

ASK THE EXPERTS WEBINAR

*Tax Considerations for S Corporations
in M&A Transactions*

October 24, 2019

PRESENTERS



Ryan Gamble *MANAGING DIRECTOR*

Years of Experience: 20+

Expert Areas: Tax planning, risk mitigation, restructuring, reorganizations, taxable and non-taxable acquisitions, ASC740 tax accounting, purchase accounting for business combinations, and transaction cost analysis.



Gary Bedsole *MANAGING DIRECTOR*

Years of Experience: 19+

Expert Areas: Transaction tax for public and private companies across a variety of industries, including media, financial services, entertainment, healthcare, and manufacturing.



Thomas Dye *SENIOR ASSOCIATE*

Years of Experience: 5+

Expert Areas: Transaction tax, including Section 382 limitation analyses, for public and private companies across a variety of industries including media, entertainment, consumer products, manufacturing and financial services.

KEY REMINDERS

- ▶ Riveron webcasts – past and upcoming
- ▶ 4 polling questions must be answered to obtain CPE
- ▶ If you have questions, feel free to ask in Q&A option in Zoom
- ▶ Webinar evaluation form & CPE certificate will be emailed to you
- ▶ On demand video is not eligible for CPE
- ▶ You will receive a follow up email including:
 - ▶ Access to this webinar recording and deck
 - ▶ The ability to join our Webinars Mailing list to receive future invites
 - ▶ Presenter contact information

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PART 1:
**S CORPORATION
OVERVIEW**

WHAT IS AN S CORPORATION?

WHAT IS AN S CORPORATION?

- ▶ An S corporation is a corporation that meets certain requirements and for which a tax election is made by the shareholders.
- ▶ S corporations are generally not subject to U.S. federal income tax at the entity level.
- ▶ Items of income, gain, loss and deduction of an S corporation are passed through to the shareholders and reported on the shareholders' respective income tax returns.
- ▶ The special rules for S corporations are set forth in subchapter S of the Internal Revenue Code.

POPULARITY OF S CORPORATIONS

| Type of Return | FY18 |
|-----------------------------|-----------|
| Form 1120S (S Corporations) | 5,128,058 |
| Form 1065 (Partnerships) | 4,239,198 |
| Form 1120 (C Corporations) | 1,720,920 |

* Form 2553 (S corporation election): 492,634

ENTITY TYPES

| | S Corporation | C Corporation | Limited Liability Company (“LLC”) |
|--------------------------------------|---|--|---|
| Formation Requirements, Costs | Must file with state, filing fee required | Must file with state, filing fee required | Must file with state, filing fee required |
| Personal Liability | Shareholders are not typically liable | Shareholders are not typically liable | Members are not typically liable |
| Management | Shareholders elect directors who manage business activities | Shareholders elect directors who manage business activities | Flexible (manager or member managed) |
| Taxation | No tax at the entity level. Income passed through to the shareholders | Taxed at corporate rate and possible double taxation ; dividends are taxed at the individual level if distributed to shareholders | No tax at the entity level. Income passed through to the members |
| Employment Tax | Salary subject to employment tax, but shareholder distributions are not subject to employment tax | Salary subject to employment tax | Salary/guaranteed payments subject to self employment tax. Partners cannot receive W-2 wages |
| Tax Forms | Form 1120S, shareholders get K-1 for personal tax returns | Form 1120 | 1 Member: sole proprietor Form 1040 – Schedule C Multiple Members: Form 1065, K-1 for personal tax returns |
| Transferability of Interest | Yes, but must observe requirements on who can own stock | Yes, subject to contractual restrictions | Yes, subject to contractual restrictions |

Polling Question 1

An S corporation is generally taxed at the entity level for U.S. federal income tax purposes.

- A. True
- B. False



OVERVIEW

S Corporation Requirements (Subchapter S of the Internal Revenue Code)

