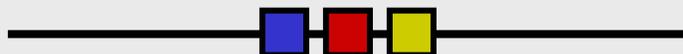
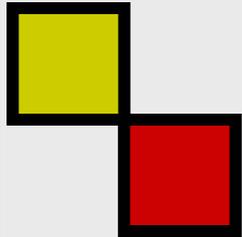
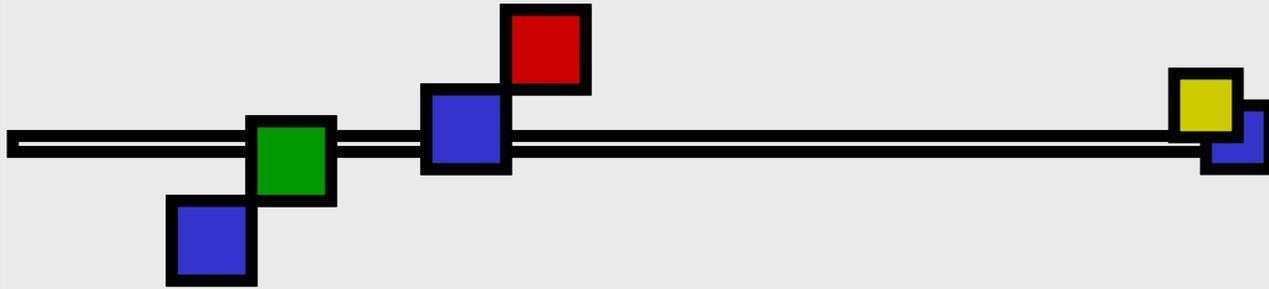


## When "Acquirer" or "Target" is Spelled with an "S" – Special Considerations for S Corporations in Mergers and Acquisitions

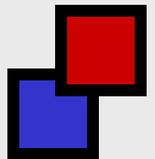


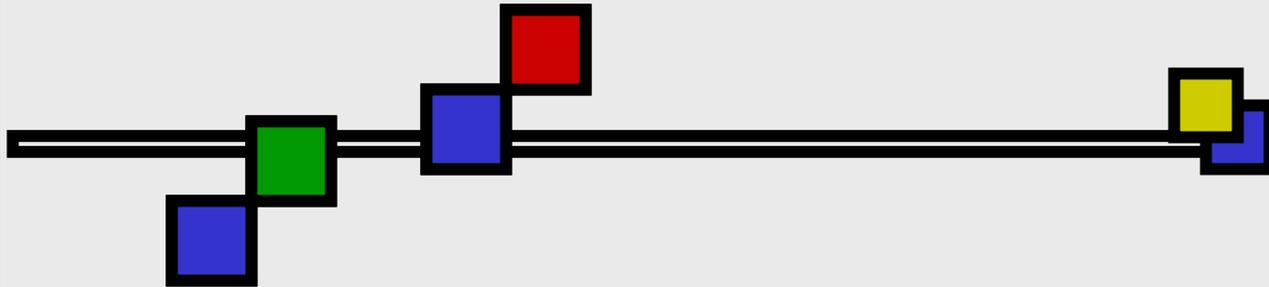
C. Wells Hall  
January 25, 2007



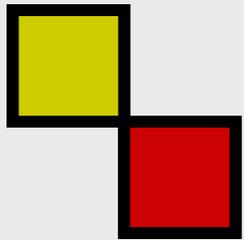


- IRS CIRCULAR 230 NOTICE. Any advice expressed herein as to tax matters was neither written nor intended by the sender or Mayer, Brown, Rowe & Maw LLP to be used and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed under U.S. tax law. If any person uses or refers to any such tax advice in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to any taxpayer, then (i) the advice was written to support the promotion or marketing (by a person other than Mayer, Brown, Rowe & Maw LLP) of that transaction or matter, and (ii) such taxpayer should seek advice based on the taxpayers particular circumstances from an independent tax advisor.

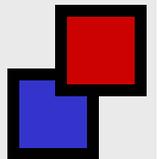




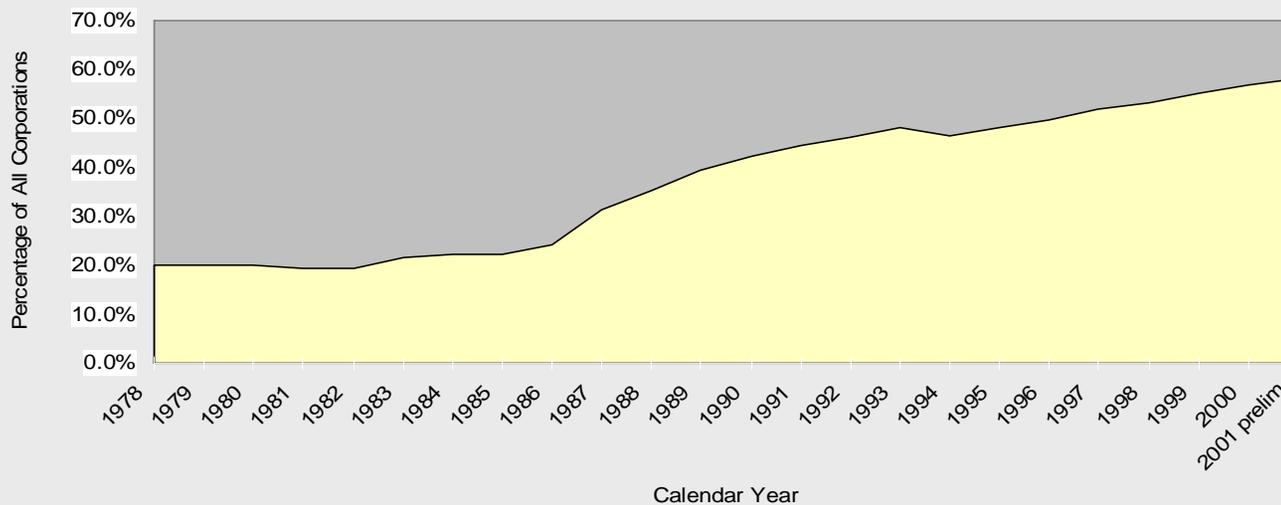
## Prevalence of Pass-Through Entities



- S Corporations
- Partnerships (General and Limited)
- LLCs

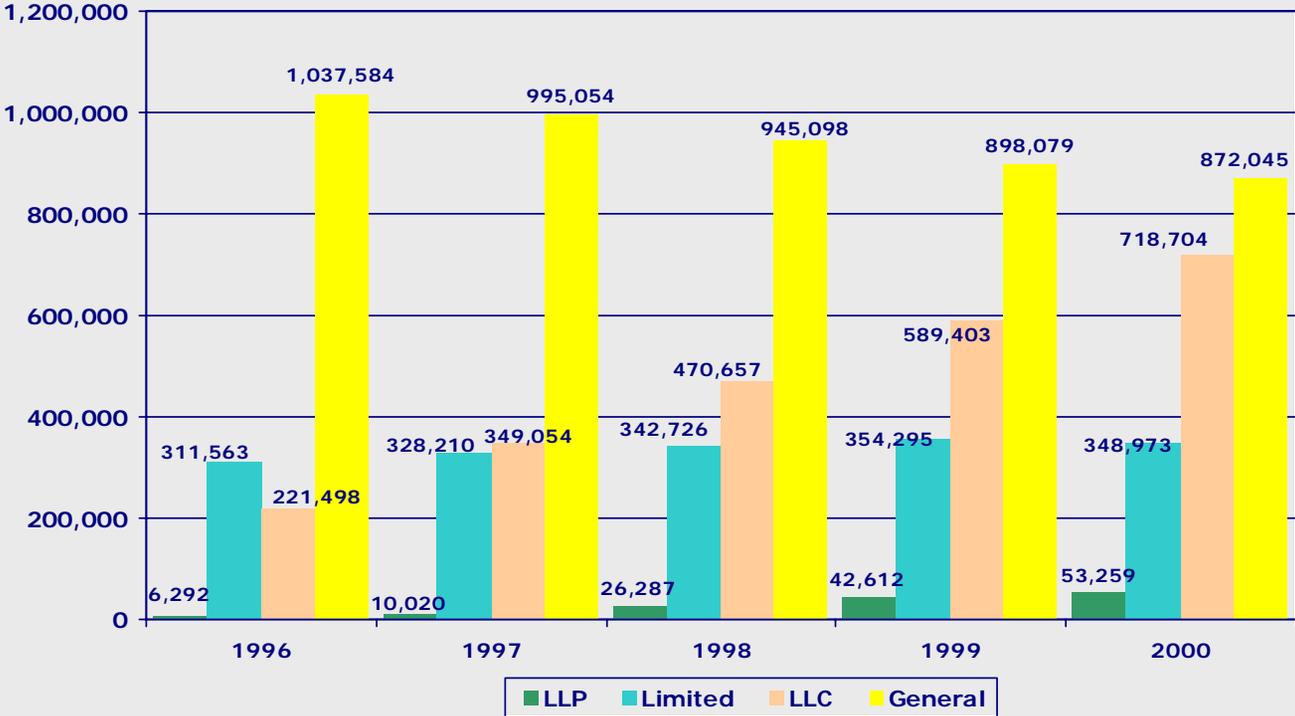


# S Corporations as a Percentage of All Corporations (1978-2001)



Source: SOI Data

# Partnership Types



Source: SOI Data

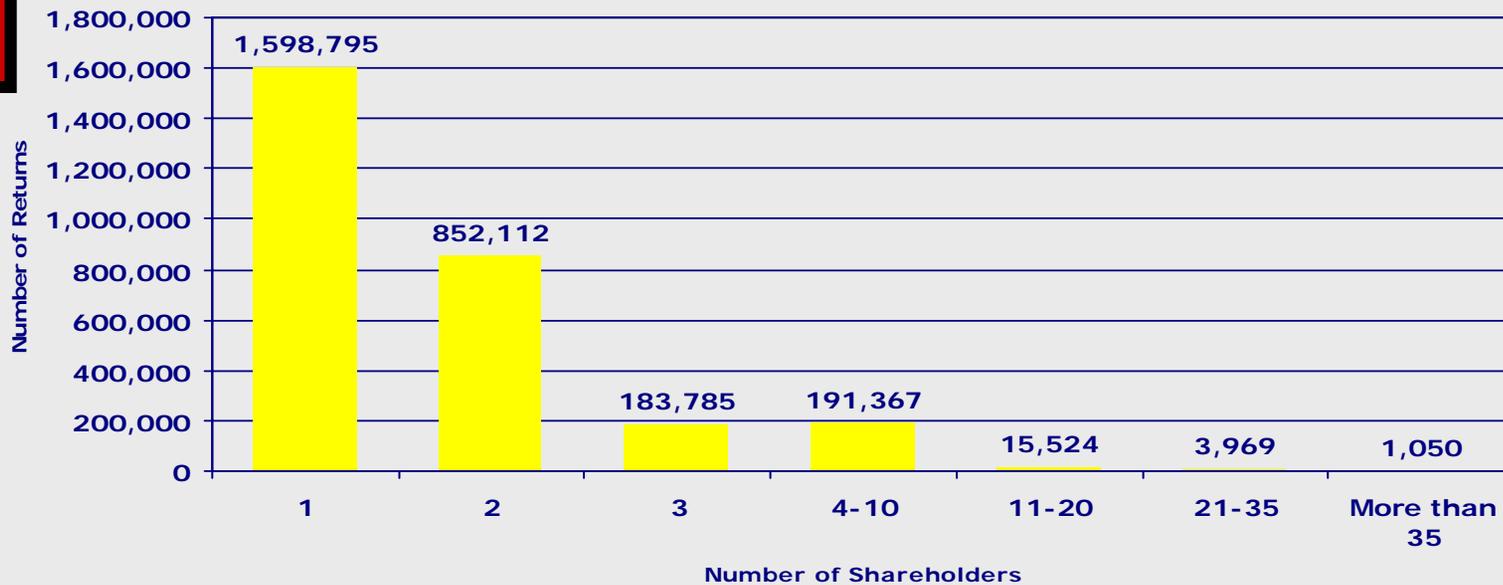
# S Corporations and Partnerships



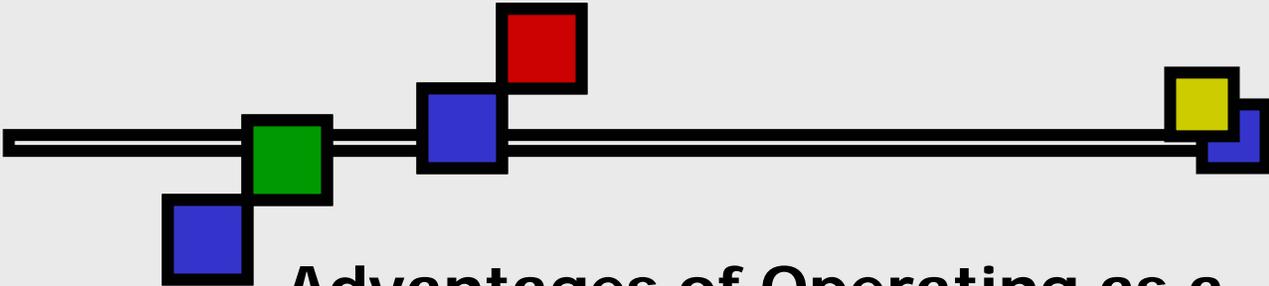
Source: SOI Data

# Number of S Corporation Returns, by Number of Shareholders

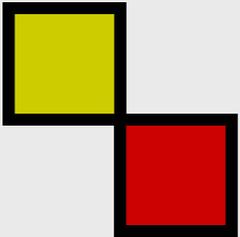
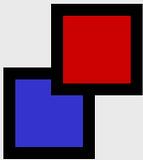
Tax Year 2000

