any disposition of built-in gain assets by the S corporation during the

---

98. *Id.*

99. Although S corporations are not subject to corporate income tax at the Federal level, they may be subject to corporate taxation at the state or municipal level. A discussion regarding the imposition of such state and local corporate taxation is beyond the scope of this article.

100. I.R.C. §§ 1374(a)–(d).

101. I.R.C. § 1374(d)(8); Treas. Reg. § 1.1374–8(a).

five-year period starting with the first day of the first taxable year that the corporation was an S corporation or the date the S corporation acquired the built-in gain assets from a C corporation.[102] Built-in gain is "measured by the appreciation of any asset over its adjusted basis at the time the corporation converts from C corporation to S corporation status (or acquires assets from a C corporation in a tax-free transaction)."[103]

The disposition of built-in gain assets during the applicable five year period will require corporate level gain recognition taxable to the S corporation at the highest tax rate applicable to corporations, which is currently a 21 percent tax rate. In addition, the built-in gain is passed through and recognized by the S corporation shareholders under Section 1366. The character of the shareholder level gain is determined by reference to the asset disposed of, reduced by Section 1366 losses.[104]

If the S corporation target holds assets with built-in gain subject to Section 1374, a stock acquisition with a Section 338(h)(10) or Section 336(e) election will trigger a built-in gains tax. A stock acquisition without a Section 338(h)(10) or 336(e) election generally will not trigger the built-in gains tax under Section 1374.

Example 7. Consider the facts from Example 3, except that RIZ Inc. was formed a C corporation in 2010 and elected S corporation status on January 1, 2020. At the time of its conversion to S corporation status, RIZ Inc. has only two assets, equipment and land. The equipment has a basis of $120,000 and a fair market value of $400,000, and the land has a basis of $180,000 and a fair market value of $600,000. On January 1, 2021, Izabella sells her RIZ Inc. stock to Lekko Corporation for $1,000,000 (when the basis and the value of the assets remain the same as at the time of conversion). If a valid Section 336(e) or Section 338(h)(10) election

102. I.R.C. §§ 1374(d)(7)-(8).

103. I.R.C. § 1374(d)(3); Potter, *supra* note 7 at *7.

104. Potter, *supra* note 7, at *6. "If the S corporation was a C corporation previously, the built-in gains at conversion that are recognized during the recognition period are subject to a corporate-level tax. If the stock sale occurs during the recognition period, the deemed asset sales generate taxable built-in gains. The tax liability is a corporate liability. Therefore, the ADADP is increased by this tax liability. If the corporation owns assets that have declined in value and/or has a net operating loss carryforward, the amount of tax due on the built-in gains from these deemed asset sales may not be equal to the net gain times the highest corporate tax rate. The gains and losses from the deemed asset sales by an S corporation (modified by the built-in gains tax) pass through and are recognized by the shareholders." Schnee & Seago, *supra* note 90, at 3.

were made, RIZ Inc. would be liable for built-in gain tax on the $280,000 of built-in gain on the equipment and $420,000 of built-in gain on the land, as measured at the time of conversion. In the deemed asset sale, the tax liabilities of RIZ Inc., including the built-in gains tax realized on the deemed asset sale, remain the liability of RIZ Inc., which means that purchaser of RIZ Inc. would be liable for built-in gain taxes under Section 1374 on the $700,000 of built-in gain as a result of RIZ Inc.'s conversion from C corporation to S corporation status prior to the acquisition.

Accordingly, in determining whether to structure an acquisition as an asset sale or a stock sale with a corresponding Election, a purchaser must consider the possible existence of any built-in gains on corporate assets, as well as the existence of unfavorable tax attributes such as earnings and profits. "To the extent any corporate-level taxes may apply, the seller would also be affected. . . ."[105]

F. Purchase Price Considerations

If the purchaser and sellers agree to proceed with an Election under either Section 338(h)(10) or Section 336(e), the sellers should insist thatthe purchaser gross-up the purchase price for any additional tax liabilities associated with the Election. This gross-up payment should include taxes that will be incurred by the S corporation shareholders as a result of the transaction being treated as an asset sale for tax purposes (on which the seller shareholders may recognize ordinary income) rather than a stock sale on which the shareholders would only recognize capital gain.[106] If the step-up in tax basis for the purchaser has a net present value that exceeds the gross-up payment requested by the sellers, the purchaser should agree to the increase in purchase price.[107] This gross-up payment is the reason S corporation shareholders are generally indifferent in terms of structuring the transaction as either an asset or a stock sale. Although sellers prefer the stock sale, they will agree to a purchaser's proposition to treat the stock sale as an asset sale for tax purposes if the gross-

105. Hamill, *supra* note 29, at 65.

106. *See* Potter, *supra* note 7, at *3.

