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Tax Planning Strategies for S Corporation Mergers and Acquisitions

Asset vs. Stock Sales, 338(h)(10) and 336(e) Elections, Qualifying for Installment Sales Treatment, Built-in Gains Tax, and More

WEDNESDAY, SEPTEMBER 28, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Caroline B. Banzali, J.D., LL.M., Partner, Transaction Advisory, **Withum Smith+Brown**, Los Angeles / New York

Daniel Mayo, J.D., LL.M., Principal, **Withum Smith+Brown**, Whippany, N.J.

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September 28, 2022

Tax Planning Strategies for S Corporation Mergers & Acquisitions

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Your Presenters

Caroline Banzali, JD, LLM

Partner & Practice Leader – M&A Transaction Tax
WithumSmith+Brown
Los Angeles / New York
cbanzali@withum.com
(310) 405-5238

Ms. Banzali leads Withum's M&A Transaction Tax Practice with over 20 years of experience serving strategic and private equity clients on both buy- and sell-side transactions ranging between $5M and $15B, including pre-transaction readiness, global tax due diligence, transaction tax structuring, spin-offs, reorganizations, debt and equity financing, IPOs/SPACs, as well as tax remediation and post-transaction integration services. Caroline's experience spans all business life-cycle stages and industries, with particular focus on private equity (PE), start-ups, technology, licensing & merchandising, media & entertainment, telecommunications, real estate & hospitality, and financial institutions.

In addition to 14 years with the "Big Four" in Los Angeles and New York, Caroline has held senior industry executive roles, including as SVP & Head of Global Tax of a prominent Los Angeles-based PE firm and ultra-high net worth family office with over $3.5B AUM specializing in structuring global media & entertainment, real estate, and technology investments, and also as deputy General Counsel and Head of Tax & Risk Management at a $4B EV/Tech start-up with a global financial and operating structure encompassing IP licensing and royalties, research & development, and manufacturing activities.

Caroline, a Southern California native, earned her business degree from the University of Southern California (USC) at the age of 19, and her J.D. and LL.M in Taxation from Loyola Law School. She is an active member of the California State Bar and frequently speaks on M&A topics relating to PE and Exit Planning. Caroline has also published several articles pertaining to the Cannabis and the Media & Entertainment industries.

Daniel Mayo, JD, LLM

Principal
Lead, National Tax Services Group
WithumSmith+Brown
Red Bank, NJ
dmayo@withum.com
(973) 532 8847

Daniel has more than 20 years of professional tax experience as well as experience in federal, international and financial products taxation. He is experienced in mergers and acquisitions, capital markets and cross-border transactions.

Daniel is a frequent author and speaker on U.S. Federal income tax and international tax topics. He is an approved arbitrator for FINRA and an adjunct faculty member with Georgetown University Law Center. Daniel is a member of the American Bar Association, previously the chair of the Banking & Savings Institutions Tax Committee, and the New York Bar Association.

Taxation of S Corporations

Taxation of S Corporations

- No double taxation – flow-through treatment on allocable share of S corp's income/gain/deduction/loss
- Exceptions were tax applies at S corp level –
  - Excess passive investment income tax – greater than 25% passive income and C corp E&P (§1375)
  - Last-in, first-out ("LIFO") inventory recapture tax – applicable only if the LIFO inventory method is used
  - Built-in gains ("BIG") tax – if the S corp's election was made within 5 years and it was previously taxed as a C corp, then any gains realized on a sale (or deemed sale) of the S corp's assets that it held while a C corp is subject to tax at corporate tax rates (§1374)
  - State entity-level tax
    - Certain states impose S corp income tax in addition to the income tax at the shareholder level (*e.g.*, California)
    - Certain states do not recognize S corp and impose tax as C corp (*e.g.*, New Hampshire, Tennessee, District of Columbia)
    - Certain states impose taxes regardless of entity classification (*e.g.*, Delaware, Washington, Texas)
- US Federal and State Income Tax Filing Obligations
  - Form 1120-S & state returns – Information return, with Schedule K-1s disclosing each shareholder's allocable share of S corp items
    - Shareholders report items on their Form 1040 and state equivalent