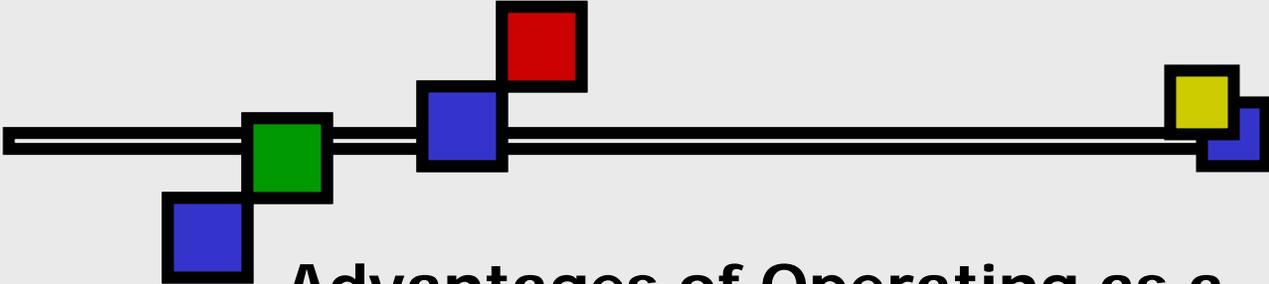


Source: SOI Data

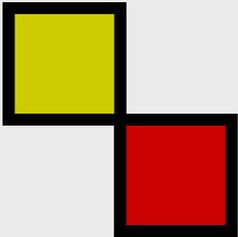
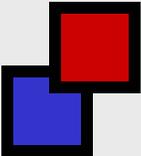


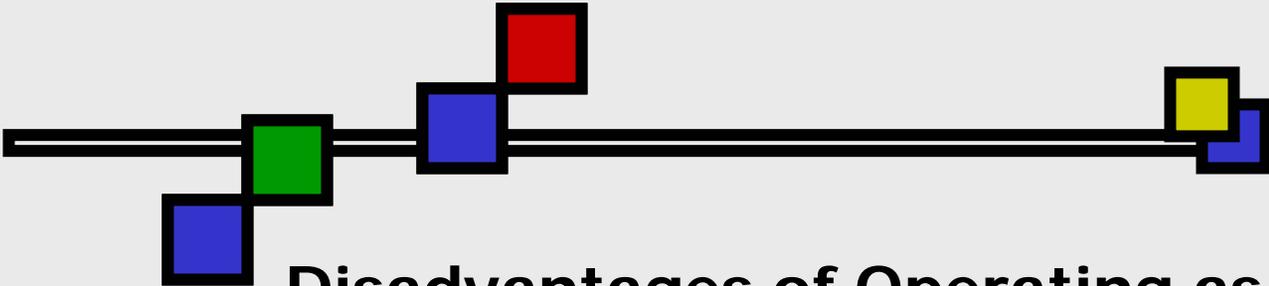
## Advantages of Operating as a Pass-Through Entity

- 
- One Level of Tax on Earnings With Increase in Owner Basis for Undistributed Earnings
  - Avoidance of Double Tax Upon Sale or Liquidation of Business
  - Corporate Alternative Minimum Tax Not Applicable
  - Pass-Through of Losses
  - Social Security Tax Considerations
- 

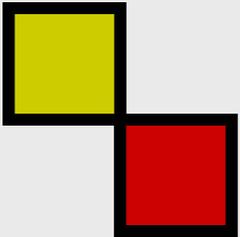
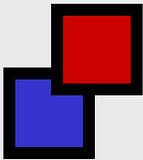


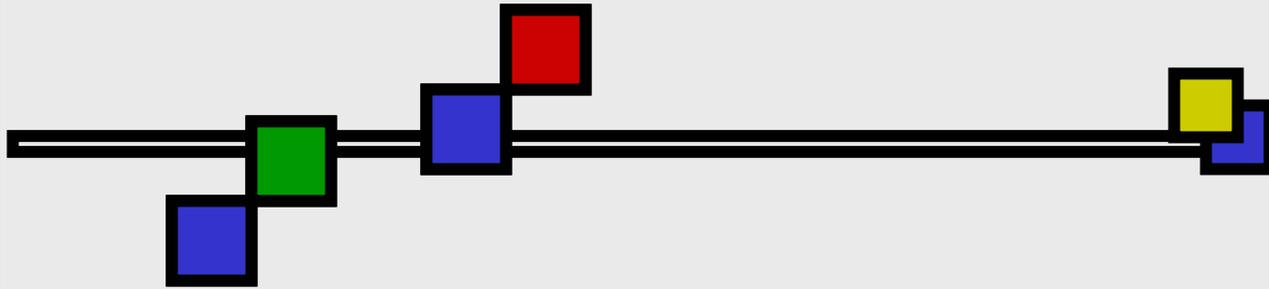
## Advantages of Operating as a Pass-Through Entity (cont.)

- 
- Avoidance of Accumulated Earnings Tax
  - Avoidance of PHC Tax
  - Deductibility of Interest on Debt Incurred to Purchase Interest in a Pass-Through Entity
  - Avoidance of Limitations on Using Cash Method of Accounting
  - State Tax Considerations
- 

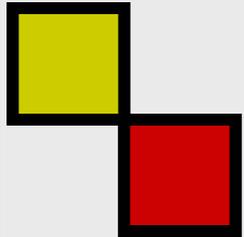


## Disadvantages of Operating as a Pass-Through Entity

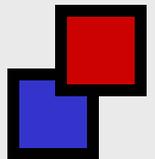
- 
- No Benefit of Lower Corporate Rates
  - Tax Costs of Converting from C to S
  - Limitations on Filing Consolidated Returns
  - Section 1202 Exclusion Not Available
  - Loss of Tax-Free Employee Fringe Benefits
  - Limitation on Selection of Taxable Year
  - Restrictive Eligibility Requirements
- 

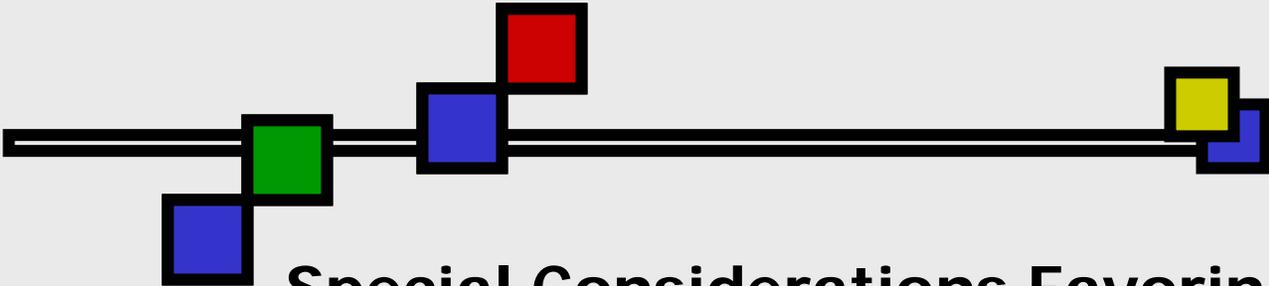


## When the LLC is the Entity of Choice

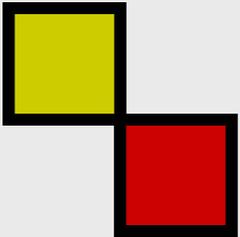
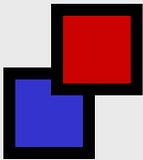


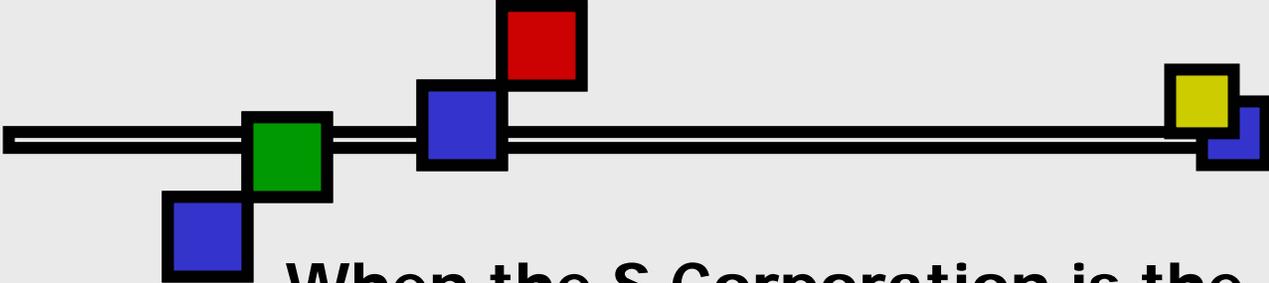
- For Venture Capital Projects and Corporate Joint Ventures Involving Ineligible S Corporation Shareholders
- For the Professional Service Business
- To Hold Real Property
- Estate Planning



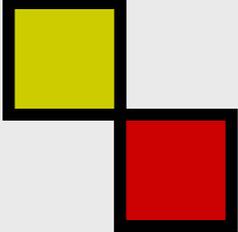
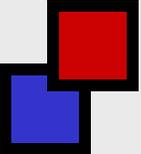


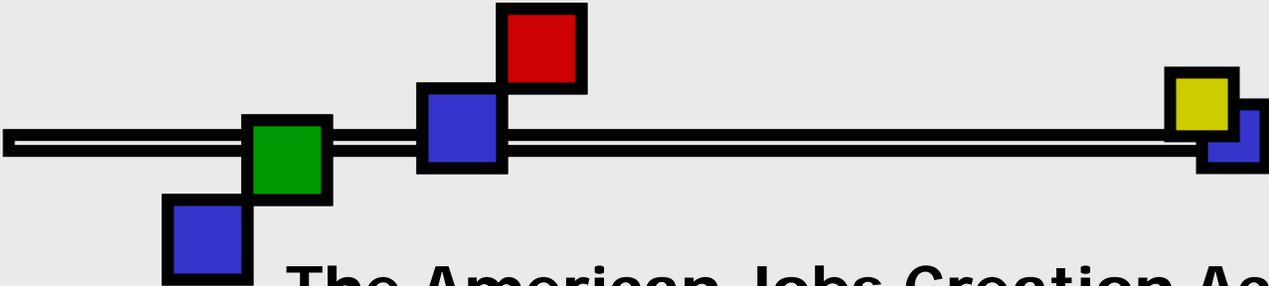
## Special Considerations Favoring Use of LLC

- 
- Pass through taxation without limitations on number or types of owners
  - Non-recognition of gain upon distribution of property to owners
  - Outside basis available for inside debt
  - Conversion to corporate classification always possible (Form 8832)
  - Flexibility in allocating income, losses, deductions and credits
  - When disregarded entity is desired for single member entity
- 

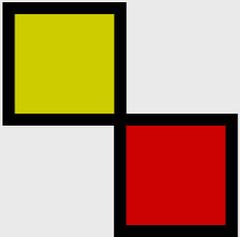
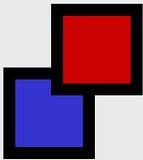


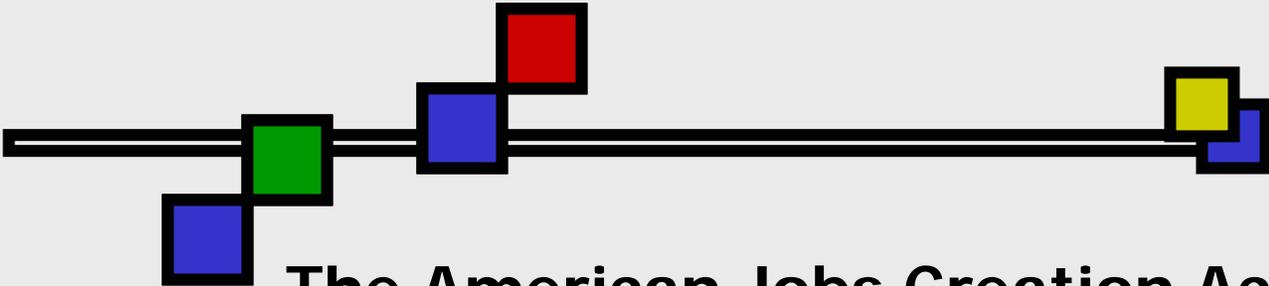
## When the S Corporation is the Entity of Choice

