PLANNING ISSUES FOR ACQUISITIONS OF S-CORPS

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I. WHY ARE S-CORPORATION TRANSACTIONS DIFFERENT?

There are a significant number of entities that have elected to be S Corporations ("**S-Corps**") for federal income tax purposes in the United States—approximately 44.5% of the entity tax turns filed are for S-Corps and 37.5% of the federal tax turns filed by Texas entities are for S-Corps.[2] Some are truly formed as a corporation under applicable state law. Many, however, are limited liability companies ("**LLCs**") that have elected to be treated as an S-Corp. The S-Corp has unique planning opportunities that to solve the gap between the tax of selling equity compared to the tax of buying assets from the seller.

It is possible to structure an S-Corp transaction so that the disposition of S-Corp stock is treated as a stock sale for legal purposes and as an asset acquisition for federal tax purposes, thereby combining some of the favorable tax and non-tax attributes of asset and stock sales.

II. TREATING A STOCK PURCHASE AS AN ASSET ACQUISITION.

What makes an S-Corp transaction unique is that it is the one entity that: (1) is eligible for pass-through taxation, and (2) maintains an outside basis (basis in the owner's stock) which is different from its inside basis (basis of the assets in the corporation). This fact alone makes structuring a sale of the business more flexible for tax purposes than in a traditional pass-through entity such as a partnership or LLC where inside and outside basis are the same, or a corporation, which is not eligible for pass through taxation.

As a result, an early step in the analysis is to assess the inside and outside basis and understand the actual tax attributes. In additional to tax basis, generally, the sellers have held shares for a sufficient period of time to permit capital gains tax rates. So a tax analysis must include inside and outside basis and differential income tax rates to account for ordinary income tax taxes and capital gains rates between the asset or stock sale scenarios. In additional to tax issues, buyers may have bona fide reasons to conduct a stock sale because of the nature and related entanglements of the assets to be acquired. If the Company's assets consist primarily of contracts that produce the income of the entity and those contracts are not freely transferrable, a buyer may have to forgo an asset purchase to consummate the transaction. Other important assets that are not freely transferrable tend to include licenses of technology, government or contractual permits , or licenses to do a special form of business. If, for example, an S-Corp was (1) recently formed or (ii) recently acquired, it is quite possible that the tax basis of the stock is very close to the fair market value of the entity, and the parties may determine that the ease and familiar tax result of a stock sale is worth the liability risk.

While sellers generally are tax advantaged by selling stock, buyers rarely are advantaged on a tax basis. Whether the buyers can maintain the S-Corp status or not, buying the stock will place the tax basis on the stock itself, depriving the new owner of the tax benefits of depreciation or amortization of the assets in the corporation, or a stepped-up basis. So as result, buyers usually push for a purchase of assets, to have access to deductions in line with the amount of the purchase price. Alternatively, if there are significant risks to transferring then assets, avoidance of those risks may trump any the advantages to an asset sale for a buyer. The S-Corp has unique tax provisions that allow for stock sales and a step-up in basis after assets that re not allowable to an LLC taxed as partnership or a corporation taxed as such.

There are three ways to effectuate an S-Corp stock sale for tax purposes, while allowing the buyer to obtain the stepped-up basis in the S-Corp's assets. In each case, the legal treatment of the transaction may allow the transfer of the S-Corp's contracts, government permits, exclusive licenses, titles and EIN without completing the assignment processes in traditional asset deals. The first method is performed pursuant to § 338[3] by structuring a qualified stock purchase with a Section 338(h)(10) election, and the second one is structuring a qualified stock disposition with a Section 336(e) election. While both allow for the transfer of S-Corp stock for legal purposes and a deemed asset sale for federal tax purposes, each method has some features and risks (discussed further below) that may make one procedural more optimal to the parties. The third method is achieved by forming a qualified subchapter S subsidiary ("**QSub**")[4] in a transaction deemed a F-Reorganization under § 368(a)(1)(F) and the conversion of that QSub into a single member LLC, which becomes the ultimate target of the sale.[5]

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[1] The author would like to express her gratitude to Caroline Pace, associate at Crain Caton & James for her contributions and assistance in preparing this article.

[2] *See* Internal Revenue Service Data Book, 2020 Publication 55-B Washington, DC June 2021 at p. 18-19; available at https://www.irs.gov/pub/irs-pdf/p55b.pdf.

