Tax Clinic

Tax planning and considerations: S corporation targets

Peter Diakovasilis, CPA

Editor: Kevin Anderson, CPA, J.D.

S Corporations

Merger-and-acquisition (M&A) activities have not slowed down during the past few years, including during the COVID-19 pandemic. From government lockdowns to labor shortages, rising inflation, and other events, the pandemic has taken a toll on businesses. M&A markets, however, have continued to thrive as long as the price and, ultimately, the structure is right. S corporations have been a popular entity choice for closely held and operated small businesses and, more importantly, have been targets in many M&A transactions both pre- and post-COVID-19.

A "small business corporation" can elect S corporation status for federal income tax purposes. Sec. 1361(b) defines a small business corporation as a domestic eligible corporation that does not have more than 100 shareholders, any shareholders that are not individuals (except for certain trusts, estates, and exempt organizations), or shareholders who are nonresident aliens. Additionally, the corporation cannot have more than one class of stock. When a small business corporation chooses to become an S corporation for federal income tax purposes, it must file an election with the IRS using Form 2553, *Election by a Small Business Corporation.*

Upon processing the election application, the IRS will issue a CP261 notice confirming its approval of the S election on the identified effective date. Certain state jurisdictions require an independently filed S election application; state S corporation election procedures vary from state to state. Owners of S corporations should maintain documentation proving the validity of the S corporation status by maintaining the executed federal election, the CP261 notice, and any state S corporation election documentation in their permanent files.

Approval of an S election by the IRS and/or a state jurisdiction does not mean that S corporation status remains safe and sound forever. The rules and requirements under Sec. 1361(b) must be adhered to from the effective date of conversion to S status until the company no longer desires to be an S corporation. Thus, if the company always intends to be treated as an S corporation, it must always follow the rules under Sec. 1361(b). The moment the company admits an ineligible shareholder or creates a second class of stock, the S status is in jeopardy and will most likely terminate, at which point the company becomes a C corporation for tax purposes.

Where the validity of a corporation's S status is uncertain (e.g., the CP261 notice is not available, or activity between the S corporation and its shareholders reflects that there might be more than one existing class of stock) a potential buyer may want to choose a different path when structuring the acquisition of the S corporation target. Buyers may acquire an S corporation in many ways. Below are three basic scenarios for acquiring an S corporation target.

Scenario 1: A potential buyer meets the definition of an eligible shareholder under Sec. 1361(b) and acquires the stock of the S corporation from the existing shareholder(s).

Scenario 2: A potential buyer is an ineligible shareholder and attempts to negotiate with the seller(s) to either acquire the assets of the business or, alternatively, acquire 100% of the stock of the S corporation with a Sec. 338(h)(10) or Sec. 336(e) election, resulting in deemed asset purchase and sale treatment.

Scenario 3: A potential buyer is an ineligible shareholder and is concerned about the S status of the target for a variety of reasons. Accordingly, the potential buyer opts for the seller to perform pre-planning F reorganization steps, which ultimately leads to converting the target into a disregarded entity (DRE) under Regs. Sec. 301.7701-3(b)(1)(ii) that is owned by a newly formed S corporation. This scenario is also commonly used when a buyer wants the seller to remain a minority interest owner in the business by rolling over a portion of the seller's existing equity while the buyer obtains a stepped-up basis in the underlying assets. This scenario follows the guidelines set forth in Rev. Rul. 2008-18, but it ultimately requires a few additional steps to achieve the end goal.

Scenario 1: Stock purchase treatment

If the buyer wishes to simply acquire stock and intends for the target to remain an S corporation, the buyer will need to get comfortable that the target's S corporation status is valid, as it will determine the tax classification and ultimately the entity type of the target in the buyer's hands. Therefore, due diligence should be performed concerning documentation of the S status.

The buyer should note that tax attributes are generally unaffected by a stock transfer, as the attributes belong to the corporation and are generally transferred to the buyer together with the other corporate assets. However, limitations may apply with respect to the buyer's ability to use certain acquired tax attributes following the ownership change. The tax basis of the S corporation's underlying assets and the S corporation's tax accounting methods are also not affected by the stock transfer — asset basis and accounting methods carry over to the new ownership.

Additionally, a buyer of stock could potentially inherit the target company's undisclosed liabilities for taxes attributable to prior C corporation periods and potential state and local income taxes. Many states do not follow federal rules for taxation of S corporations, and some that do also impose entity-level taxes, in addition to flowthrough tax treatment for shareholders (e.g., California and Illinois). If the target was never a C corporation, the risk of prior federal taxes is moot, but the state nexus profile of the target should be carefully reviewed.

From the seller's perspective, a stock sale is often desired, as it results in one level of tax, with the gain being long-term capital gain (assuming the holding period requirement under Sec. 1222(3) has been met), which is currently subject to a favorable maximum tax rate of 20% (15% or 0% for taxpayers with taxable income below certain thresholds). In addition, current law provides an exception from the imposition of the net investment income tax under Prop. Regs. Sec. 1.1411-7 for gains from dispositions of certain S corporation stock.