107. *See id.* at *5. Alternatively, the gross-up payment may result in the Election being cost-prohibitive if it exceeds the step-up in tax basis. *See id.* at *4.

up payment makes up for any additional taxes sellers may incur from the Election.

V. EFFECT OF SECTION 338(H)(10) AND SECTION 336(E) ELECTIONS

The impact of an election under either Section 338(h)(10) or Section 336(e) will generally have a similar effect—the transaction will be treated as a deemed asset sale, typically followed by a complete liquidation.[108] A single level of tax is imposed at the entity level. The stock sale is ignored for tax purposes. Instead, the target corporation is treated as making a deemed sale of its assets and then liquidating.[109]

An Election creates a tax fiction that treats a qualified stock purchase (in the case of a Section 338(h)(10) election) or a qualified stock disposition (in the case of a Section 336(e) election) of target corporation as a deemed asset sale of the "Old Target" assets to a new and fictional "New Target," both of which are legally the same entity but generally different corporations for federal tax purposes.[110] An Election with an S corporation target has the following effect:

Step 1. Old Target (while Old Target is owned by S corporation shareholders) is deemed to sell all of its assets to New Target in exchange for the negotiated consideration plus any liabilities assumed,[111] which is the aggregate deemed sale price ("ADSP") under Section 338 or the aggregate deemed asset disposition price ("ADADP") in the case of a Section 336(e) election.[112] Old Target recognizes gain or loss on this deemed asset sale (equal to the consideration received plus liabilities assumed less tax basis of target corporation's assets), which passes through to all the S corporation shareholders.[113]

---

108. Treas. Reg. §1.336-1(a)(1) (providing that generally, except to the extent inconsistent with section 336(e), the results of section 336(e) should coincide with those of section 338(h)(10)); *see* Schnee & Seago, *supra* note 90.

109. *See* Horacio Sobol, Ryan Prillaman, & Sam Starr, *Section 336(e) Deemed Asset Acquisitions and S Corporations*, BLOOMBERG BNA - DAILY TAX REPORT (Mar. 31, 2014).

110. Treas. Reg. § 1.338(h)(10)–1(d); *see also* Potter, *supra* note 7, at *11.

111. Treas. Reg. §§ 1.338(h)(10)–1(d)(3); *see also* Potter, *supra* note 7, at *4.

112. *See* Treas. Reg. § 1.338(h)(10)–1(d)(3) (for § 338(h)(10) election); § 1.336–2(b)(1)(i)(A) (for §336(e) election); *see also* Schnee & Seago, *supra* note 90, at 2. If the stock is sold (rather than distributed under § 336(e)), the ADADP under § 336(e) will equal the ADSP under §338(h)(10). *Id.*

113. Treas. Reg. § 1.338(h)(10) –1(d)(5)(i).

Step 2. New Target, owned by the purchaser, is deemed to purchase the Old Target's assets and assume its non-tax liabilities from an unrelated seller for the adjusted grossed-up basis ("AGUB").[114] AGUB is the grossed-up basis of the purchased target corporation stock, plus the liabilities of New Target.[115] AGUB is allocated to the individual assets under the residual method set forth in Treas. Reg. Section 1.338–6.[116]

Step 3. Old Target is deemed to liquidate, distributing the sale proceeds from the deemed asset sale to its shareholders.[117] Following the deemed sale by the target of all its assets, the target is deemed to have liquidated, which is treated as a taxable liquidation under Sections 331 and 336.[118] Old Target does not recognize any gain or loss on the liquidation, because of the basis step-ups to target assets and to target stock.[119]

