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Transaction Tax Deductions and Buying an S Corporation

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I. Introduction

Here's the scenario: A family-owned S corporation (S Corp) is being marketed for sale, and because it's very successful, the bidding process is very competitive. To win the bid, a private equity group makes an attractive offer, wins the bid, and agrees to acquire the equity of S Corp with no tax elections or proposed reorganization. In other words, there will be no elections under section 338(h)(10) or section 336(e) and no reorganization under section 368(a)(1)(F). Because S Corp will become a C corporation postclosing, the private equity group will form a corporation as the buyer (X).

The owners of S Corp (Owners) are thrilled with the offer, and to reward S Corp's employees, they intend to have S Corp pay very large bonuses to certain employees on the closing date out of the purchase price to be received at the closing. S Corp has plenty of taxable income for the year, and Owners assume the bonus and certain other transaction expenses paid at the closing will be deductible on S Corp's final S corporation tax return. Owners may be in for a surprise.

As described below, an accrual taxpayer generally is only allowed to deduct expenses if the all-events test is met. For certain contingent expenses paid by an S corporation target at closing when the S corporation status terminates as a result of the sale, those expenses will be paid after the end of the S corporation's final tax year. Those expenses would seem to fall into the S corporation's post-closing C corporation tax year and create a taxable benefit to the buyer, leaving the selling shareholders bearing the economic burden but not sharing in the tax benefits of the deductions. There may be a position to take, however, that would allow those deductions to be taken in the final S corporation tax year.

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