- 
- Already an S Corporation
  - Existing C Corporation Desiring to Convert to Pass Through Entity
  - Entities Desiring to Participate in Tax Free Mergers and Reorganizations
  - Self Employment Tax Reduction (Medicare Portion – 2.9%)
- 

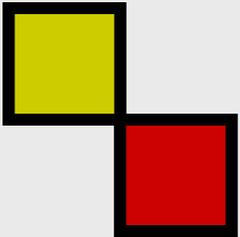
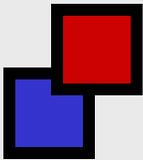


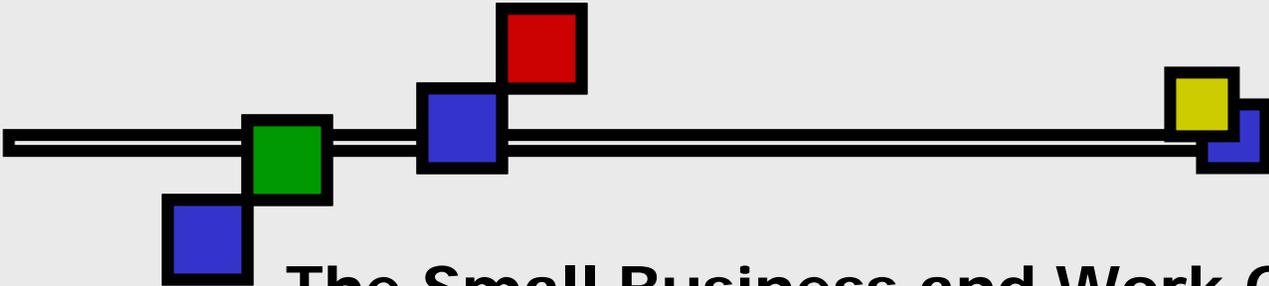
## The American Jobs Creation Act of 2004 (HR 4520)-S Corporation Provisions

- 
- Section 199 deduction relating to income attributable to domestic production activities –available to S corps, LLCs
  - Members of family treated as 1 shareholder
  - Increase in number of shareholders to 100
  - Existing IRAs eligible shareholders of bank S corps
  - Disregard of unexercised powers of appointment in determining potential current beneficiaries of ESBT.
  - Transfer of suspended losses incident to divorce
- 

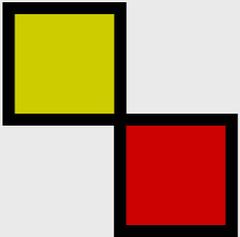
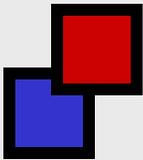


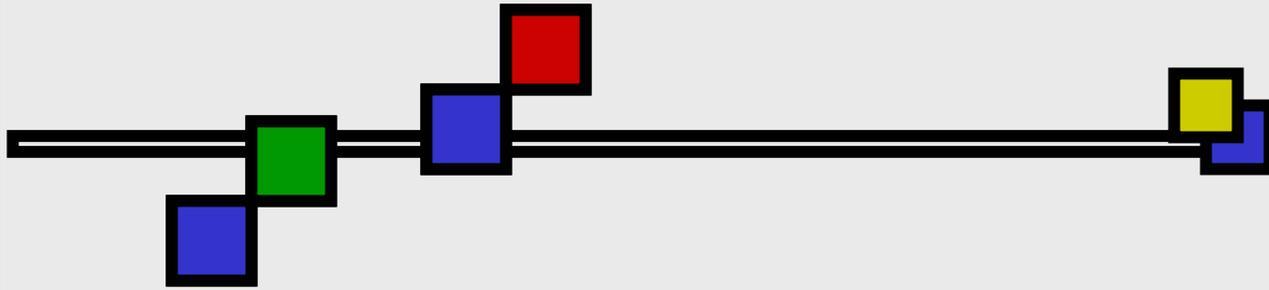
## The American Jobs Creation Act of 2004 (HR 4520)-S Corporation Provisions

- 
- QSST income beneficiaries may deduct suspended PALs and at-risk amounts when QSST disposes of S corporation stock
  - Investment securities income excluded from passive income test for bank S corps
  - Relief from inadvertently invalid QSUB elections and terminations
  - Information returns for QSUBs
  - Repayment of ESOP loans with distributions from qualifying employer securities
- 

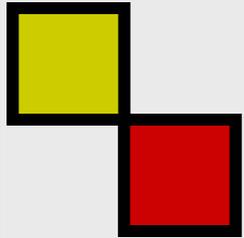


## The Small Business and Work Opportunity Act of 2007 - S Corporation Provisions

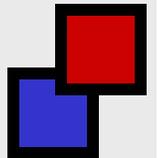
- 
- Gain from sales or exchanges of stock or securities excluded from passive investment income for purposes of Sections 1375 and 1362(d)(3)
  - Qualifying bank director shares not treated as second class of stock
  - Bank converting to S status may elect to charge adjustments from change from reserve method of accounting to final C year
  - Termination of Qsubs protected from busted 351 treatment
  - Elimination of C E&P for taxable years before 1983
  - Nonresident aliens may be potential current beneficiaries of ESBTs
- 

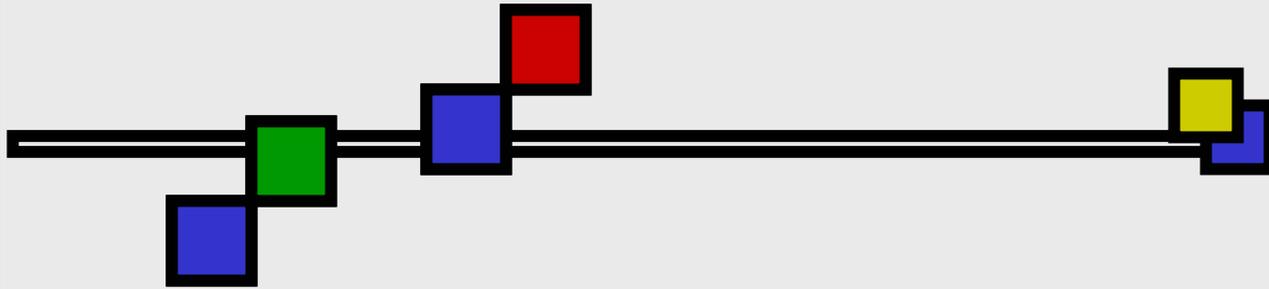


## Disregarded Entities

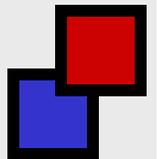
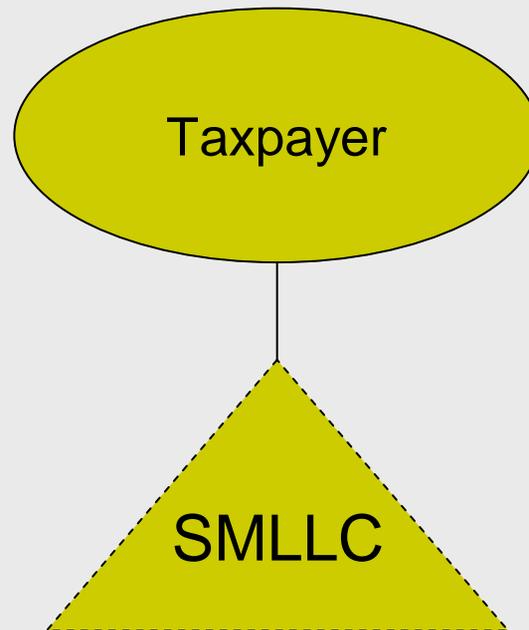
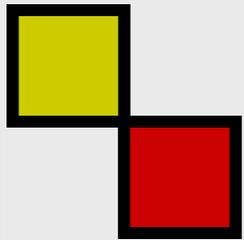


- Single Member LLCs
- Qsubs
- Qualified REIT Subsidiaries

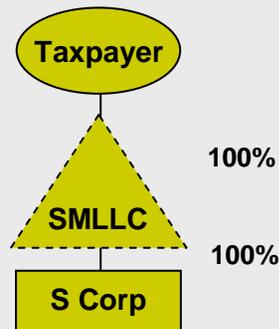




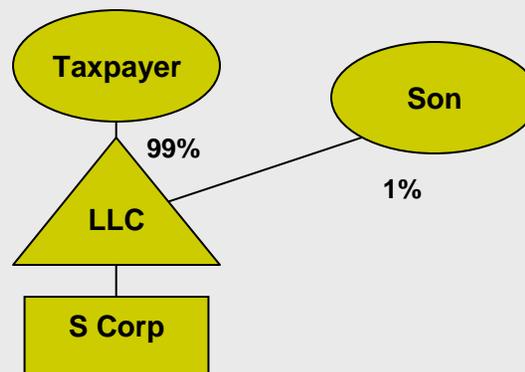
## Single Member LLC - Disregarded



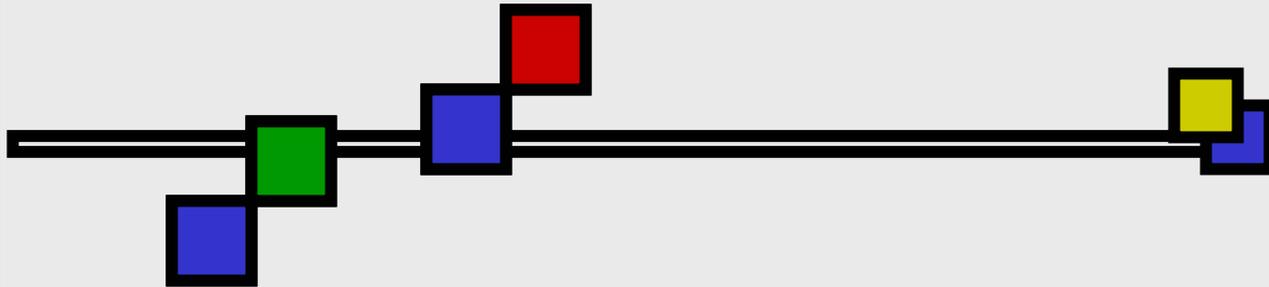
# Single Member LLC – Disregarded Stockholder of S Corporation



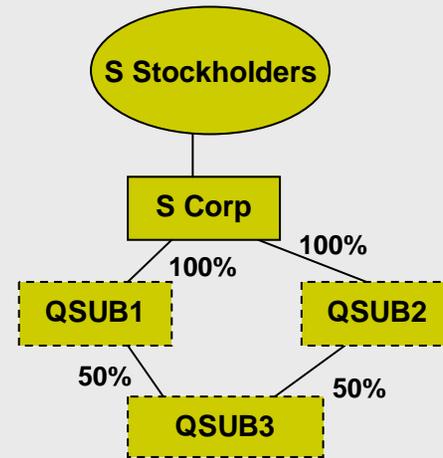
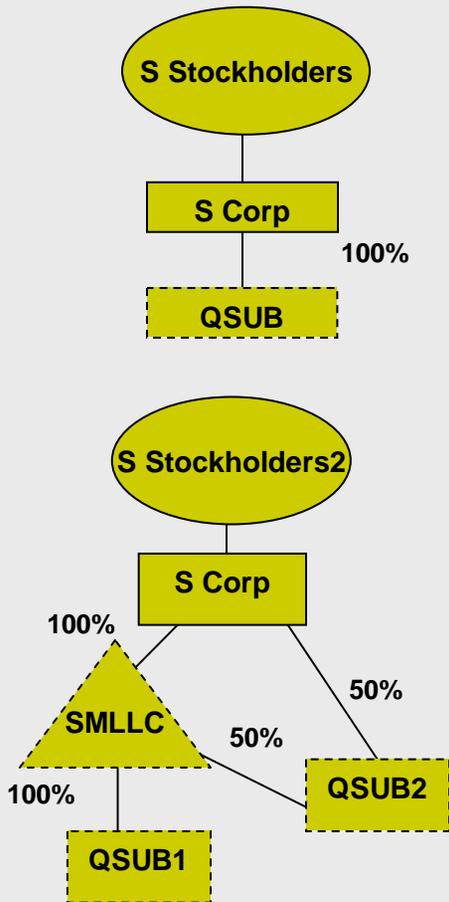
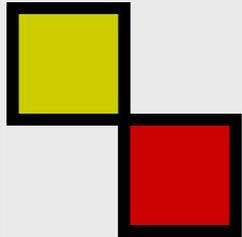
Taxpayer is a permitted S stockholder. SMLLC is disregarded. Thus, S Corp can maintain its S election.



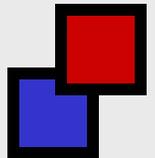
This slight variation results in the termination of the S election. A partnership is not a permitted S stockholder.

