

M&A Nugget: To Split or Not to Split (The Tax Years)

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By Glenn D. Solomon

The sale of the stock of an S Corporation raises a tax issue. The S Corporation is a pass through entity, that is, its net income or loss is passed through to its owners and included on their individual tax returns. When the sale of an S Corporation occurs effective the last day of the tax year, there is no tax issue – the seller owned the business for the entire year prior to the sale and therefore reports all income from that year. A sale in the middle of a year, however, raises an issue. Absent an agreement, the income of the company is reported using the “per share per day” method. Under that method, a pro rata portion of the income for the entire year is allocated to the seller. The pro rata portion is the number of days the seller owned the company during the year divided by 365. However, the purchaser and seller can agree to use what is known as the “cutoff” or “specific accounting” method. Under this method, the tax year is split into two years, the first year starting on the first day of the year and ending on the day before the closing date and the second year beginning on the closing date and ending on the last day of the year. Under this method, the seller is allocated one hundred percent of the income attributable to the first tax year. These two methods of allocating income (or loss) can result in substantially different tax impacts on the seller and the purchaser. When an S Corporation is sold in the middle of the year, the decision of whether or not to split the tax years must be carefully considered.