Example 8. Consider the facts from Example 4(a). Upon making a Section 338(h)(10) election, old RIZ Inc. is deemed to sell all of its assets to new RIZ Inc. in exchange for the negotiated consideration of $1,000,000. Old RIZ Inc. recognizes $700,000 of income, which is passed through to Izabella and increases Izabella's stock basis in old RIZ Inc. After the deemed asset sale, RIZ Inc. is treated as a new corporation and new subsidiary of Lekko Corporation for tax purposes. New RIZ Inc. (owned by Lekko Corporation) is deemed to purchase old RIZ Inc.'s assets and assume its non-tax liabilities from an unrelated seller for the AGUB, which is also equal to $1,000,000. Old RIZ Inc. is deemed to liquidate.

A. Deemed Asset Purchase Price Allocation

If either a Section 338(h)(10) or Section 336(e) election is made, the parties must allocate the purchase price, *i.e.*, the ADSP (for a Section 338(h)(10) election) or the ADADP (for a Section 336(e) election), among the basis of the various target assets

114. Treas. Reg. §§ 1.336-2(b)(1)(ii), 1.338(h)(10)–1(d)(2). "The AGUB for new T's assets is determined under § 1.338–5 and is allocated among the acquisition date assets under §§ 1.338–6 and 1.338–7." Treas. Reg. § 1.338(h)(10)–1(d)(2).

115. Treas. Reg. § 1.338–5(b)(1).

116. Treas. Reg. 1.338(h)(10)–1(d)(2). The AGUB in a § 336(e) election is calculated the same as the AGUB in a § 338(h)(10) election and is allocated under Treas. Reg. § 1.338–6. Treas. Reg. §§ 1.336–2(b)(1)(ii), 1.336–4.

117. Treas. Reg. §§ 1.338(h)(10)–1(d)(4)-(5), 1.336–2(b)(1)(iii).

118. Treas. Reg. § 1.336–2(b)(1)(iii); *see also* Schnee & Seago, *supra* note 90.

119. Treas. Reg. § 1.338(h)(10)–1(d)(5); Potter, *supra* note 7.

acquired in accordance with the residual method of valuation.[120] The ADSP or ADADP is allocated among the first six classes in the order listed, and if there remains additional consideration, it is then allocated to the residual category under class seven. The seven classes listed in order are:

(1) Cash and demand deposits;

(2) Actively traded personal property, including certificates of deposit and foreign currency;

(3) Assets the value of which is marked-to-market and debt instruments, including accounts receivable;

(4) Inventory;

(5) All assets that are not classified in any other category;

(6) Code Section 197 intangibles (other than goodwill or going concern value); and

(7) Goodwill and going concern value.[121]

"Allocated gain or loss is characterized by reference to the nature of the corporation's purpose in holding the particular assets sold."[122] This will likely cause some portion of the reported gain to be ordinary income, or perhaps unrecaptured Section 1250 gain, rather than 20 percent capital gain. "Target shareholders typically require additional sales consideration to compensate for the added tax burden, which becomes a deal point in negotiations to make an Election election."[123]

B. Deemed Asset Sale Tax Treatment for S Corporation and Shareholders

In general, the tax consequences of an asset sale by an S corporation are relatively straightforward because the S corporation itself is a pass-through entity and is generally not

120. I.R.C. § 1060; Treas. Reg. §§ 1.338–6, 1.338–7.
121. Treas. Reg. § 1.338-6.
122. Looney, *supra* note 42, at 27.
123. Hamill, *supra* note 29, at 74.

treated as a taxable entity for federal income tax purposes, and as such, its shareholders are subject to only one level of tax.[124]

The S corporation election, as explicitly stated by the Regulations, persists till the final day of the deemed asset sale..[125] Since S corporations do not pay federal income tax, as a general rule, the computation of the ADSP or ADADP does not include an adjustment for the tax liability.[126] The gain or loss on a sale of assets by an S corporation will be the difference between the consideration received on the sale from the purchaser and the S corporation's adjusted tax basis in the assets sold, as determined under the general rules of Section 1001.[127] The amount and character of this gain or loss from the deemed asset sale passes through to and is taxed at the shareholder level.[128]