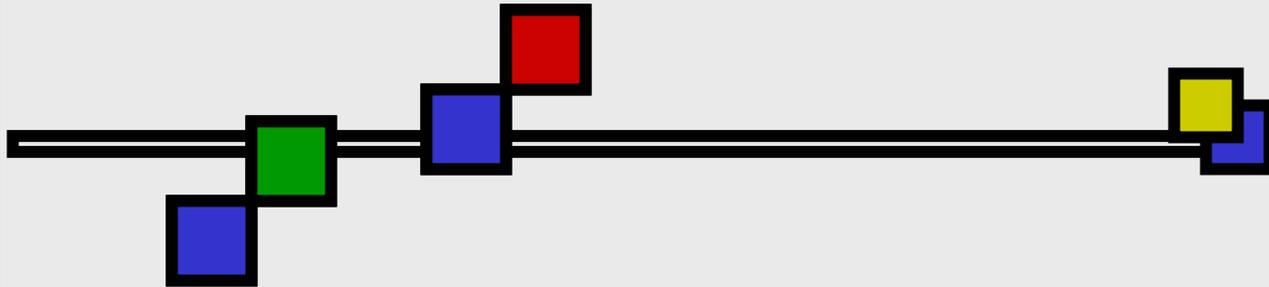


## QSUB - Disregarded

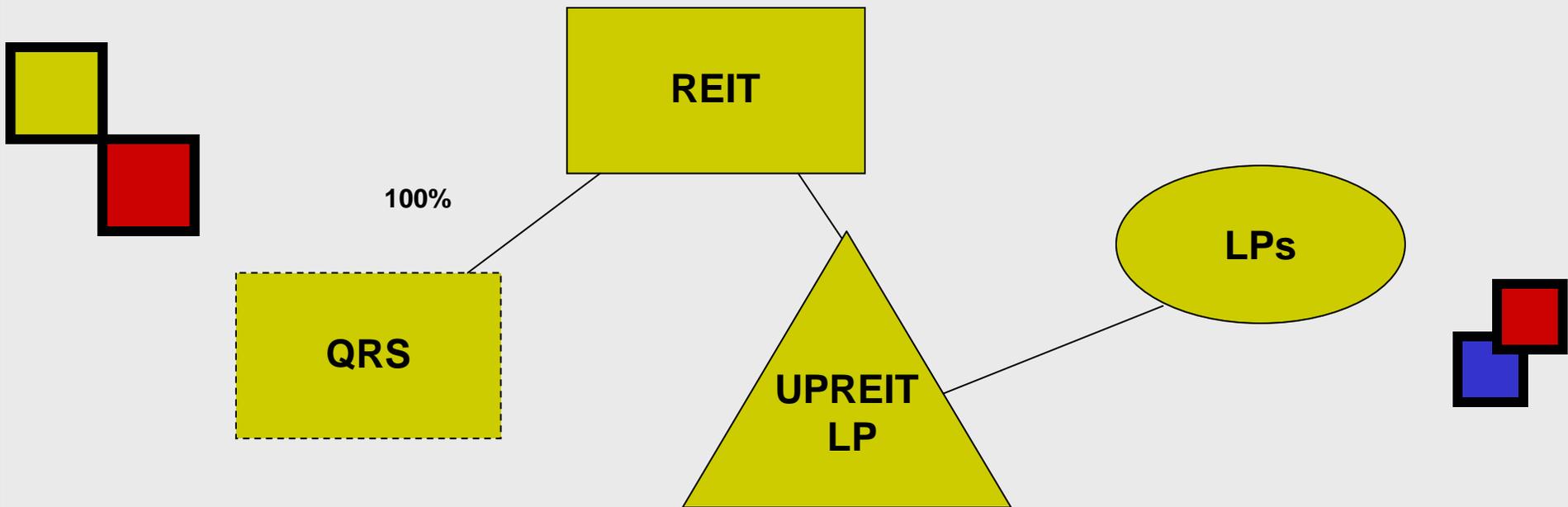


In all of these examples, the QSUBs are valid QSUBs.