S Corporation Election & Eligibility Requirements

- Once a valid S corp election is made, it remains in effect until revoked, or it ceases to meet the S corp requirements
- Elect on Form 2553 – filed by an "eligible corporation" no later than two months and 15 days after the beginning of the tax year for which the election takes effect (*e.g.*, on or before March 15 for effective date of January 1)
    - Election must be signed by all shareholders at the time of the election, including spouses in community property jurisdictions (*e.g.*, California, Texas, *etc.*)
    - IRS acceptance letter should be retained as proof of valid/timely election
    - Most states conform to the federal S corp election and IRS acceptance, but there are certain states that require a separate S election to be made (*e.g.*, Arkansas, New Jersey, New York)
    - Certain states do not recognize S corps and tax them as C corps (*e.g.*, New Hampshire, Tennessee, District of Columbia)

S Corporation Election & Eligibility Requirements (cont'd)

- Requirements of an "eligible corporation" –
  - Domestic (US) corp or other entity (*e.g.*, LLC) that elects to be treated as a corp for US federal income tax purposes (Form 8832)
  - No more than 100 shareholders, subject to attribution rules (*e.g.*, spouses, family members, and their respective estates may be treated as a single shareholder)
  - All shareholders (and spouses in community property jurisdictions) are "eligible S corporation shareholders", which are generally US individuals, estates, and certain trusts (*e.g.*, grantor trusts, electing small business trusts ("ESBTs"))
  - Only one class of stock, but can have voting and nonvoting shares (*e.g.*, no differences in distribution or liquidation rights among the shareholders; no disproportionate distributions)
  - Is not an "ineligible corporation" – *e.g.*, bank or thrift institution, insurance company, current or former domestic international sales corp ("DISC")

Common Tax Due Diligence Issues

- If the S election is revoked or invalidated, the entity reverts to being taxed as a corp for federal and state income tax purposes (*i.e.*, double tax applies)
  - A buyer of an S corp "inherits" this risk; thus, general tax due diligence must include validation of the S corp election

- Invalid/Late S Election – it is not uncommon for a company to be unable to produce proof of a valid/timely filed S election and/or its IRS acceptance letter, but if it is determined that there is a risk that the S election was invalid or not timely filed, there is IRS relief available as long as all other S corp requirements have been continuously met since the effective date and the company and its shareholders had been filing/treating it as an S corp
  - Election was not signed by all shareholders at the time of the election, including spouses in community property jurisdictions
  - Lost IRS acceptance letter
  - Failure to file separate state S corp election in a state where the company has tax filing nexus (*e.g.*, Arkansas, New Jersey, New York)

Common Tax Due Diligence Issues (cont'd)

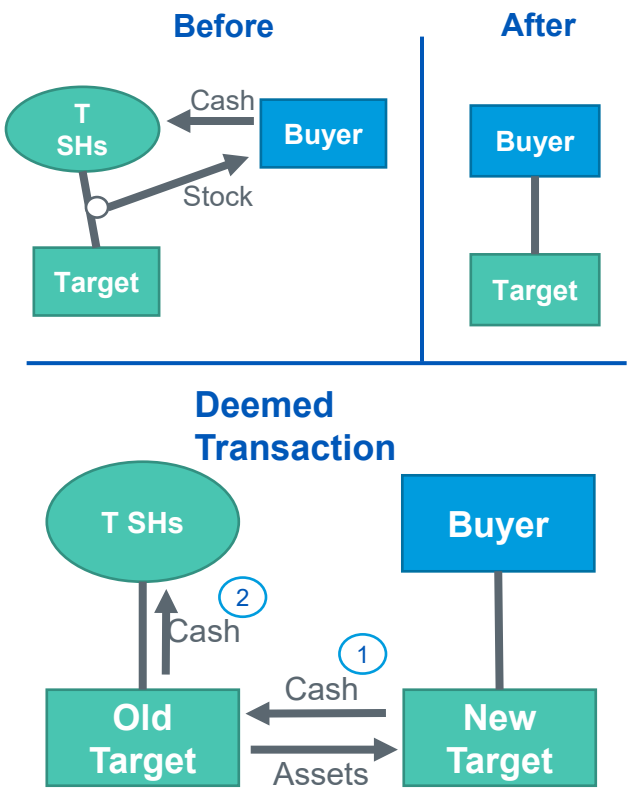
- Ineligible shareholder(s):
  - More than 100 shareholders, subject to attribution rules (*e.g.*, spouses, family members, and their respective estates may be treated as a single shareholder)
  - Ineligible foreign shareholder (*e.g.*, not US citizen or resident) and/or spouse in community property states
  - Ineligible trust shareholder – trusts other than grantor trusts must generally apply to the IRS to be treated as ESBTs
  - Ineligible corporate shareholder

