When “Acquirer” or “Target” is Spelled with an “S” - Special Considerations for S Corporations in Mergers and Acquisitions

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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

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<td>1996</td>
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<td>26,287</td>
<td>470,657</td>
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<td>42,612</td>
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Source: SOI Data
S Corporations and Partnerships

Source: SOI Data
Number of S Corporation Returns, by Number of Shareholders

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%)

- 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

- 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

- 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

Taxpayer

SMLLC
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.
In all of these examples, the QSUBs are valid QSUBs.
QRS - Disregarded

100%

QRS

REIT

UPREIT LP

LPs
QSUB Election for Target

Buyer S Corp

Target SH

Target

Buyer S Corp

Target QSUB
QSUB Sale - Buyer S Corp Continues QSUB Election
QSUB Termination - Reg. §1.1361-5(b)(3)

S Corp

21%

Cash

QSUB

Busted 351-Example 1
(Changed by 2007 Act)

Use of SMLLC in Lieu of QSUB

S Corp

100%

QSUB

SMLLC

100%

Merger

S Corp

21%

Cash

SMLLC

SMLLC

Buyer

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

Acquirer

S Corp

SMLLC

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

Acquirer

S Corp

Subcorp

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 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).
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).
Example 12

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).
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).
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).