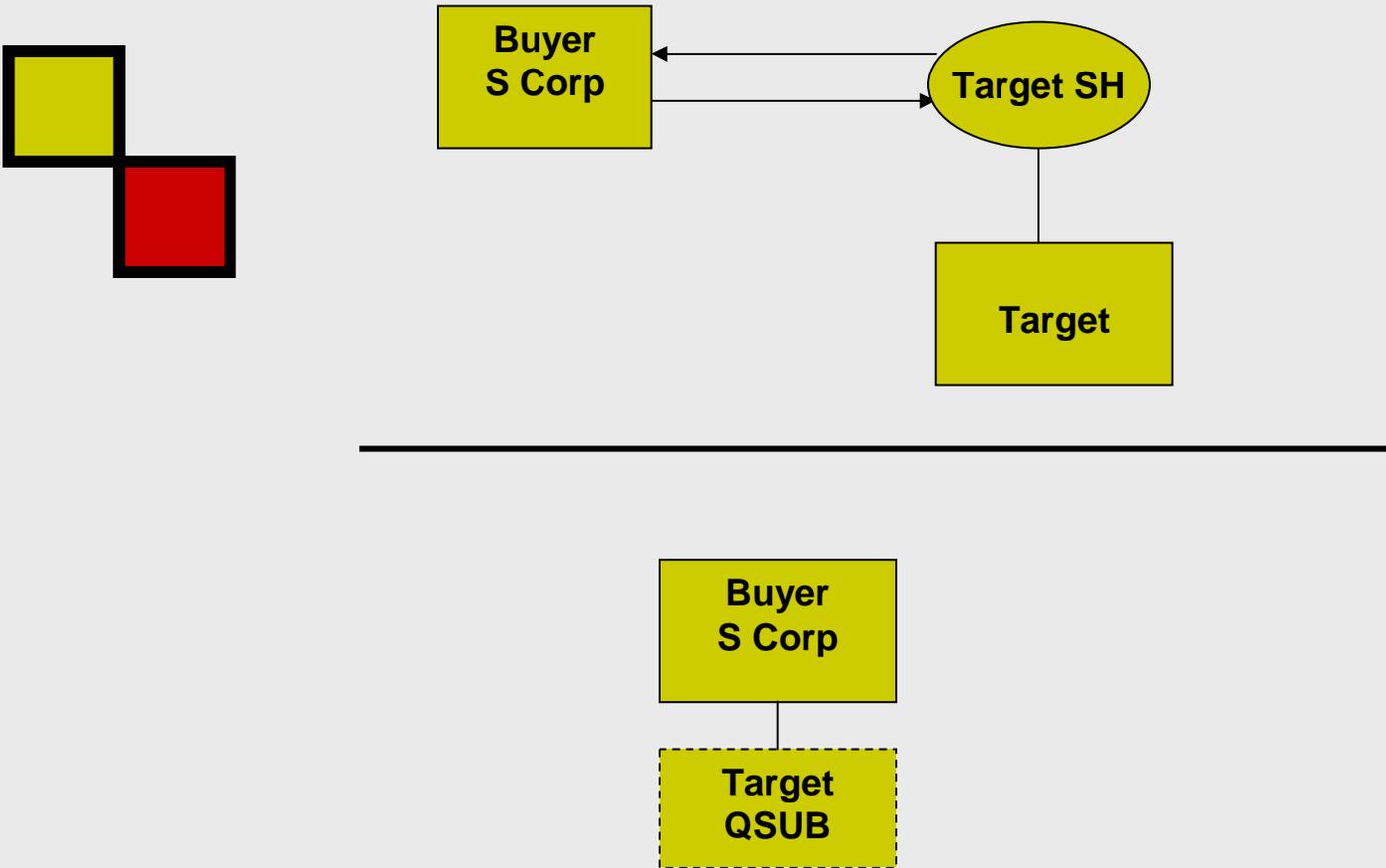


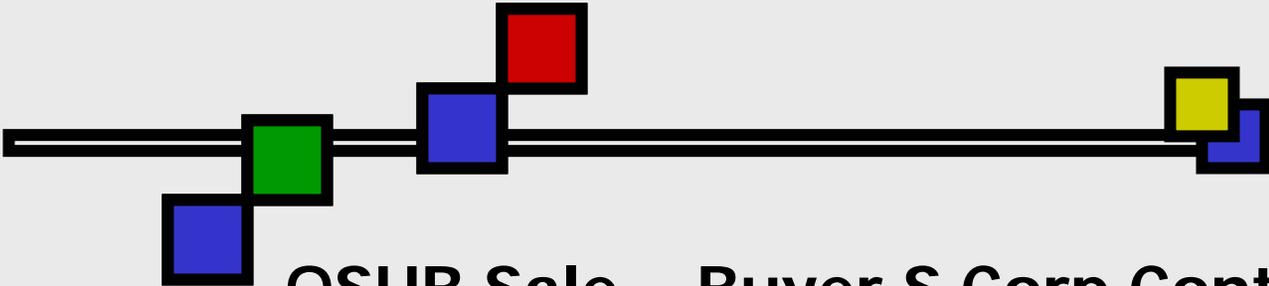


**QRS - Disregarded**

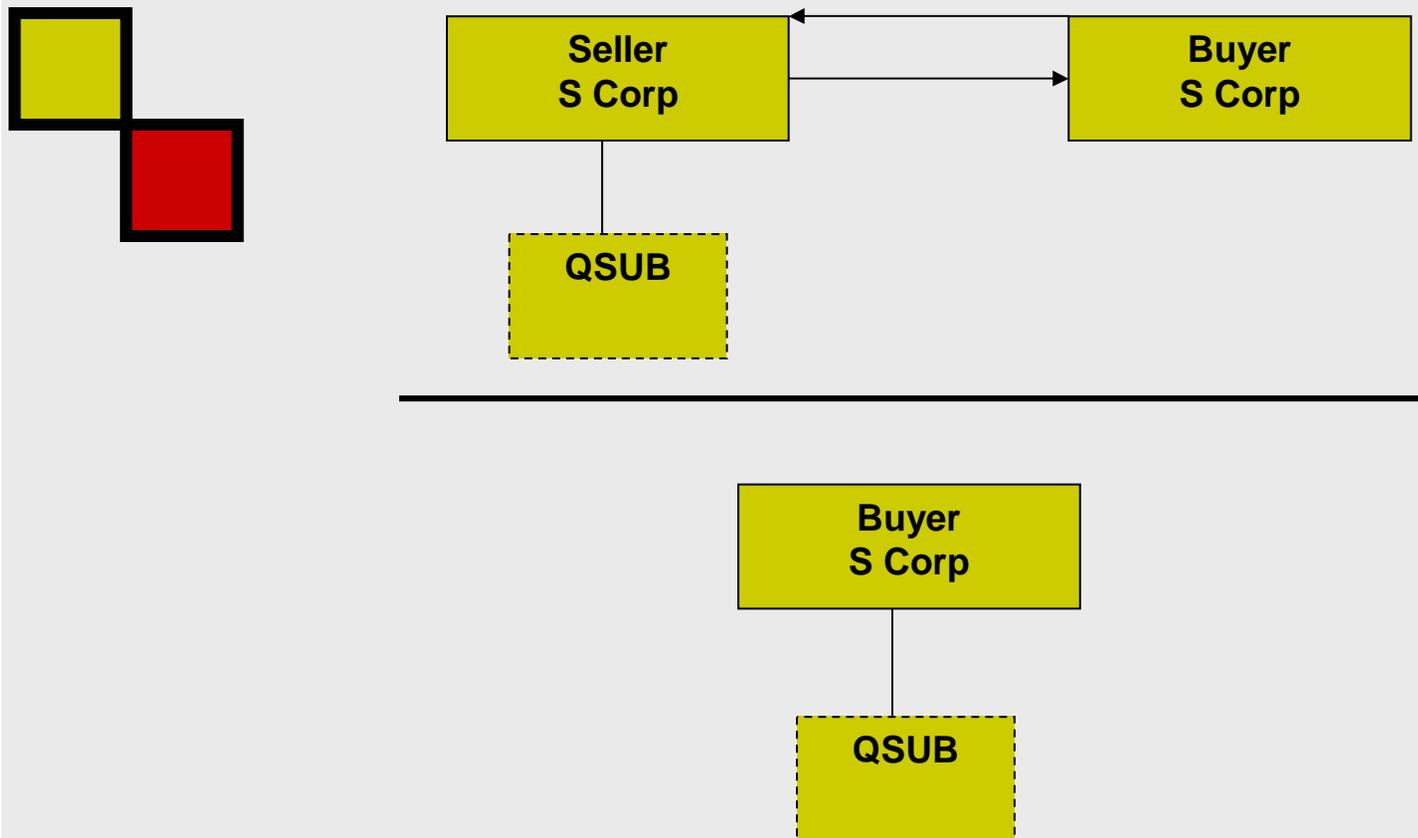


# QSUB Election for Target

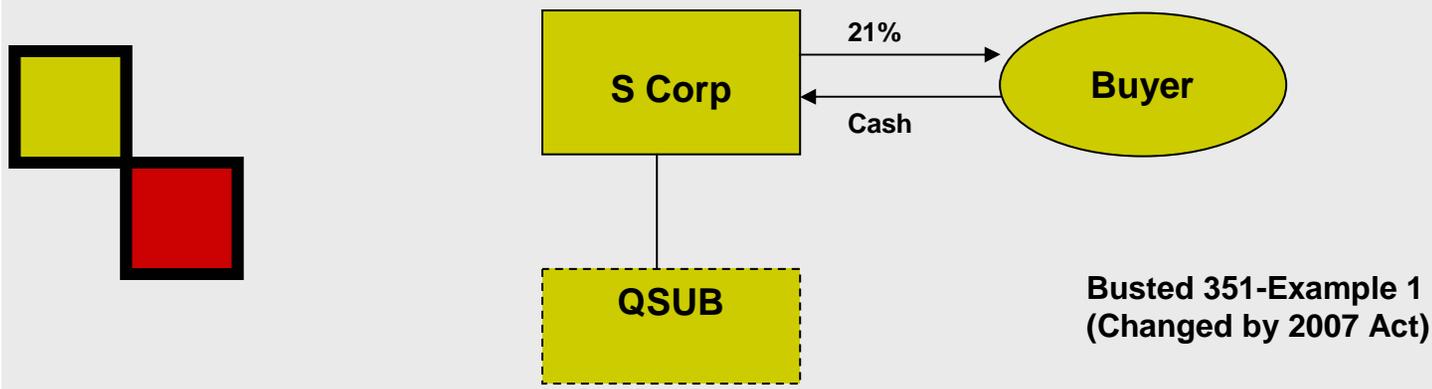




## QSUB Sale – Buyer S Corp Continues QSUB Election

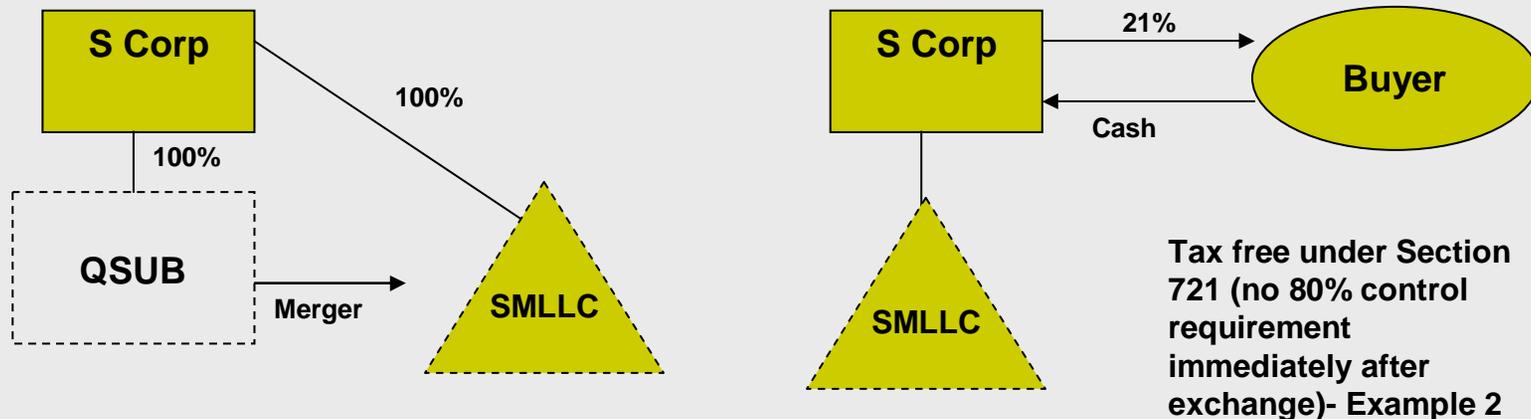


## QSUB Termination – Reg. §1.1361-5(b)(3)

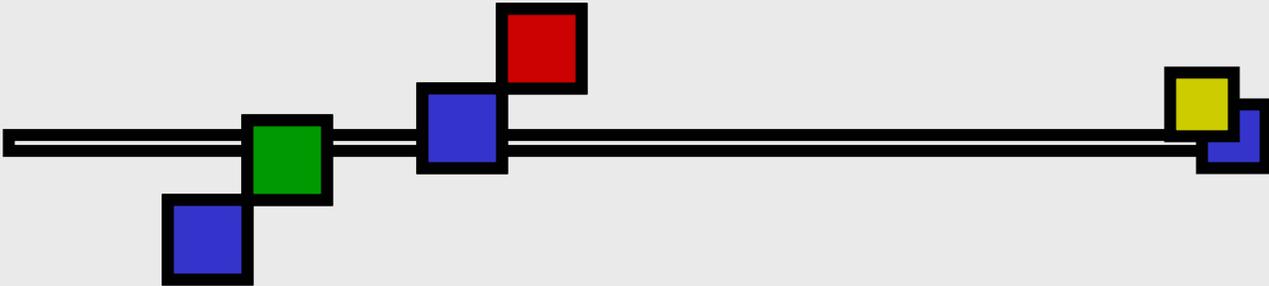


Busted 351-Example 1  
(Changed by 2007 Act)

### Use of SMLLC in Lieu of QSUB

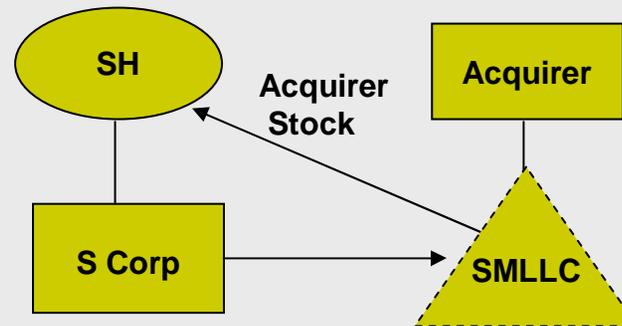


Tax free under Section 721 (no 80% control requirement immediately after exchange)- Example 2



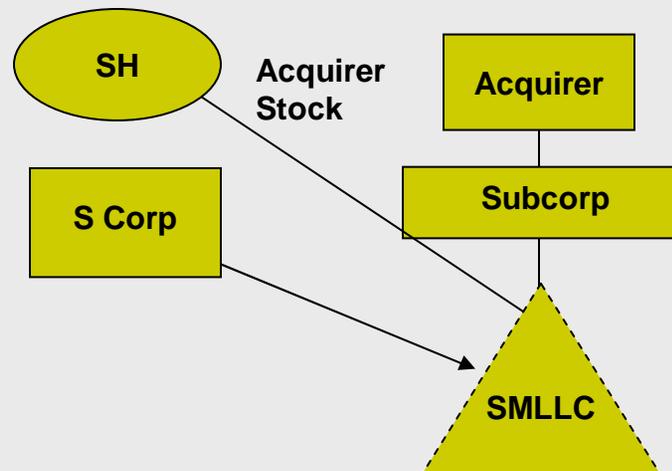
## A Merger or Tri-A Merger Using SMLLC

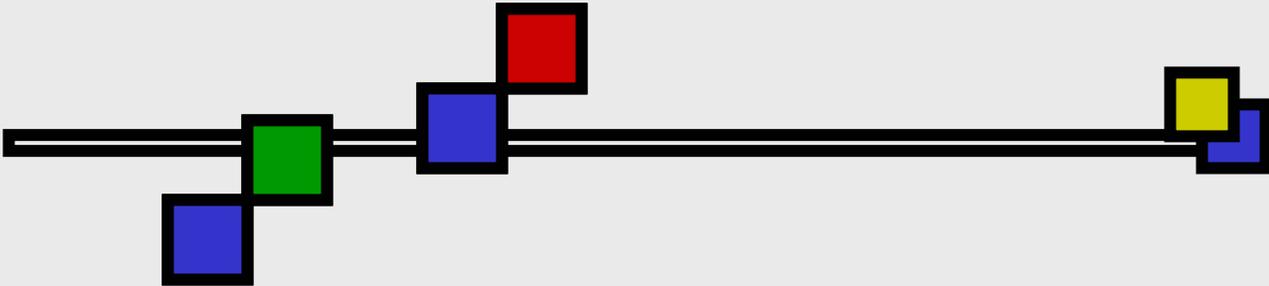
### (A) Merger Using SMLLC



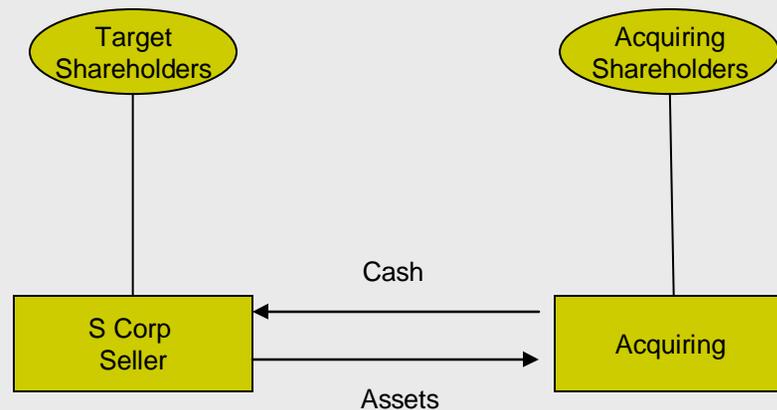
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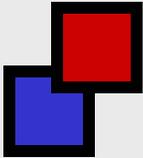
### (a)(2)(D) Merger Using SMLLC

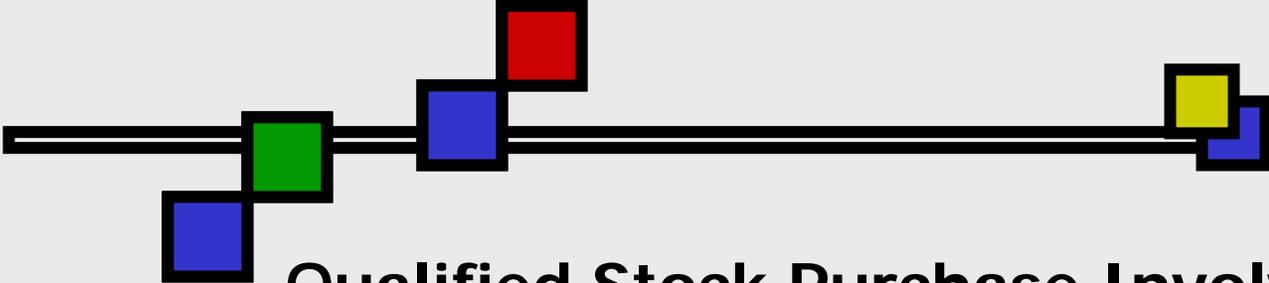




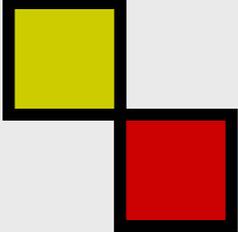
## Taxable Asset Acquisition – S Corp Seller



- Seller treatment
    - No double tax (except for BIG, entity level state taxes)
    - Potential for character differences
    - Installment sales treatment
  - Buyer treatment
    - Step-up basis in assets (including amortizable goodwill) for Buyer
    - Buyer generally does not inherit exposure for pre-closing taxes
    - Exclude unwanted assets and excluded or undisclosed liabilities
- 

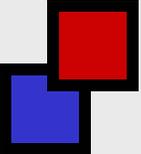


## Qualified Stock Purchase Involving S Corporations?



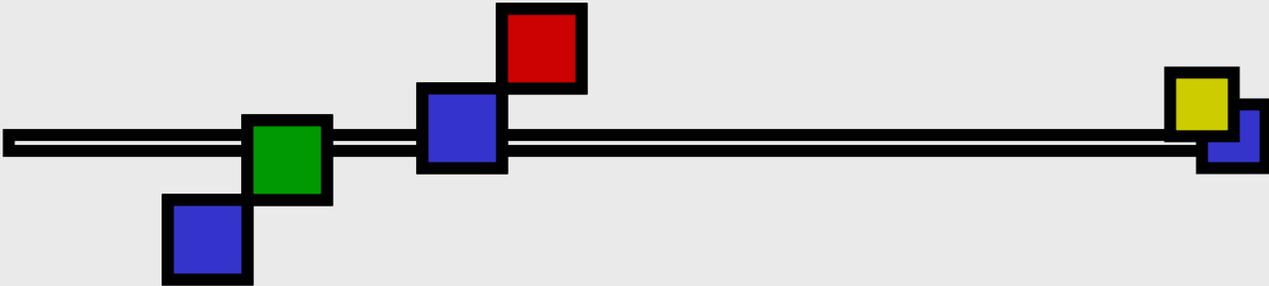
Old Section 1371(a)(2): "S corporation treated as an individual in its capacity as a shareholder of another corporation"