Common Tax Due Diligence Issues (cont'd)

- Impermissible "second" class of stock – S corp shareholders must have identical distribution and liquidation rights, although they may have different voting rights
  - Disproportionate distributions not permitted, but some timing differences are okay
  - "Unreasonable" compensation
  - Family members or other related parties/affiliates being paid for goods/services on non-arms-length terms
  - Shareholder loans/advances on non-arms-length terms
  - "Profits" interests or "change of control" rights to sale proceeds granted to employees, vendors, and/or other non-shareholders
- Other:
  - Provisions in S corp governing documents (*e.g.*, Articles, Bylaws) that are inconsistent with S corp principles (*e.g.*, partnership tax clauses)
  - Businesses in certain regulated industries (*e.g.*, bank or thrift institution, insurance company) or certain types of tax entities (*e.g.*, current or former DISC) are not permitted to be S corps

Stock Sale with §338(h)(10) Election

Stock Sale with §338(h)(10) Election



- Overview
  - Legal structure is that Buyer purchases 80%-100% of the shares of the T from T's shareholders for cash, note(s), and/or other property (*e.g.*, Qualified Stock Purchase ("QSP"))
    - Buyer must be a C corp
    - Target ("T") must be either an S corp or a subsidiary member of a consolidated group of C corps
  - Buyer and T shareholders make a joint §338(h)(10) election to treat the QSP as if T sold all of its assets, followed by a deemed liquidation
- Seller's treatment
  - T recognizes gain or loss on deemed asset sale
    - Amount realized generally is sales price plus liabilities assumed
    - Gain is generally capital, except for gain attributable to A/R, inventory, and depreciation/amortization recapture
    - Gain/loss flows through to shareholders on K-1s, increasing their outside basis
    - But watch for §1374 BIG tax (*e.g.*, T taxed as a C corp if assets sold within 5 years)
  - T SHs recognizes gain in deemed liquidation if distribution exceeds outside stock basis

§338(h)(10) Election (cont'd)

- Buyer's treatment
  - Cost basis in T shares and T assets, which is a tax basis "step-up" if the aggregate purchase price is greater than T's pre-Closing tax balance sheet
  - T's tax attributes (E&P, NOL, *etc.*) do not carryover
  - T's S election terminates and T becomes a C corp, and T generally joins Buyer (and other subs) in the filing of a US federal consolidated income tax return
- Election / Reporting
  - Form 8023 – election filed jointly by purchasing corporation and all S corp shareholders, even those that do not sell stock in the QSP
    - Election must be filed within 8½ months of QSP
  - Form 8883 – Old T and New T must attach this form to the return that reflects the transaction
    - Parties generally negotiate and agree on a purchase price allocation among the asset classes, which determines the amount of ordinary vs capital gain recognized by T's selling shareholders
    - Final amounts of purchase price allocated may differ depending on each party's transaction costs

§338(h)(10) Election (cont'd)

Other considerations

- Sale of stock in form, so need approval of T's shareholders
- Buyer must be a corporation (this is the key difference from §336(e) election)
  - §338(h)(10) takes precedence if a transaction meets both §338(h)(10) and §336(e)
- Seller cannot obtain tax-free equity rollover
- Buyer often agrees to "gross-up" the purchase price to account for the incremental tax to seller (as compared to a straight stock sale by seller)
- T must be a valid S corp or else the §338(h)(10) election is invalid
  - Buyer would not obtain a basis step-up in T's assets
  - Buyer would inherits T's historical C corp tax liabilities and must sue T's selling shareholders and seek indemnification (if available under the purchase agreement)
  - Consider "F" Reorganization to mitigate risk to Buyer (discussed later)
- State taxes must be considered, as with all transaction structures