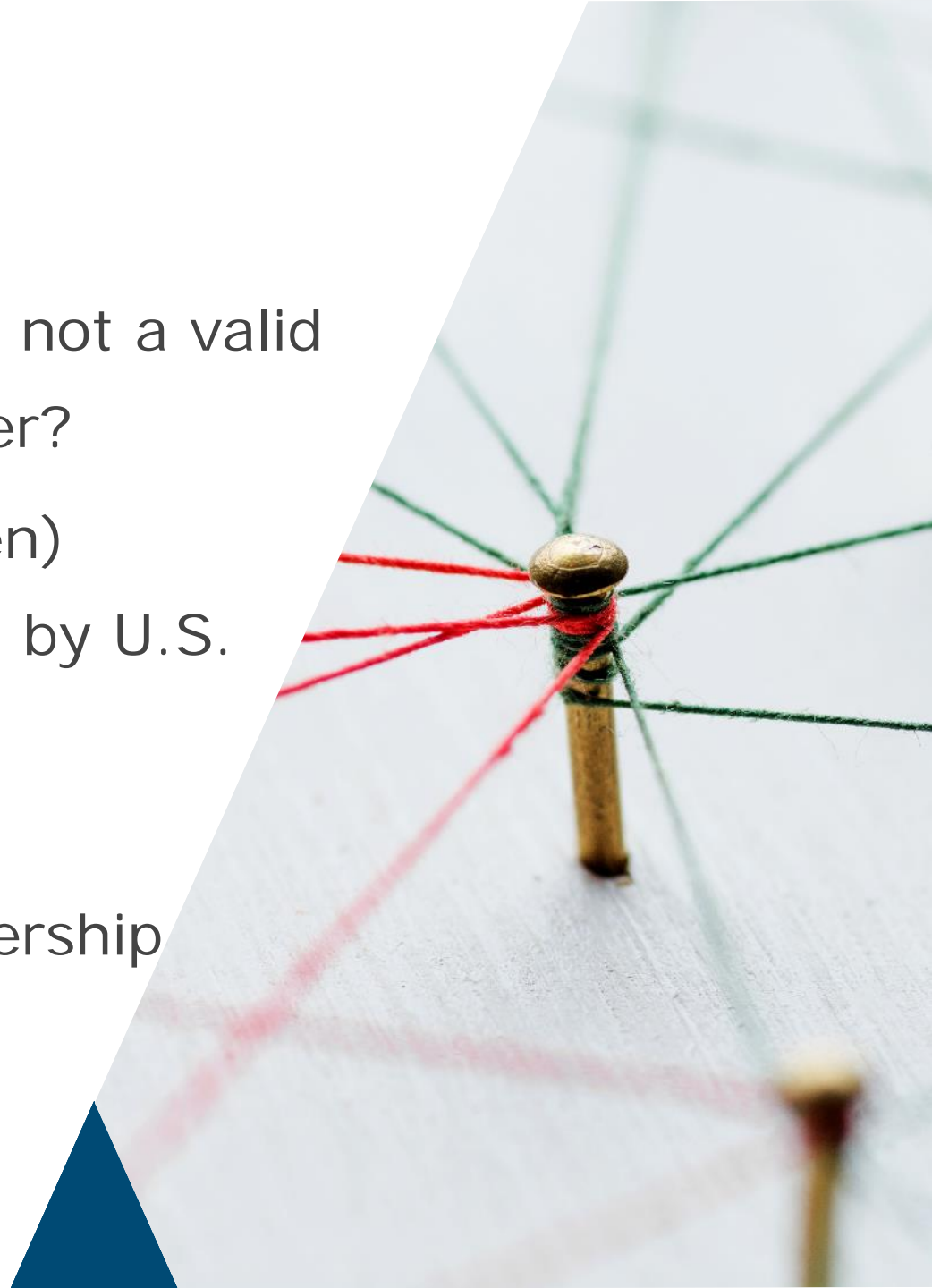
S corporations are “small business corporations” for which an election has been made to pass corporate income, gain, loss, deduction and credit through to the shareholders. To qualify as a small business corporation, a corporation must:

- ▶ Be a domestic corporation
 - ▶ Excludes certain ineligible corporations
 - ▶ May include legal entities that have elected to be taxed as corporations
- ▶ Have no more than 100 “allowable” shareholders
 - ▶ Allowed: individuals (other than non-resident aliens), certain trusts and estates, exempt orgs
 - ▶ Disallowed: partnerships, corporations, foreign shareholders, certain trusts and estates
- ▶ Have only one class of stock outstanding
 - ▶ Multiple classes with identical distribution and liquidation (economic) rights permitted

Polling Question 2

Which of the following is not a valid S corporation shareholder?

- A. Individual (U.S. Citizen)
- B. Grantor Trust (Owned by U.S. Citizen)
- C. Partnership/LLC
- D. Employee Stock Ownership Plan (ESOP)



S CORPORATION ELECTION

S Corporation Requirements (cont'd)

- ▶ IRS Form 2553, *Election by a Small Business Corporation*
 - ▶ Must be filed with the appropriate IRS service center
 - ▶ Separate elections required in certain states (e.g., Arkansas prior to 8/1/2018, New Jersey, and New York)
 - ▶ All shareholders must consent to election
 - ▶ Community property state rules may apply (spouse must also sign election)
 - Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin
- ▶ Federal Return
 - ▶ Form 1120S
- ▶ Any corporation that has revoked its S election within the previous 5 years is not allowed to make an S election

Polling Question 3

An S corporation is allowed to have multiple classes of stock outstanding as long as the economic rights of the classes are the same.

- A. True
- B. False



S CORPORATION TAX DUE DILIGENCE OVERVIEW

S CORPORATION TAX DUE DILIGENCE

S-Corporation Diligence: High Priority Requests & Procedures

- ▶ Form 2553, *Election by a Small Business Corporation*
 - ▶ Confirm all shareholders signed Form 2553 in timely manner.
- ▶ IRS Acceptance Letter
 - ▶ Confirm the IRS provided letter noting acceptance of the election.
- ▶ Schedule of distributions to shareholders since electing S status
 - ▶ Confirm that all distributions were made pro-rata based on shareholder ownership.
- ▶ Details of related-party transactions
 - ▶ Determine whether related-party transactions are at arm's length and/or meet certain safe harbors.
- ▶ Form 1120S filed for open years
 - ▶ Read the return for any elections made, related-party transactions disclosed, methods of accounting, shareholder ownership, officer compensation, etc.