TAM 9245004: "Section 1371(a)(2) does not prevent an S corporation from being treated [in its capacity as a shareholder of T] as a corporation for purposes of applying Sections 338 and 332"

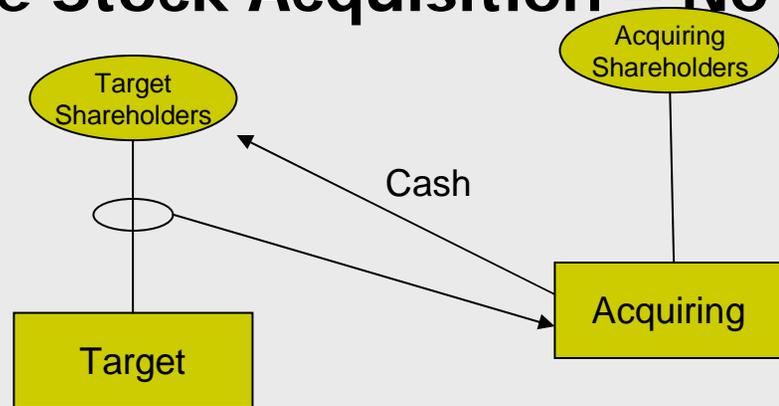


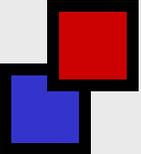
SBJPA of 1996:

- Repealed Section 1371(a)(2)
- Permitted S corporation to hold 80% - 100% subsidiaries
- Qsub – DRE treatment of 100% subsidiary

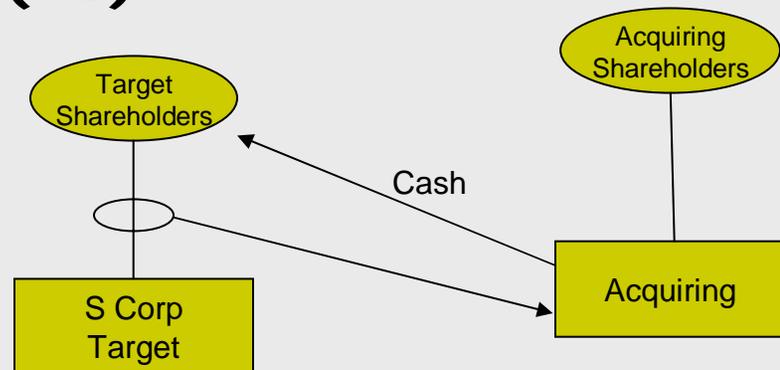


## Taxable Stock Acquisition – No 338(h)(10)

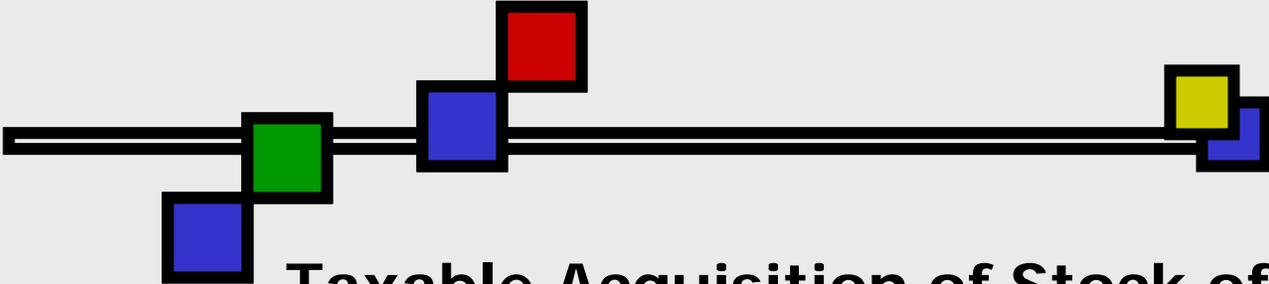


- Seller treatment
    - Generally capital gain/loss
    - No double tax
    - Possible Installment sale treatment
  - Buyer treatment
    - carryover of asset basis – no step up
    - carryover of tax attributes, but may be limited
    - Buyer inherits old tax history – all of it – no amortizable goodwill
  - Same tax consequences if Target is acquired in a taxable reverse subsidiary merger
- 

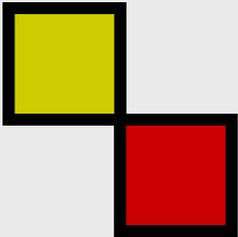
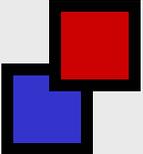
## Taxable Acquisition of Stock of S Corp Target – 338(h)(10)

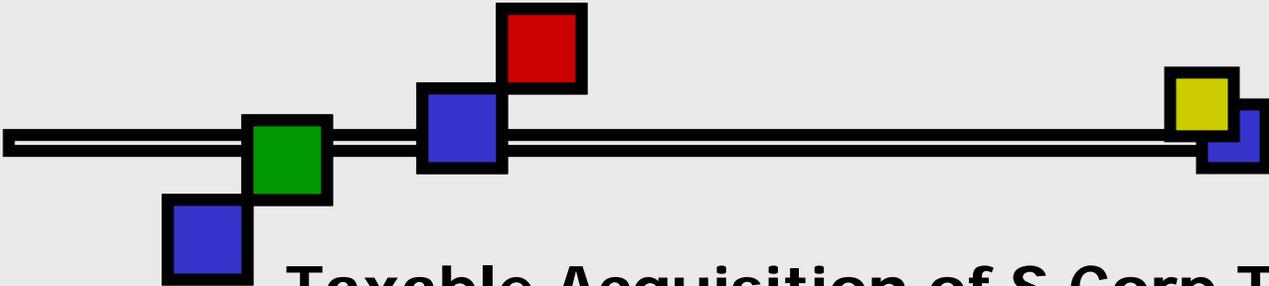


- Deemed asset sale/deemed liquidation
- Seller treatment
  - S Corp Target shareholders must consent to 338(h)(10) election
  - Sellers may qualify for installment sales treatment
  - Potential for timing and character mismatch
- Buyer treatment
  - Treated like an asset purchase
  - Assets basis adjusted to purchase price
  - Buyer may be exposed to BIG tax and any entity level state income taxes
  - Same tax treatment if target acquired in Cash Out Corporate or LLC merger (Rev. Rul. 69-6, PLR 200628008)

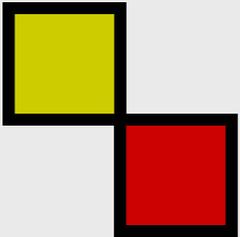
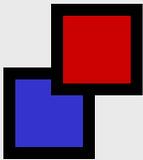


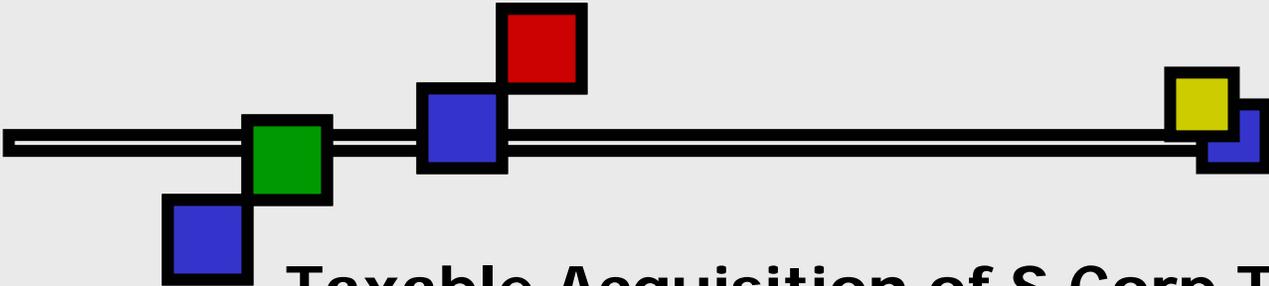
## Taxable Acquisition of Stock of S Corp Target – Section 338(h)(10)

- 
- Requirements:
    - Joint Election (Form 8023) to treat purchase of stock as purchase of assets for tax purposes
    - Target is S corp [or member of affiliated group]
    - Need a purchasing corporation (C or S)
    - QSP
      - 80% of vote and value within 12 months
      - Treas. Reg. §1.338(h)(10)-1(c)(2) - turn-off step transaction
- 

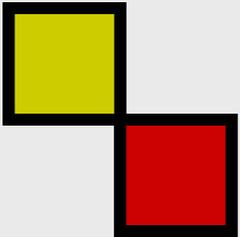
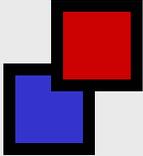


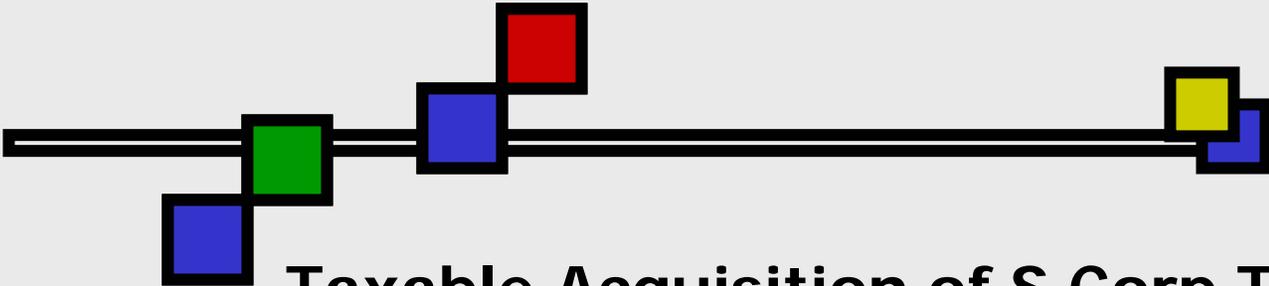
## Taxable Acquisition of S Corp Target – Section 338(h)(10)

- 
- Tax Consequences To Seller
    - Deemed asset sale
    - Depreciation recapture at ordinary income rates
    - If T has Subchapter C history (10 year Section 1374 taint) BIG recognized at corporate level
    - T's taxable year closes on the acquisition date with respect to selling shareholders
    - State tax consequences
    - Deferral still available from installment reporting
- 

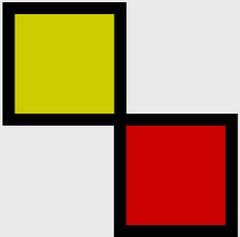


## Taxable Acquisition of S Corp Target – Section 338(h)(10)

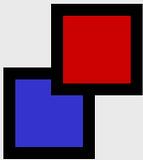
- 
- Tax Consequences To Buyer
    - Basis of Assets Stepped Up To Purchase Price of Stock
      - Excess value allocable to goodwill
      - Increased depreciation, amortization deductions
      - Reduced gain on subsequent sale of assets
    - T may qualify as Qsub of S Corporation Acquirer
      - Election must be filed with 2-1/2 months
      - No Section 1374 taint on assets
    - T may merge upstream into S Corporation Acquirer
- 

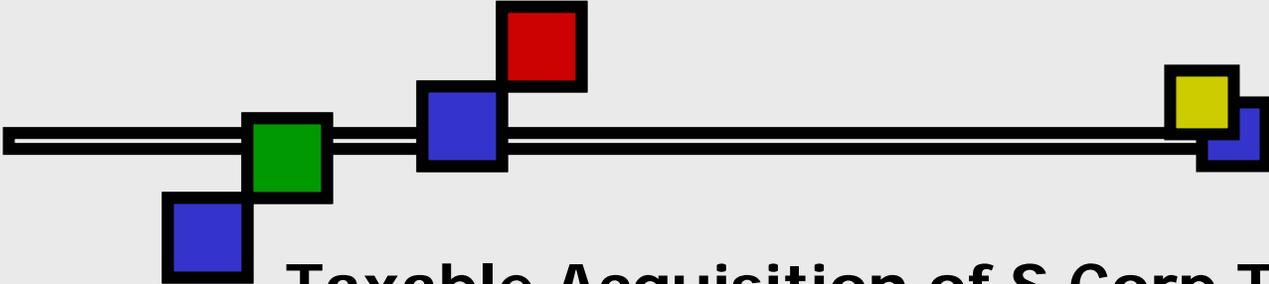


## Taxable Acquisition of S Corp Target – Section 338(h)(10)

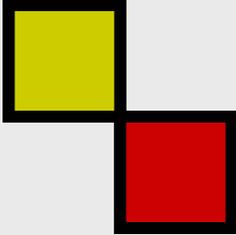
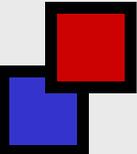