Installment Sale & "1-Day-Note" Strategy

- Shareholders of S corp engaging in a §338(h)(10) transaction may have accelerated gain recognition if the S corp receives cash in addition to an installment note or other deferred payment arrangement
- Although installment sale rules of §453 generally allow for deferred gain recognition, such gain is recognized under §453B if the note is distributed to shareholders
- S corp exception: an exception eliminates gain on the distribution if the note is distributed within 12 months of adoption of a plan of liquidation (*see* §453B(h) & Reg. §1.338(h)(10)-1(e), Ex. 10(iv))
  - This effectively defers gain recognition until payments on the note are made
  - But the SH's "adjusted" outside basis must be allocated between the cash and the note distributed in the deemed liquidation based on relative value, and this can trigger gain recognition in the deemed liquidation because basis is allocated away from the cash

Installment Sale & "1-Day-Note" Strategy (cont'd)

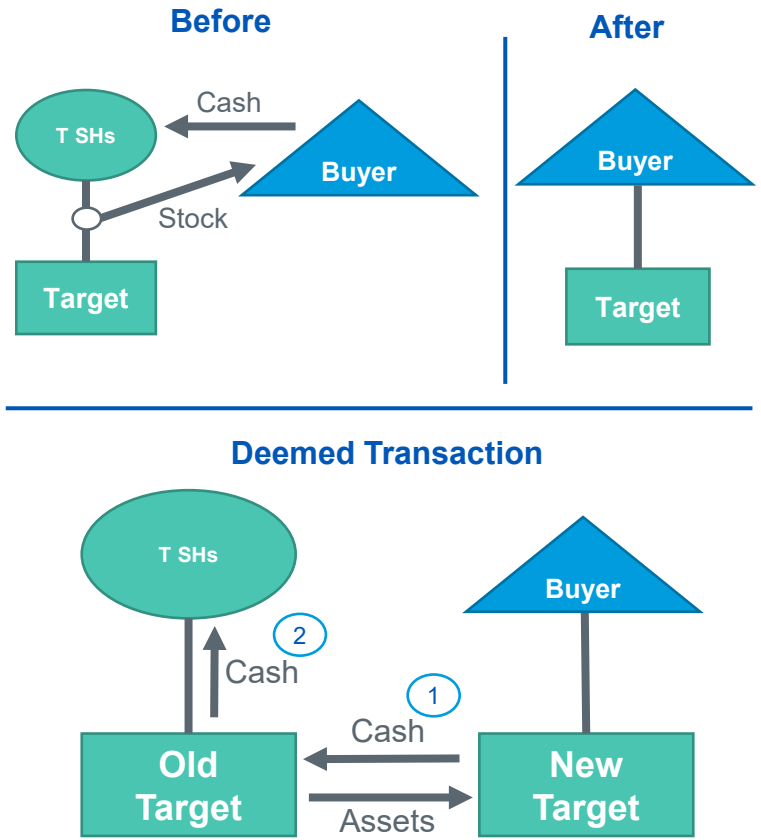
- See example on next slide
  - §338(h)(10) sale – receipt of note vs. receipt of note and cash
  - Note that receipt of cash at closing causes gain recognition on the asset sale, and then again in the deemed liquidation because basis created by such gain is allocated between cash and note
- Possible Solution: 1-Day-Note Strategy – Buyer pays the full purchase price with a note; terms of note require cash payment shortly after closing and the remainder after a few years
  - In this case, there is no gain recognition in the deemed liquidation under §453B(h) because only the note is distributed in the liquidation
  - Consider economic substance doctrine of §7701(o) and state tax consequences

1-Day-Note Example

	Sale for Cash and Note		Sale for Note Only	
	Deemed Asset Sale		Deemed Asset Sale	
	Cash	Note	Cash	Note
Amount Realized (AR)	100	900	0	1,000
Adjusted Basis (AB)	0	0		0
Gain realized	100	900	0	1,000
Gain recognized b/c of cash	100		0	
	Deemed Liquidation		Deemed Liquidation	
	Cash	Note	Cash	Note
AR	100	900	0	1,000
AB (from gain recognized)	10	90		0
Gain realized	90	810	0	1,000
Gain recognized @ closing	90		0	
Gain deferred	810		1,000	
Gain recognized @ day 2	0		100	
Gain recognized @ year 3	810		900	