The fact that a shareholder did not sell stock is immaterial. All the shareholders recognize their share of the gains and losses.[129] S corporation shareholders take their pro rata share of the deemed sale tax consequences into account under Section 1366 and increase or decrease their basis in target entity stock under Section 1367. Because Old Target is an S corporation, the shareholders' adjusted tax basis in their Old Target shares is adjusted (*i.e.*, increased) for any gain recognized by Old Target on the deemed asset sale.[130] After recognizing the gains and losses, the shareholders adjust their basis in the S corporation stock owned before the sale by the amount apportioned to them. They increase their basis by apportioned gains and income, and reduce basis by deductions and losses.[131]

---

124. Looney, *supra* note 42, at 27. "Where the S corporation has been a qualifying electing small business corporation for its entire history and has not acquired the assets of a C corporation (or an S corporation subject to the built-in gain tax) within the past ten years in an exchanged basis transaction, then the corporate-level tax from the asset sale is, for federal (and most state) income tax purposes, passed through to the shareholders and results in a single level of tax." *Id.*; *see supra* text accompanying note 99.

125. Treas. Reg. § 1.336-2(b)(1)(i).

126. Schnee & Seago, *supra* note 90, at 3. "There are two potential modifications to the ADADP for S corporation taxes. If the S corporation was a C corporation that used the LIFO method at the time of the conversion, the corporation has to pay tax on the LIFO recapture. If the installments have not all been paid at the time of the sale, the remaining installments are corporate liabilities that increase the ADADP. A more important potential adjustment is in Sec. 1374." *Id.*

127. Looney, *supra* note 42, at 27.

128. Potter, *supra* note 7, at *2; Treas. Reg. 1.338(h)(10) –1(d)(5)(i).

129. Schnee & Seago, *supra* note 90.

130. Potter, *supra* note 7, at *4; Treas. Reg. § 1.338(h)(10)–1(d)(5)(i).

131. Schnee & Seago, *supra* note 90 at 3.

Additionally, per I.R.C. Section 199A, individuals are eligible for a 20 percent deduction for certain qualifying business income ("QBI") from flow-through entities, which includes S corporations.[132] If the deduction is available and not restricted by wage and basis limitations, it would reduce the S corporation shareholder's individual maximum tax rate to 29.6 percent on QBI. Notably, certain ordinary income (such as depreciation recapture) from a deemed asset sale would be treated as QBI qualifying for the 20 percent tax deduction.[133] The QBI deduction under Section 199A makes the S corporation competitive with C corporations.

Example 9: Consider the facts from Example 8. RIZ Inc. recognizes $280,000 income ($400,000 amount realized – $120,000 basis) for the sale of the equipment and $420,000 income ($600,000 amount realized – $180,000 basis) for the sale of the land, totaling $700,000 in income, which "flows through" to Izabella (RIZ Inc.'s shareholder), and which increases Izabella's stock basis in RIZ Inc. from $100,000 to $800,000. Izabella is taxed on that $700,000 of gain based on the characterization of such income from the asset to RIZ Inc. The character of the gain will be $150,000 ordinary income (for the equipment depreciation recapture) and the remaining $550,000 as capital gain. The $150,000 in ordinary income is taxed at the maximum individual rate of 29.6 percent (as reduced by the flow through QBI deduction), resulting in $44,400 of tax. The $550,000 taxed at the maximum capital gain tax rate of 20 percent results in $110,000 of tax. Izabella ends up with $154,400 total tax due, which when deducted from the $1,000,000 purchase price, resulting in $845,600 cash on an after-tax basis. When old RIZ Inc. is deemed to distribute the sales proceeds to Izabella, Izabella receives $1,000,000 of cash, which results in $200,000 of capital gain ($1,000,000 cash – $800,000 stepped-up basis in old RIZ, Inc.). Ultimately, Izabella recognizes $900,000 of gain, which is the same amount Izabella would have recognized had this been a stock sale of RIZ Inc. ($1,000,000 AR – $100,000 basis = $900,000 gain).