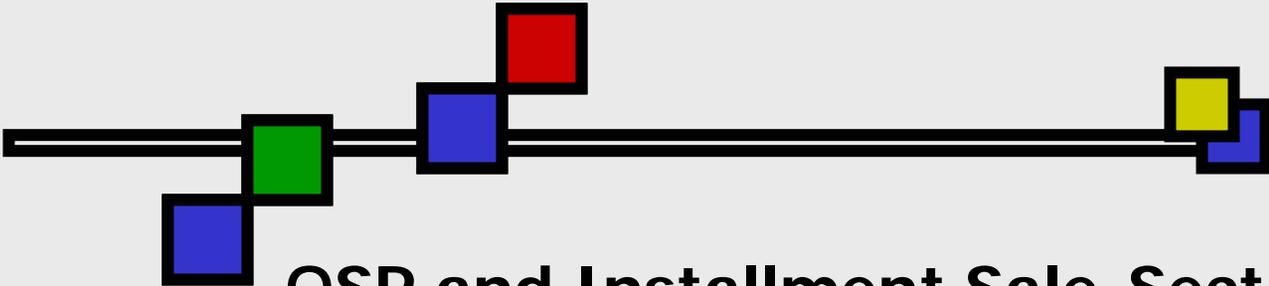
### ■ Tax Matters Provisions in Acquisition Agreement

- Target has been S Corp since \_\_\_\_\_ [and will be an S Corp through the Closing Date]
  - Disclosure of all Qsubs [and Qsub history]
  - Disclosure of BIG tax exposure and existence of Section 1374(d)(8) assets (assets acquired from C corp during previous 10 years with carry over basis at corporate level)
  - Target and each Selling Shareholder will join with Buyer in making Section 338(h)(10) election
  - Selling Shareholders will pay any BIG tax or state or local tax imposed on Target [or adjust purchase price accordingly]
  - Purchase price will be allocated to Target assets consistent with Sections 338 and 1060
- 

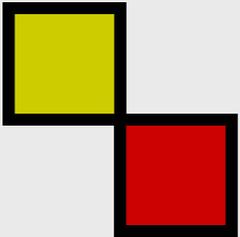
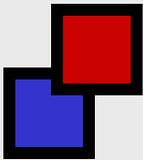


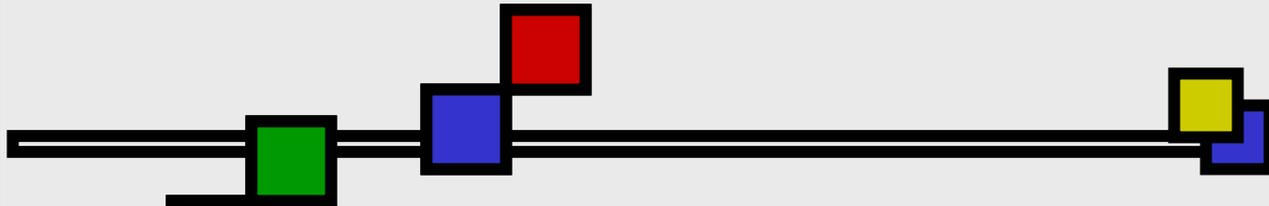
## Taxable Acquisition of S Corp Target – Section 338(h)(10)

- 
- Tax Matters Provisions in Acquisition Agreement (cont.)
    - Selling Shareholders will be responsible for all income tax liabilities passed through to Shareholders for tax periods ending on or before the Closing Date
    - [Sellers] [Buyer] shall prepare Target tax returns for periods ending on or before the Closing Date and filed after the Closing Date [subject to review and comment by the other parties]
    - Buyer, Sellers shall retain records relevant to any tax examination and cooperate with other party in the event of any tax examination during the applicable statute of limitations
    - Any tax sharing agreements between the Target, Selling Shareholders, or Qsubs shall be terminated as of the Closing
- 



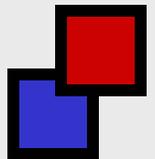
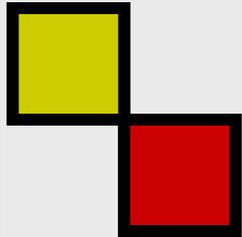
## QSP and Installment Sale-Sections 453(h) and 453B(h)

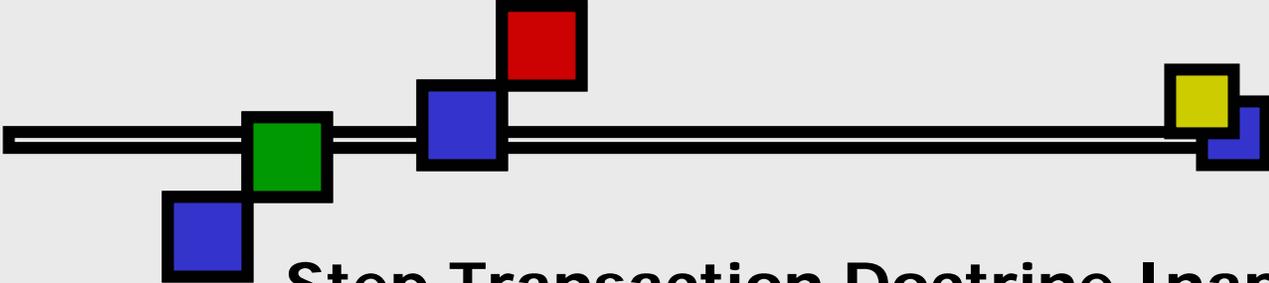
- 
- Background-repeal of GU
  - Section 453B(h)- S gain not triggered on distribution of installment note
  - Reg. §1.453-11 implementing section 453(h)
  - Reg. §§1.338(h)(10)-1(d)(8) and -1(e), Example 10
  - The one day note strategy –more favorable gross profit percentage calculation for Seller
- 



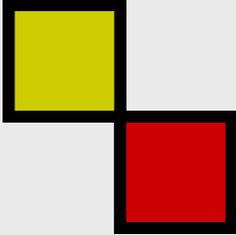
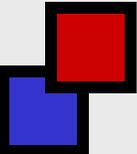
## Section 338(h)(10) Elections in Multi-Step Acquisitions

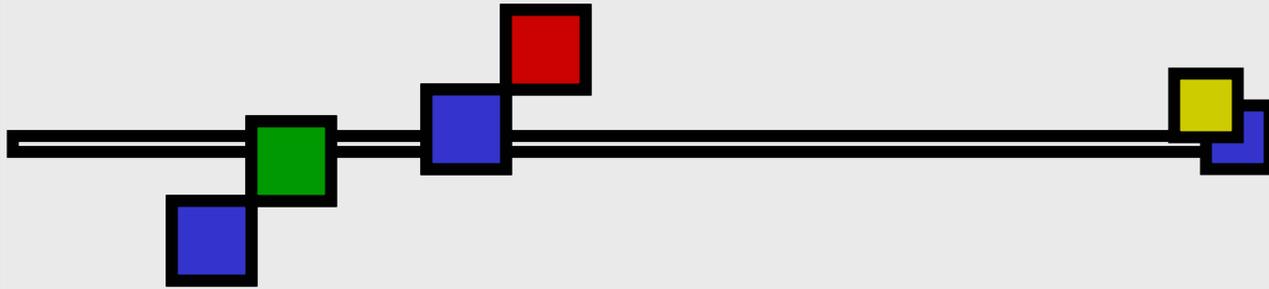
(Applicable to Both S and C Corp Targets)





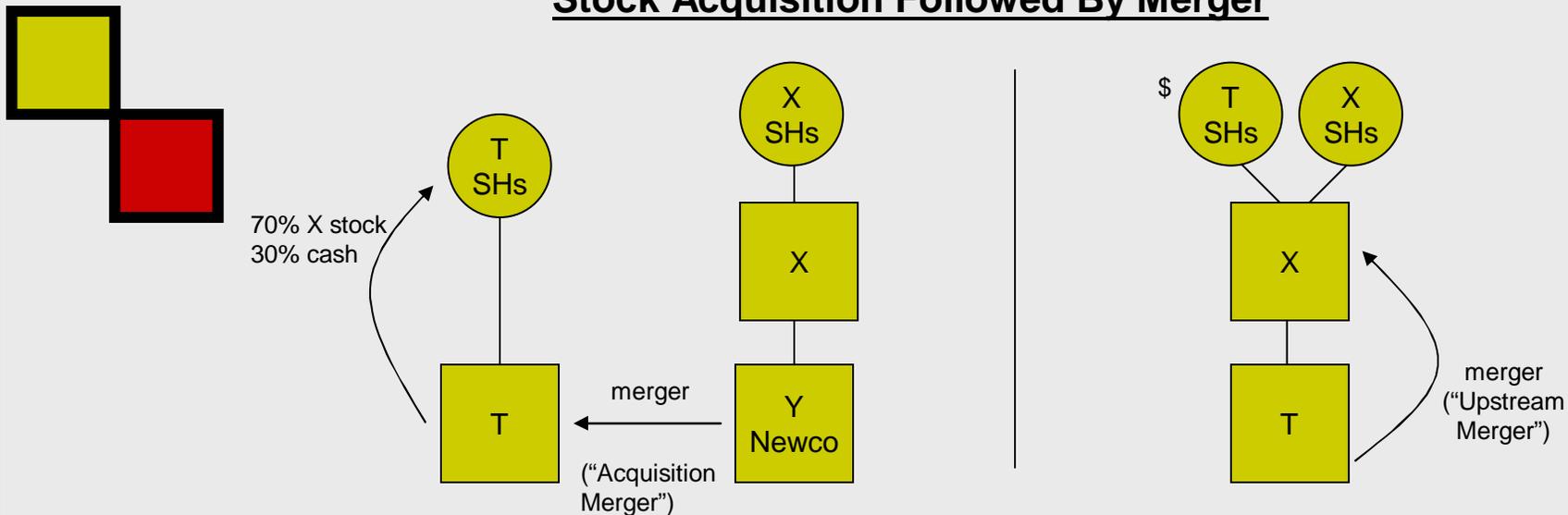
## Step Transaction Doctrine Inapplicable with QSP and Valid Section 338(h)(10) Election

- 
- The Final Regulations (the "Regs") provide that the step transaction doctrine will not apply if a corporation (i) engages in a qualified stock purchase ("QSP"), and (ii) makes a valid Section 338(h)(10) election.
  - The Regs reflect the general principles of Rev. Rul. 2001-46, 2001-2 C.B. 321.
  - The Regs are applicable to stock acquisitions occurring on or after July 9, 2003.
- 

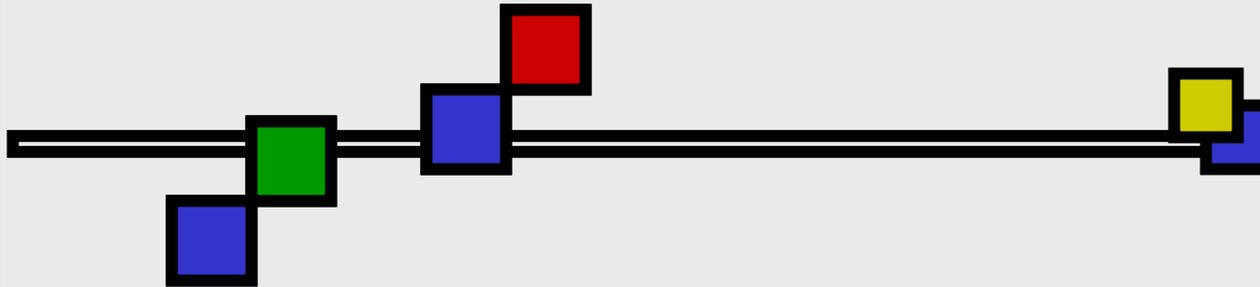


## Rev. Rul. 2001-46 (Situation 1)

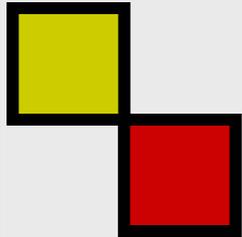
### Stock Acquisition Followed By Merger



- Assumption that the steps are integrated to be treated as an asset acquisition.
- Because Section 338 policies do not dictate otherwise, this transaction is treated as an "A" reorganization. *See King Enterprises, Inc. v. U.S.*, 418 F.2d 511 (CT. CL. 1969); *Cf. Rev. Rul. 67-274.*

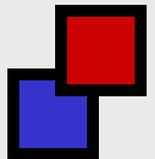


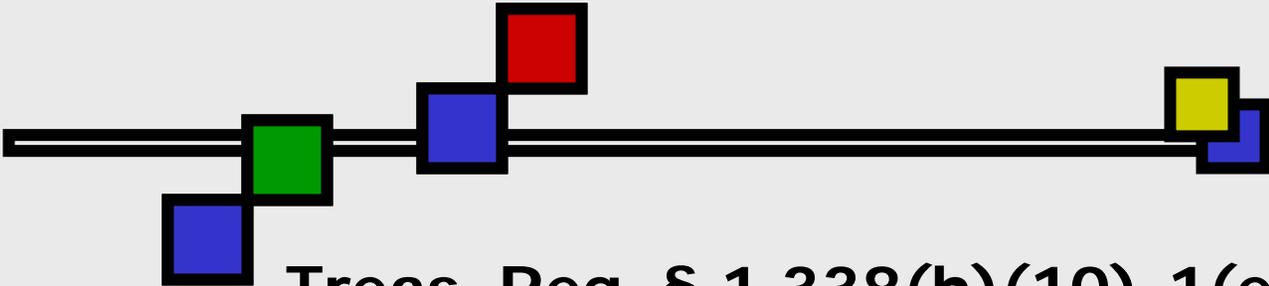
Treas. Reg. § 1.338(h)(10)-1(c)(2)



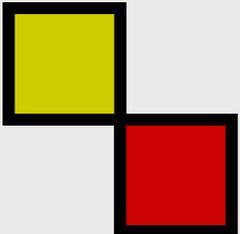
## Availability of Section 338(h)(10) Election in Certain Multi-Step Transactions

**Rule:** If a Section 338(h)(10) election is made in a case where the acquisition of T stock followed by a merger or liquidation of T into P qualifies as a reorganization described in Section 368(a), for all Federal tax purposes, P's acquisition of T stock is treated as a QSP and is not treated as part of a reorganization described in Section 368(a).