Stock Sale with §336(e) Election

Stock Sale with §336(e) Election



Overview

- Similar to §338(h)(10) transaction EXCEPT:
  - Buyer is not a corporation (*e.g.*, LLC such as a private equity fund, or other acquirer taxed as a partnership, sole proprietorship, *etc.*) and
  - No single party needs to acquire at least 80% of T stock (*e.g.*, qualified stock disposition ("QSD") rather than QSP)
  - Recall that §338(h)(10) takes precedence if there is a corporate Buyer

Seller's treatment

- Same as §338(h)(10) transaction

Buyer's treatment

- Same as §338(h)(10) transaction, except that T may make a new S election if Buyer(s) is an eligible S corp shareholder

§336(e) Election (cont'd)

- Election / Reporting
  - Election is made by attaching a statement to a timely-filed return
    - Caution – If T is an S corp, then the return generally must be filed within 2½ months of the month in which the disposition occurs, unless an extension is filed because old T ceases to exist (thus, §1362(e)(6)(B) does not apply)
    - Compare with 8½ months to file an election under §338(h)(10)

§336(e) Election (cont'd)

- General requirements – *see* Reg. §1.336-2(h)
  - Sellers and T must enter into a written, binding agreement to make the election by the due date, including extensions, of the return for the year that includes the disposition date
    - If T is an S corp, then all shareholders must enter into the agreement, even non-selling SHs because they will have gain recognition too (and a repurchase at FMV)
  - Parent of T must retain a copy of the agreement (or the S corp if T is an S corp)
  - §336(e) election statement in Reg. §1.336-2(h)(5) and (6) must be attached to the timely filed return for the year that includes the disposition date
    - S corp target must attach the statement to its timely-filed return that includes the disposition date
- Form 8883 – Old T and New T must attach this form to the return that reflects the transaction
  - Parties generally negotiate and agree on purchase price allocation among asset classes for all tax purposes, which determines the amount of ordinary vs capital gain realized by T's selling shareholders
  - Aggregate amount of purchase price allocated may differ depending on each party's transaction costs

§336(e) Election (cont'd)

- Other considerations
  - Sale of stock in form, so need approval of T's shareholders
  - Regulations refer to a qualified stock disposition ("QSD") rather than to a QSP as with a §338(h)(10) election
    - QSD refers to the sale of 80% of vote and value within a 12-month period
    - Exceptions from QSD status generally include tax-free dispositions, sales or dispositions to related parties, substitute basis transactions, and stock acquired from a decedent
  - Seller cannot obtain tax-free equity rollover (same as with §338(h)(10))
  - Buyer often agrees to "gross-up" the purchase price to account for the incremental tax to seller (as compared to a straight stock sale by seller) (incremental cost can relate to tax rate differences or for delayed use of capital loss carryovers)
  - A new "S" election must be filed if qualified SHs and that is desired going forward
  - If Buyer is not an eligible S corp SH, T can obtain flow-through status by converting T to an LLC – should not result in additional tax cost because of §336(e) step-up
  - State taxes must be considered, as with all transaction structures

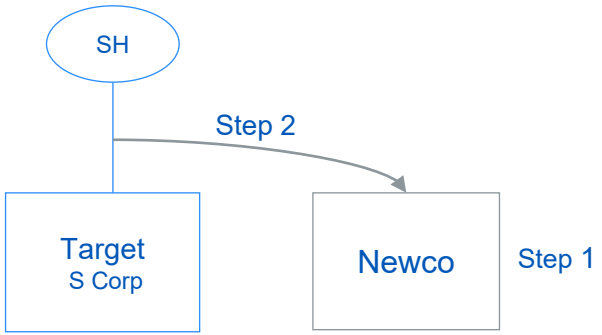
Comparison of §338(h)(10) & §336(e)