Notably, S corporation shareholders selling an S corporation will report the same amount of gain on the transaction, whether or not an Election is made. What is different in the case of an asset acquisition versus a stock acquisition is the characterization of

132. Subject to sunset at the end of 2025.
133. Potter, *supra* note 7, at *6; Hamill, *supra* note 29, at 67.

that gain. An Election has the effect of converting some or all of an S corporation shareholder's capital gain from a stock sale into ordinary income in an asset sale. This can occur if the S corporation shareholder has an outside basis equal to or less than the S corporation's inside basis. On the other hand, if the S corporation shareholder's outside basis is greater than the S corporation's inside basis, the S corporation shareholder would report a capital loss. The capital loss serves to offset the additional ordinary income realized by the S corporation on the deemed asset sale, which is also recognized by the S corporation shareholder. "Although the total net income reported by the shareholder is the same, the classification can greatly affect the shareholder's tax liability."[134]

C. Tax Treatment on Liquidation of S Corporation

Immediately following the deemed asset sale, the S corporation is treated as having distributed the amount received from the asset sale to the shareholders, followed by a termination of the S election.[135] In most cases, such a transfer of the cash asset, *i.e.*, the distribution, is treated as a distribution in complete liquidation of the corporation.[136] Because the shareholders of an S corporation are typically individuals, Section 331 governs the liquidation.[137] Such deemed liquidation of Old Target will not usually generate gain because of the stepped-up basis in the S corporation assets and to the S corporation stock. The application of Section 331, rather than Section 332, "is a major difference under Sec. 336(e) for S corporation shareholders that make the election, compared with C corporations that make the election for the sale of a subsidiary."[138]

---

134. Schnee & Seago, *supra* note 90.

135. *See* Treas. Reg. § 1.338(h)(10)–1(d)(5).

136. Treas. Reg. § 1.338(h)(10)–1(d)(4) (although the Regulation states it may be treated as a redemption or reorganization).

137. Treas. Reg. § 1.338(h)(10)–1(d)(4). The application of Section 331, rather than Section 332, "is a major difference under Sec. 336(e) for S corporation shareholders that make the election, compared with C corporations that make the election for the sale of a subsidiary." Schnee & Seago, *supra* note 90.

138. Treas. Reg. § 1.338(h)(10)–1(d)(4); Schnee & Seago, *supra* note 90.

D. Tax Treatment to Purchaser of Assets

The tax consequences to a purchaser of assets of an S corporation are simple—the purchaser receives a cost basis in the acquired assets.[139] This means that the purchaser receives a basis in the acquired assets equal to the purchase price paid (plus any assumed liabilities).[140] Because the cost basis is typically higher than the basis the S corporation target had in those assets, a cost basis usually results in a stepped-up basis for the purchaser. The basis is used by the purchaser, among other things, to calculate depreciation and amortization deductions on the acquired assets, as well as to determine gain or loss on the sale or other disposition of the assets in the future. A stepped-up basis translates into significant tax benefits for the purchaser by allowing it to take greater depreciation and amortization deductions on those assets and by reducing the amount of taxable income or gain (or increasing the amount of loss) on a later sale or other disposition of the assets.[141]

1. 100 Percent Bonus Depreciation

One such tax benefit is afforded to the purchaser under I.R.C. Section 168(k), whereby the purchaser can take bonus depreciation in the first year for tangible personal property with a life of 20 years or less.[142] The depreciation percentage is based on the year that the property is purchased and placed in service.[143] Qualifying property placed in service after September 27, 2017, but before January 1, 2023, is eligible for 100 percent bonus depreciation.[144] However, starting on January 1, 2023, full bonus depreciation is phased down at a rate of 20 percent per year until fully phased out after the end of 2026.[145]

---

139. I.R.C. § 1012; *see* Greenberg & Davis, *supra* note 13, §4.03(2)(a).
140. Treas. Reg. § 1.338(h)(10)–1(d)(2); *see* Greenberg & Davis, *supra* note 13, §4.03(2)(a).
141. *See* Steven D. Shapiro, *Acquisition Planning for a Tax Basis Step-Up*, FLA. BAR J., Vol. 91, No. 1 (January 2017), https://www.floridabar.org/the-florida-bar-journal/acquisition-planning-for-a-tax-basis-step-up/.
142. I.R.C. § 168(k).
143. *See* Treas. Reg. § 1.168(k)-2(b).
144. *See* Erica York et al., *The Economic, Revenue, and Distributional Effects of Permanent 100 Percent Bonus Depreciation*, TAX FOUND. (August 30, 2022), https://taxfoundation.org/research/all/federal/permanent-100-percent-bonus-depreciation-effects/.
145. *Id.*