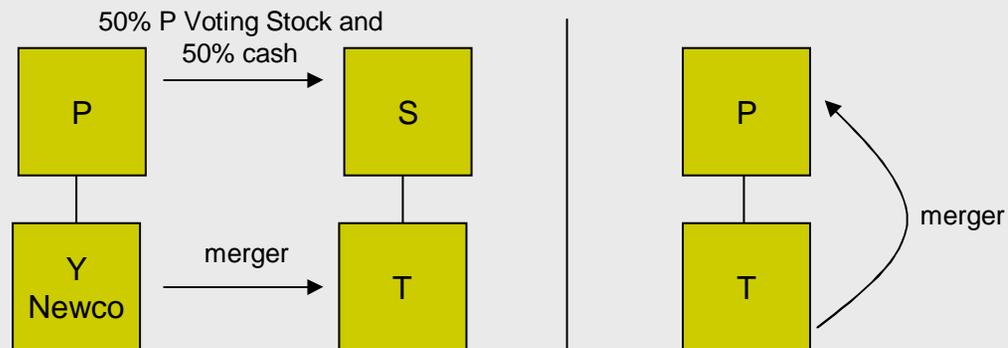


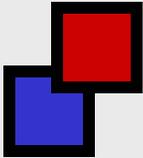


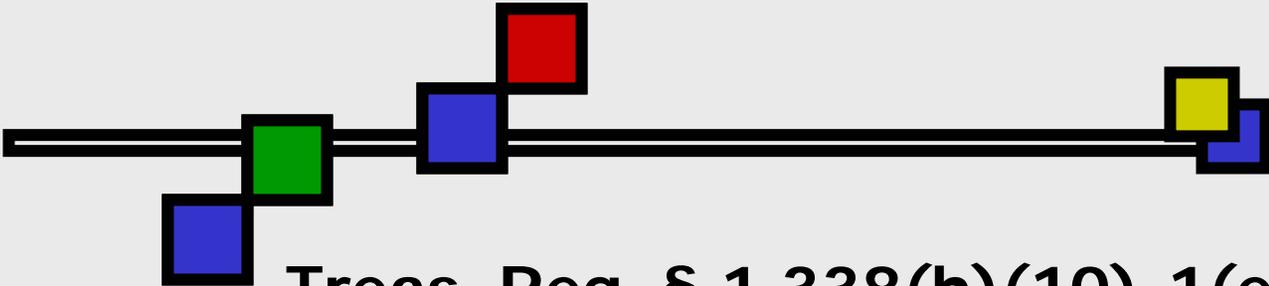
Treas. Reg. § 1.338(h)(10)-1(e)  
Example 11



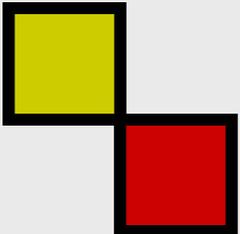
Stock Acquisition Followed By Upstream Merger –  
Without Section 338(h)(10) Election



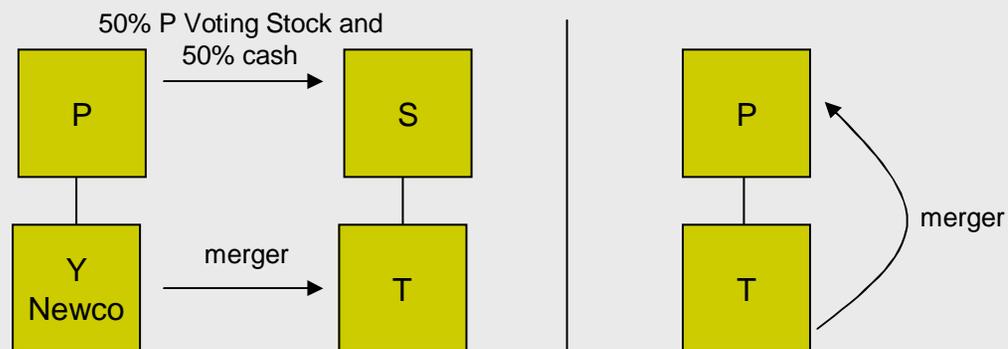
- P acquires all the stock of T in a statutory merger of Y into T, with T surviving. S receives consideration consisting of 50% P voting stock and 50% cash. T subsequently merges into P.
  - P and S do not make an election under Section 338(h)(10) for T. Absent the application of Treas. Reg. §1.338(h)(10)-1(c)(2), step transaction applies to treat P's acquisition of the T stock and T's merger into P as an asset reorganization described in Section 368(a).
- 

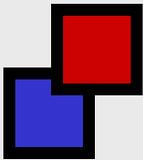


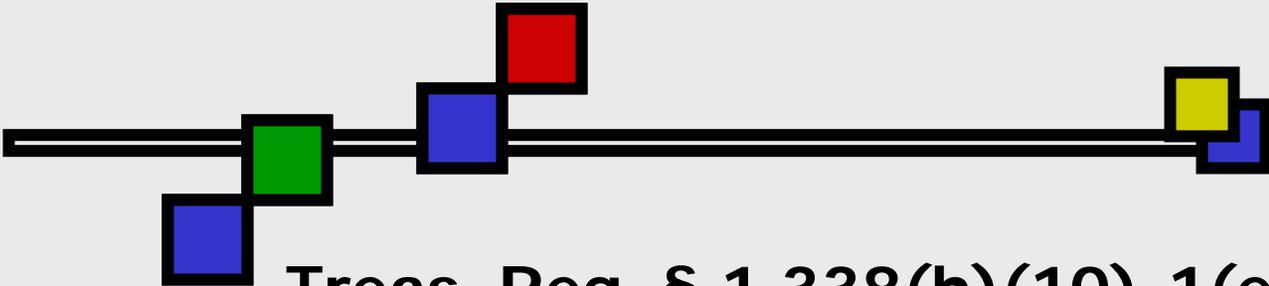
**Treas. Reg. § 1.338(h)(10)-1(e)  
Example 12**



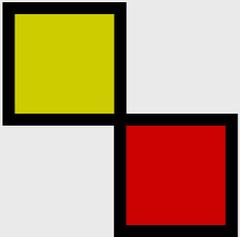
**Stock Acquisition Followed By Upstream Merger –  
With Section 338(h)(10) Election**



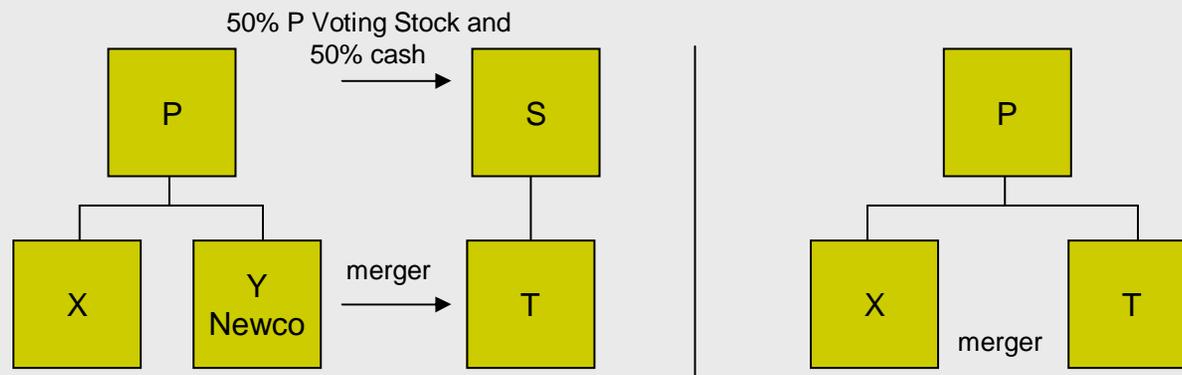
- 
- The facts are the same as in Example 11 except that P and S make a joint election under Section 338(h)(10) for T.
  - Pursuant to Treas. Reg. §1.338(h)(10)-1(c)(2), as a result of the election under Section 338(h)(10), P's acquisition of the T stock is treated as a QSP and not as part of a reorganization described in Section 368(a).

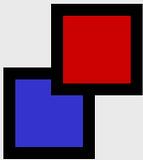


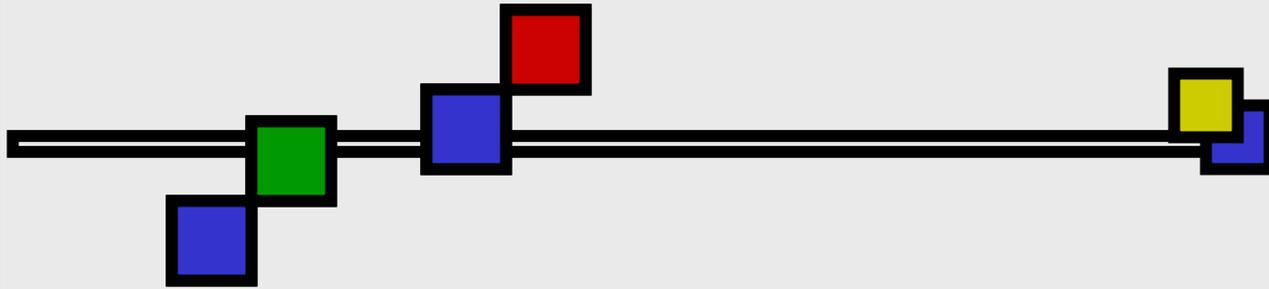
**Treas. Reg. § 1.338(h)(10)-1(e)  
Example 13**



**Stock Acquisition Followed By Brother-Sister Merger –  
With Section 338(h)(10) Election**

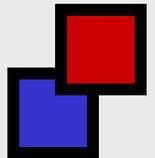
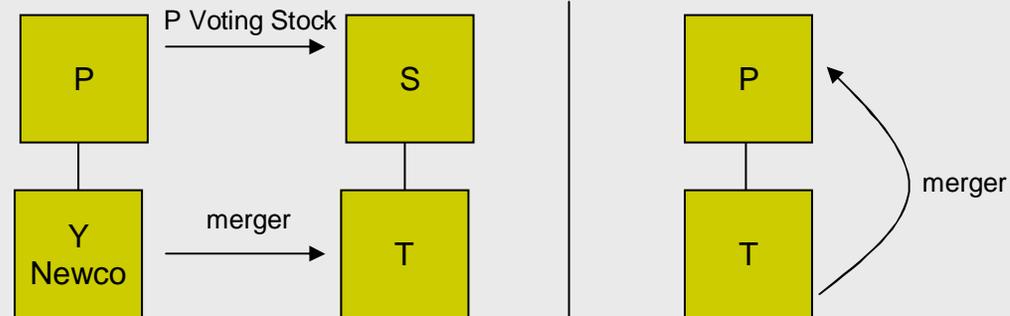
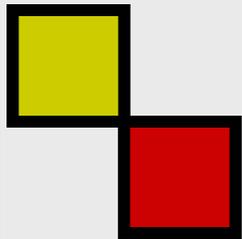


- 
- The facts are the same as in Example 12, except that, following P's acquisition of the T stock, T merges into X, a domestic corporation that is a wholly owned subsidiary of P.
  - Pursuant to Treas. Reg. §1.338(h)(10)-1(c)(2), as a result of the election under Section 338(h)(10), P's acquisition of the T stock is treated as a QSP and not as part of a reorganization described in Section 368(a).



## Treas. Reg. § 1.338(h)(10)-1(e), Example 14

### Stock Acquisition that Does Not Qualify as a QSP Followed by Upstream Merger



- The facts are the same as in Example 11, except that, in the statutory merger of Y into T, S receives only P voting stock.
- Pursuant to Treas. Reg. §§1.338-3(c)(1)(i) and (c)(2), no election under Section 338(h)(10) can be made with respect to P's acquisition of the T stock because the acquisition does not constitute a QSP under Section 338(d)(3). Accordingly, P's acquisition of the T stock and T's upstream merger into P is treated as a reorganization under Section 368(a).