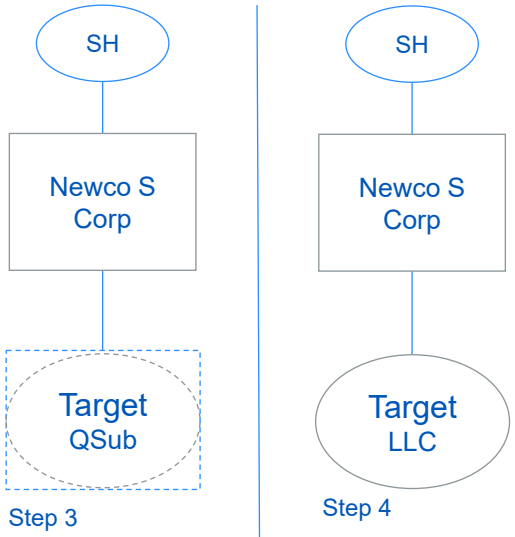
	§338(h)(10)	§336(e)
Buyer	Single corp (C or S, domestic or foreign)	Individual, partnership, LLC, corp, or multiple purchasers
Target	(i) Domestic corp that is a member of an affiliated or consolidated group or (ii) S corp	Domestic C or S corporation
Seller	Selling consolidated group, a selling affiliate (i.e., a domestic corporation that has §1504(a)(2) ownership but does not file a consolidated return with the target), or shareholders of S corp	(i) Domestic corp that makes a QSD or (ii) shareholders of S corp
Qualification	QSP (sale or exchange) -- QSP status trumps QSD status	QSD (includes sale, exchange, and certain distributions)
Election	Joint election by buyer and seller (and must include all shareholders of S corp)	Seller's unilateral election (including all SHs of S corp), though a binding, written agreement between seller and target is required
Tax Treatment	Asset sale and liquidation	Asset sale and liquidation

“F” Reorganization

"F" Reorganization (Rev. Rul. 2008-18, Situation 1)

- Allows Target to continue in existence and allows for basis step-up to Buyer and Seller to get tax-deferred rollover equity if desired





Step 1 – form Newco Inc.

Step 2 – T SHs contribute 100% of shares of T to Newco solely in exchange for Newco shares

Step 3 – Newco makes an election on Form 8869 to treat T as a qualified S corp subsidiary ("Qsub"), which is a disregarded entity (this completes the F reorganization)

- Requires a plan of reorganization, but this is a formality
- Pursuant to Rev. Rul. 2008-18, Newco succeeds to T's original S corp election, no new election is required and there is no lapse in of S corp status, and no short tax period

Step 3 – Pursuant to state conversion statute, T converts to an LLC

- DRE to DRE is a tax-free conversion

Step 4 – Buyer acquires 100% of the membership interests of T LLC from Newco, with Newco remaining as Seller and indemnity obligor with T's historical SHs.

"F" Reorganization (cont'd)

- Purchase of LLC membership interests is treated as an asset acquisition for US federal and most state income tax purposes
  - Gain on deemed sale of T's assets flows through to Newco's SHs, increasing their outside basis and taxable income
  - Buyer obtains tax basis "step-up" in T's assets
  - Buyer does not acquire T's tax attributes

"F" Reorganization (cont'd)

- Election / Reporting
  - Qsub election for T is made on Form 8869
    - There are other "F" reorganization structures available in addition to those described in Rev. Rul. 2008-18
  - Disclosure statement required to be attached to the returns of the reorganized entity (Newco) and its significant holders (*see* Reg. §1.368-3(a))
  - Conversion of T to LLC pursuant to state conversion statute (*e.g.*, paperless vs statutory merger with and into New LLC)
  - Both parties must file Form 8594 if the assets constitute a trade or business
    - Parties generally negotiate and agree on purchase price allocation among asset classes, which determines the amount of ordinary vs capital gain realized by T's selling shareholders
    - Final amounts may differ because of each party's transaction costs

"F" Reorganization (cont'd)

- Other considerations
  - Sale of equity in form, so need approval of T's shareholders
  - Structure most often used when Buyer has concerns about T's qualification as an S corp
    - Buyer's tax basis step-up in T's assets is assured, even if T's S corp status is invalidated
  - Flexible structure (no restrictions on type of buyer or ownership percentage sold)
  - Works well when Buyer may not be acquiring 100% of T (*e.g.*, T is taxed as a partnership)
  - Structure accommodates acquisition percentages less than 80%
  - T generally retains its tax history, taxable year, and EIN
  - Not particularly useful in the context of C corps (because of double tax)