The 2017 Tax Cuts and Jobs Act expanded property eligible for bonus depreciation to include certain used property.[146] The purchaser is able to take bonus depreciation on property that is acquired by purchase, provided that the property is not acquired from a related party.[147] Deemed acquisitions of property pursuant to a Section 338(h)(10) election or a Section 336(e) election are subject to the same treatment as actual acquisitions and thus are eligible for Section 168(k) bonus depreciation. The availability of bonus depreciation in such instances is a valuable tax benefit to the purchaser in merger-and-acquisition transactions and can serve as "additional consideration during negotiations."[148]

The ability to deduct 100 percent of a high-priced asset's cost in the year of purchase under Section 168(k) can generate significant tax savings and possibly even refunds for purchaser.[149] A purchaser's tax benefits from the 100 percent bonus depreciation deduction could potentially exceed the tax burden at the shareholder level tax, resulting in no net tax to either party. However, as the phaseout of 100 percent bonus depreciation takes its course and the depreciation percentage decreases from year to year, the tax benefits will also gradually be diminished and eventually completely phased-out.

2. Section 179 Expensing

I.R.C. Section 179 is another immediate expense deduction available to the purchaser, pursuant to which the purchaser can elect to expense the cost of any qualified property and deduct it in the year the property is placed in service.[150] This allows a purchaser to lower its current-year tax liability instead of capitalizing and depreciating the assets over time in future tax years. Section 179 applies to purchases of depreciable business equipment such as office equipment, business machinery,

---

146. Sharon Kay & Caleb Cordonnier, *Proposed bonus depreciation regs. Provide answers, create new questions*, THE TAX ADVISER (Feb. 1, 2019), https://www.thetaxadviser.com/issues/2019/feb/proposed-bonus-depreciation-regs-provide-answers-create-questions.html.

147. Potter, *supra* note 7, at *6.

148. Kay & Cordonnier, *supra* note 146.

149. *Id.*; *see* Jeremy Sompels et al., *The TCJA 100% bonus depreciation starts to phase out after 2022*, PLANTE MORAN (February 16, 2023), https://www.plantemoran.com/explore-our-thinking/insight/2022/08/the-tcja-100-percent-bonus-depreciation-starts-to-phase-out-after-2022.

150. I.R.C. § 179.

computers, vehicles, or software.[151] The full amount of the purchase price for such purchased equipment is eligible for the Section 179 deduction. The Section 179 deduction is limited to a maximum of $1,160,000 and a value of property purchased to $2,890,000 for the year 2023.[152] The deduction begins to phase out on a dollar-for-dollar basis after $2,890,000 is spent, with the entire deduction becoming unavailable once $4,050,000 in purchases is reached.[153]

E. Impact of Election on Purchase Agreement

Depending on the type of Election available for the acquisition and whether it is beneficial to the parties, counsel on either side of a transaction should ensure that certain specific provisions and items are included in the purchase agreement with respect to making the Election. One such provision that should always be included when the transaction involves an Election is the purchase price allocation, whereby the parties mutually agree to allocate the purchase price to the specific classes of assets acquired in the transaction. Both parties must report the same allocation, so the purchase price allocation schedule is typically agreed upon at or shortly after the closing in accordance with this provision. This provision should indicate where the allocation schedule can be found, which party is responsible for preparing it, when it must be completed, and a dispute resolution procedure in case the parties cannot agree on the allocation scheme. It should also state that the tax returns of both parties must be filed in accordance with the purchase price allocation schedule.