Scenario 2: Asset purchase treatment

Buyers generally prefer to acquire assets, as they will receive a stepped-up basis in the target's underlying assets, and any risk associated with acquiring the stock of the business (e.g., the validity of the S status, undisclosed claims/liabilities) is potentially mitigated. However, if the seller insists that the stock be legally sold, a Sec. 338(h)(10) or 336(e) election can be made. Such elections result in a deemed asset sale for both buyer and seller, thus creating income tax results similar to an actual asset sale.

Depending on the nature and value of the target's underlying assets, an asset sale could produce favorable tax deductions for the buyer — such as, but not limited to, accelerated depreciation under Sec. 168(k) for eligible fixed assets and amortization of intangible assets including goodwill under Sec. 197.

While asset sale treatment can significantly benefit the buyer from an income tax perspective, it can negatively impact the seller by potentially increasing the seller's overall tax burden on the sale of the business as compared with Scenario 1. Accordingly, most sellers request a gross-up be factored into the purchase price negotiations before committing or agreeing to an asset purchase arrangement. A gross-up generally provides additional proceeds to the seller intended to make the seller whole with respect to any incremental taxes owed on the asset sale as compared with a hypothetical stock sale. In a typical gross-up arrangement, a gross-up calculation is performed as soon as the purchase price allocations are finalized.

For example, incremental taxes can result from ordinary and short-term capital gains on the sale of the underlying assets of the business (e.g., Sec. 1245 recapture on depreciable and amortizable assets, appreciated inventory, appreciated real estate, etc.) or from higher state taxes. State tax liabilities can be higher in an asset sale when compared with a stock sale due to the potential for a higher income tax base and depending on where the business (as opposed to the shareholder) is liable for state taxes.

Another consideration in an asset sale is the potential imposition of built-in gains (BIG) tax under Sec. 1374 in addition to shareholder-level taxes. The BIG tax generally applies to C corporations that make an S election and have unrealized built-in gains on the conversion date and to tax-free acquisitions of C corporation assets by an S corporation. The target entity could be liable for BIG tax if certain assets that existed at the time of the conversion or acquisition are sold during the statutory recognition period. The BIG tax is computed by applying the highest corporate tax rate (currently 21%) to the net recognized built-in gain for the tax year, creating incremental taxes for the seller.

Buyers and sellers should carefully review whether proper, complete documentation has been maintained and is available with respect to the underlying assets of the corporation as of the S election effective date. Such documentation includes, but is not limited to, asset appraisals, tax basis records and calculations, and documentation of tax attributes from the period that the corporation was a C corporation, which ultimately can affect any potential BIG tax.

Scenario 3: F reorganization approach

The steps necessary to execute a proper F reorganization under Sec. 368(a)(1) (F) are included in Rev. Rul. 2008-18. Under this revenue ruling, target shareholders form a new holding company

(Holdco), then transfer their stock held in the target to Holdco in exchange for Holdco stock. Effective on the same date, Holdco properly makes an election to treat the target as a qualified Subchapter S subsidiary (QSub) by filing Form 8869, *Qualified Subchapter S Subsidiary Election*. Under Rev. Rul. 64-250, Holdco should be viewed as retaining the target's original S election status without filing a new S election if it is involved in a qualified F reorganization and Holdco qualifies as a small business corporation (see Sec. 1361(b)).

Once these steps have been completed, the goal is to convert the target into a limited liability company (LLC) — how this is accomplished will depend on the facts and circumstances. For example, if the target is legally an LLC but previously was deemed to have made a check-the-box election under Regs. Sec. 301.7701-3(c)(1)(v)(C) to be classified as a corporation for tax purposes, the target can file Form 8832, *Entity Classification Election*, and elect to be treated as a DRE. Note that under Regs. Sec. 301.7701-3(c) (1)(iv), an entity generally is prohibited from changing its entity classification within 60 months of a previous entity classification election (other than an original entity classification election). Careful consideration should be given to the timing of such elections (see Regs. Sec. 301.7701-3(g)(3)(i)). Accordingly, the target should consider making this election effective at least two days from the original QSub election.

If the target was a *per se* entity, such as a state law corporation, a potential solution might be to convert or merge the target into an LLC, depending on the state law of the target.

Upon the completion of the transaction, Holdco is an S corporation and wholly owns an LLC (the target) that is treated as a DRE for income tax purposes. New investors can either acquire a percentage interest in the target from Holdco or contribute capital directly into the target in exchange for an interest in the target. Both would result in a stepped-up basis in the underlying assets for the buyer/new investor (see Rev. Rul. 99-5, Situations 1 and 2). Note, however, that the original target would no longer be an S corporation and would be treated as a partnership for income tax purposes. From Holdco's perspective (the seller in the transaction), any sale of the interest in the LLC would generate similar treatment and considerations as those identified under Scenario 2. Accordingly, Holdco may request a gross-up if the new investors choose to acquire an interest in the LLC.

Planning for efficiencies

Careful tax planning is critical for taxpayers contemplating acquiring or selling their existing S corporation business(es). With proper planning, buyers and sellers may be able to create efficiencies with respect to tax cash flow as a result of acquiring or selling the S corporation target.

Editor Notes

Kevin D. Anderson, CPA, J.D., is a managing director, National Tax Office, with BDO USA LLP in Washington, D.C. Unless otherwise noted, contributors are members of or associated with BDO USA LLP. For additional information about these items, contact Mr. Anderson at 202-644-5413 or kdanderson@bdo.com.