[3] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended.

[4] *See* Rev. Rul. 2008-18 CB 674 (March 7, 2008).

[5] *See* Rev. Rul. 99-5, 1999-1 CB 434 (January 15, 1999).

A. What issues are unique to S-Corps in an Acquisition?

Because this article focuses on the methods of structuring transactions with S-Corp target entities, one of the requirements that must be satisfied is that the target qualifies for S-Corp status. Section 1361(b) sets forth the requirements. To qualify, a corporation or LLC must make a timely election under § 1362(a) by filing IRS Form 2553 (Election by a Small Business Corporation) and must:

1. Be eligible to be taxed as a corporation, formed under the laws of one of the States of the United States;
2. Have only allowable shareholders as follows:

    a. May be individuals, certain trusts, and estates;
    b. May not be entities taxed as a partnership or corporation[6]; and
    c. May be a United States citizen or foreigner, non-citizen, resident alien, but cannot be a nonresident alien;[7]

3. Have no more than 100 shareholders;
4. Have only one class of stock; and
5. Not be an ineligible corporation (i.e. certain financial institutions, insurance companies, and domestic international sales corporations).[8]

An S-Corp election for an entity that does not fully comply with the above § 1361(b) requirements is not a valid S-Corp, and an S-Corp that fails to continually to maintain compliance with § 1361(b) throughout its corporate life forfeits its S-Corp status.[9] The S-Corp's status ends on the day the entity fails to comply with any one requirement of § 1361(b) and beginning the following day, the entity is taxed as a C-Corporation ("**C-Corp**").[10] Below we will discuss on the features of an S-Corp by providing its tax attributes and then follow that with the most common traps that invalidate or terminate an entity's S-Corp's status.

B. Taxation of S-Corps.

Despite the § 1361(b) S-Corp requirements, there are tax-related reasons that owners chose to form S-Corps over LLCs. One important tax attribute of S-Corps relates to payroll and self-employment taxes. An owner of an LLC must pay all (i.e., employer, employee) federal payroll and self-employment tax on 100% of the income. A shareholder-employee of S-Corp, however, may allocate some income as a distribution to avoid payroll and self-employment tax. The S-Corp shareholder is deemed an employee with respect to the portion of his or her income not considered a distribution, and as an employee of the S-Corp, the owner and S-Corp equally share the payroll and self-employment tax burden.[11] The amount allocated to payroll must be an amount that is "reasonable" as a salary for that particular level of employee and the remainder may be distribution. S-Corp income is taxed on a pass-through basis, similar to a partnership.

The S-Corp tax attribute of pass-through taxation for distributions may be another reason owners choose to elect S-Corps status. While C-Corp shareholders incur double taxation, i.e., the C-Corp is taxed on its income (after offsetting the income with losses, deductions and credits) and the shareholders incur personal income taxes on the after-tax income that is distributed as dividends. In contrast, generally, S-Corp shareholders incur only a single-level of tax, i.e., the S-Corp is not taxed[12] and its shareholders are taxed only on their after-tax dividends. Shareholders of S-Corps report the pass-through of income, losses, deductions, and credits on their individual tax returns and taxes are assessed at their individual income tax rates.[13] After these items pass through, the stock basis for each shareholder is adjusted pursuant to § 1367.[14] Section 1367 provides that a shareholder's basis is increased by the amount of income that is passed through to the shareholder and decreased by the amount of deductions and losses that are passed through,

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[6] *See* PLR 200816002, 200816003 and 200816004 (Jan. 14, 2008) (a single member LLC that is that is completely owned by an eligible S corporation shareholder can be an S-Corp shareholder.

[7] A nonresident alien is an alien who has not passed the green card test or the substantial presence test.

[8] Section 1361(b); 26 CFR § 1.1361-1.

[9] Section 1362(d)(2).

[10] *Id.* .

[11] Rev. Rul. 74-44.

[12] There are limited instances when the S-Corp itself incurs taxes. For example, S-Corp that used to be C-Corps are subject to three taxes that are not passed to shareholders; namely: the excessive net passive income tax (Section 1375) the built-in gains tax (Section 1374) and the LIFO recapture tax (Section 1363(d).

[13] Section 1366(a).

[14] *Id.*

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