1. Purchase Agreement from Purchaser's Perspective

If the purchaser believes it will benefit from a Section 338(h)(10) election, purchaser's counsel should ensure that the purchase agreement includes a provision whereby purchaser and seller jointly agree to make the Section 338(h)(10) election, if requested by purchaser.[154] This type of provision is beneficial to

---

151. Publication 946 (2022), How To Depreciate Property, IRS, *available at* IRS.gov/Pub946. *How To Depreciate Property,* I.R.S., at 16 (Feb. 23, 2022), IRS.gov/Pub946.
152. *Id.*
153. *See* Section 179 at a Glance for 2023, SECTION179.ORG, https://www.section179.org/section_179_deduction/ (last visited Aug. 30, 2023).
154. *See* Greenberg & Davis, *supra* note 13, §4.03(2)(a).

the purchaser due to the fact that the Section 338(h)(10) election must be made jointly by purchaser and seller. Binding the seller under the purchase agreement ensures that the seller will proceed with making the Election.

On the other hand, a Section 336(e) election can be made only by seller and without the purchaser's consent. Therefore, if the purchaser performs an evaluation and determines that a Section 336(e) election would cause it adverse tax consequences, purchaser's counsel should consider including a negative covenant in the stock purchase agreement preventing the seller shareholders and target corporation from making a Section 336(e) election.[155]

2. Purchase Agreement from Seller's Perspective

Both Elections can have adverse tax consequences for the seller shareholders, particularly if a substantial amount of the assets held by the S corporation target would be subject to ordinary income characterization, taxed at ordinary income rates to the S corporation shareholders. Therefore, counsel for the seller shareholders should seek that the purchase agreement includes a provision whereby purchaser agrees to make a gross-up payment compensating the sellers for any increased tax liabilities in connection with making the Election. Alternatively, counsel may include an indemnification provision whereby purchaser would be required to indemnify the sellers as a result of any such additional tax liabilities incurred.[156]

VI. EFFECTS OF BIDEN ADMINISTRATION PROPOSED TAX CHANGES

The popularity of the S corporation in the world of mergers and acquisitions stems from current favorable tax rates and the corresponding tax benefits available with this specific form of business entity. The tax benefits available to shareholders and purchasers of S corporations are at risk of being eliminated under President Biden's proposed tax plan. President Biden's tax plan seeks to raise the corporate tax rate from 21 percent to 28 percent and the maximum individual rate from 37 percent to 39.6 percent

155. *Id.* §4.04(2)(e).
156. *Id.* §4.04(2)(e)(a)(i).

for individuals making more than $400,000. Under current law, the top capital gain rate is 20 percent (or 23.8 percent including the NIIT if applicable). Biden's proposed tax plan would eliminate the capital gains preference for those making more than $1 million, thus imposing a tax for taxpayers with over $1 million in income at the top ordinary income rate of 39.6 percent (or 43.4 percent including the NIIT). An additional proposal would increase the NIIT rate by 1.2 percentage points above $400,000, bringing the marginal NIIT rate to 5 percent for investment income above the $400,000 threshold.[157] "Together, the proposals would increase the top marginal rate on long-term capital gains and qualified dividends to 44.6 percent" (*i.e.*, 39.6 percent plus 5 percent NIIT).[158] Thus, "[l]ong-term capital gains and qualified dividends of taxpayers with taxable income of more than $1 million would be taxed at ordinary rates. . . ." [159]= In addition to raising the maximum individual rate, Biden's tax plan aims to eliminate the tax benefits under Section 199A, which is currently available to owners of high-earning passthrough entities, including S corporations. This would be accomplished by phasing out the Section 199A deduction for taxpayers with income of more than $400,000.[160]

An increase in capital gains tax could have a distressing impact on asset and stock acquisitions involving pass-through entities as targets.[161] The phase-out of the QBI deduction for owners of S corporations might make the C corporation a more

157. The proposal would expand the NIIT base to ensure that all pass-through business income of high-income taxpayers is subject to either the NIIT or employment taxes under the Self-Employment Contributions Act.

158. General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals, DEP'T OF THE TREASURY, at 79 n.20 (March 9, 2023), https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf.

159. *Id.* at 79.

160. *M&A Tax Talk: Power Shift, Tax Shift?* DELOITTE (Jan. 2021), https://www2.deloitte.com/us/en/pages/tax/articles/m-and-a-tax-talk.html. "The analysis of different structuring alternatives may also change. If long-term capital gains are taxed at ordinary rates (for certain individuals), sellers may not be as concerned with structuring transactions to achieve capital gains tax treatment. . . . Alternatively, businesses may become more concerned with tax structuring alternatives. For example, a buyer typically favors a structure that is treated as an asset acquisition or deemed asset acquisition because it may deliver a step-up in tax basis. If the rates increase, the tax basis step-up will drive incremental value by providing additional deductions that would offset taxable income subject to higher tax rates." *Id.* at 2.

161. *Election Pivotal for Tax Impact of Future Deals,* GRANT THORNTON LLP (Sept. 18, 2020), https://web.archive.org/web/20201026073114/https://www.grantthornton.com/library/alerts/tax/2020/Insights/election-pivotal-for-tax-impact-future-deals.aspx.

lucrative entity structure as compared to the S corporation, eliminating the ability of S corporations to compete. This is because C corporations are not eligible for the QBI deduction, while S corporations are eligible. The phaseout of the QBI deduction would increase the tax rate on QBI to 39.6 percent (which is equal to the highest individual rate under the Biden tax plan) for taxpayers with income of more than $400,000.[162] "Thus, as with the proposed changes to corporate taxes, the potential phaseout of this deduction increases the income taxes associated with operating a pass-through business."[163] Still, the C corporation may not be a more appealing alternative to the S corporation considering the increased corporate tax rate from 21 percent to 28 percent.

To demonstrate the potential impact of the Biden tax plan on the net proceeds of a sale of business, consider the facts from Example 3(b). Izabella has $900,000 capital gain ($1,000,000 amount realized – $100,000). Additionally, assume Izabella has income from other sources and her total income is greater than $1 million. Under current law, with the capital gains tax rate at 20 percent, the sale would generate $180,000 in taxes due ($900,000 x 20 percent capital gain rate), which results in $720,000 net proceeds to Izabella. Under Biden's proposed tax plan, because Izabella's total income is greater than $1 million, the $900,000 in taxable long-term capital gain would be taxed at 39.6 percent, generating $356,400 in tax, and resulting in $543,600 in net proceeds to Izabella. This would result in $176,400 of additional tax to Izabella versus current law.[164]

VII. CONCLUSION

In conclusion, the unique tax structure of the S corporation, which corresponds with its high popularity as an entity choice, makes the S corporation a likely and worthy target in either an asset acquisition or a stock acquisition. The elections under Section 338(h)(10) and Section 336(e) to treat the stock sale as a

162. The proposal to repeal the Section 199A deduction for individuals with more than $400,000 in income would raise the top effective rate on qualifying pass-through business income from 29.6% to 39.6%.

163. Crystal Howard, *Biden Victory Tax Concerns Could Spur M&A Activity*, LAW360 (Oct. 30, 2020, 5:53 PM), https://www.law360.com/articles/1324333.

164. *Id.*

deemed asset sale for tax purposes make the stock acquisition of an S corporation even more worthwhile for all parties involved by allowing the transaction to proceed with the ease of transferability of a stock sale, while benefitting from the favorable tax consequences of an asset sale. The proposed increased tax rates, phased-out deductions, and limited tax planning opportunities applicable to S corporations under President Biden's tax plan may diminish the preferred status of the S corporation as a key player in the world of mergers and acquisitions, thereby becoming commensurate with the C corporation from a tax perspective. On the other hand, if long-term capital gains are taxed at the same rates as ordinary income (for certain high income individuals), S corporation sellers may become completely indifferent as to whether a transaction is structured as an asset or a stock sale because both would result in the same tax treatment regardless of the character of assets held by the S corporation; in which case, there would be an absolute alignment between potential purchasers and S corporation sellers for the deemed asset acquisition structure available with the Section 338(h)(10) and Section 336(e) elections.[165] Notably, the increased tax rate for high earning individuals will have the greatest impact in determining whether to acquire the stock or assets of a target entity because the individual tax rates are used to calculate any gross-up in purchase price between the two acquisition structures. Still, the purchaser will continue to benefit from a stepped-up basis in a target entity's assets. Accordingly, the tax rate increases under President Biden's proposed tax plan will make transactions that provide for tax basis increases to assets, such as with deemed asset acquisitions using the Section 338(h)(10) or Section 336(e) election, more attractive for C corporations and S corporations alike.

165. In comparison, the shareholders of a C corporation target would continue to prefer a stock sale to avoid the double taxation that comes with a sale of assets.