S CORPORATION TAX DUE DILIGENCE

Why is Due Diligence of an S Corporation Important?

- ▶ Structuring:
 - ▶ Section 338(h)(10) elections are only available if the corporation is a valid S corporation
 - ▶ A Section 338(h)(10) election treats an acquisition of the stock of an S corporation as an acquisition of the assets of the S corporation for tax purposes. This election permits the buyer of an S corporation to receive a tax basis step-up in the assets of the S corporation.
 - ▶ F Reorganizations also permit the buyer of an S corporation to receive a tax basis step up in the assets of the S corporation, regardless of the validity of the S election.
 - ▶ F Reorganizations are more complicated.
- ▶ Successor Liabilities:
 - ▶ Buyer can be held responsible for tax liabilities.
 - ▶ Invalid S Corporation Election:
 - ▶ S corporation is treated as a C corporation on the date of the termination.
 - ▶ The C corporation is liable for tax.

S CORPORATION TAX DUE DILIGENCE ISSUES

Issues Typically Seen in S Corporation Tax Due Diligence:

- ▶ Ineligible shareholders
- ▶ IRS acceptance letter or Form 2553 missing and/or not signed by all shareholders
- ▶ Second class of stock
 - ▶ Actual second class of stock with different distribution or liquidation rights
 - ▶ Disproportionate distributions
 - ▶ Distributions that are not pro-rata
 - Actual distribution/income allocation does not match shareholder ownership percentage
 - ▶ Loans from shareholders that do not meet safe harbor
 - ▶ Loans from S corporation that are not respected as debt
 - ▶ Loans to/from affiliated entities that are not respected as debt
 - ▶ Other arrangements

S CORPORATION TAX DUE DILIGENCE ISSUES (CONT'D)

- ▶ Shareholder salaries
 - ▶ Concern if the shareholders are not receiving a salary or receiving a salary that is too low compared to similar positions at similar companies.
 - ▶ Generally, shareholders want to receive more in distributions than salary to avoid payroll taxes
- ▶ Built-in gains
 - ▶ Applies to S corporations that were previously C corporations
 - ▶ Sell within a statutory period (5 years) built-in gain assets that the C corporation previously owned
 - ▶ Gain is taxed at the entity level

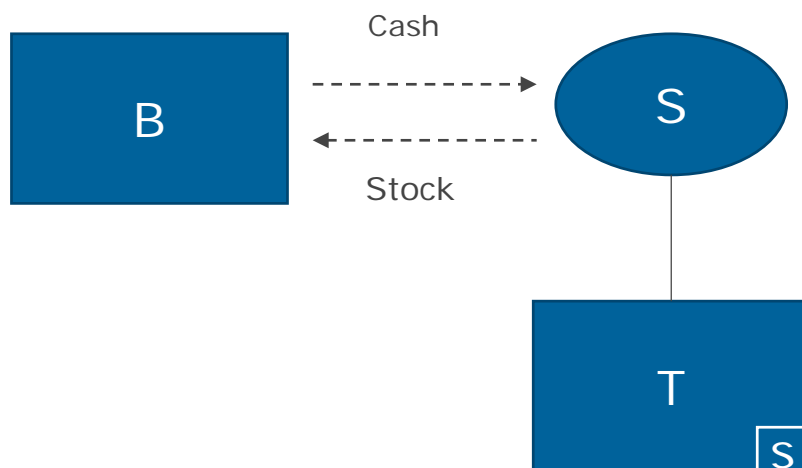
PART 2:

**S CORPORATION
ACQUISITION
STRUCTURES**

S CORPORATION ACQUISITIONS

Stock Purchase

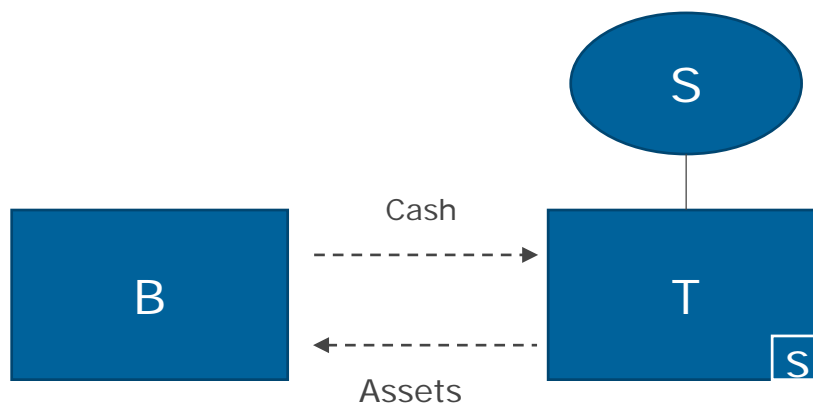
- ▶ Shareholder
 - ▶ Receives long-term capital gain
 - ▶ Minimizes state taxes
- ▶ Buyer
 - ▶ Maintains FEIN of target
 - ▶ Does not receive tax basis step up



S CORPORATION ACQUISITIONS (CONT'D)

Asset Purchase

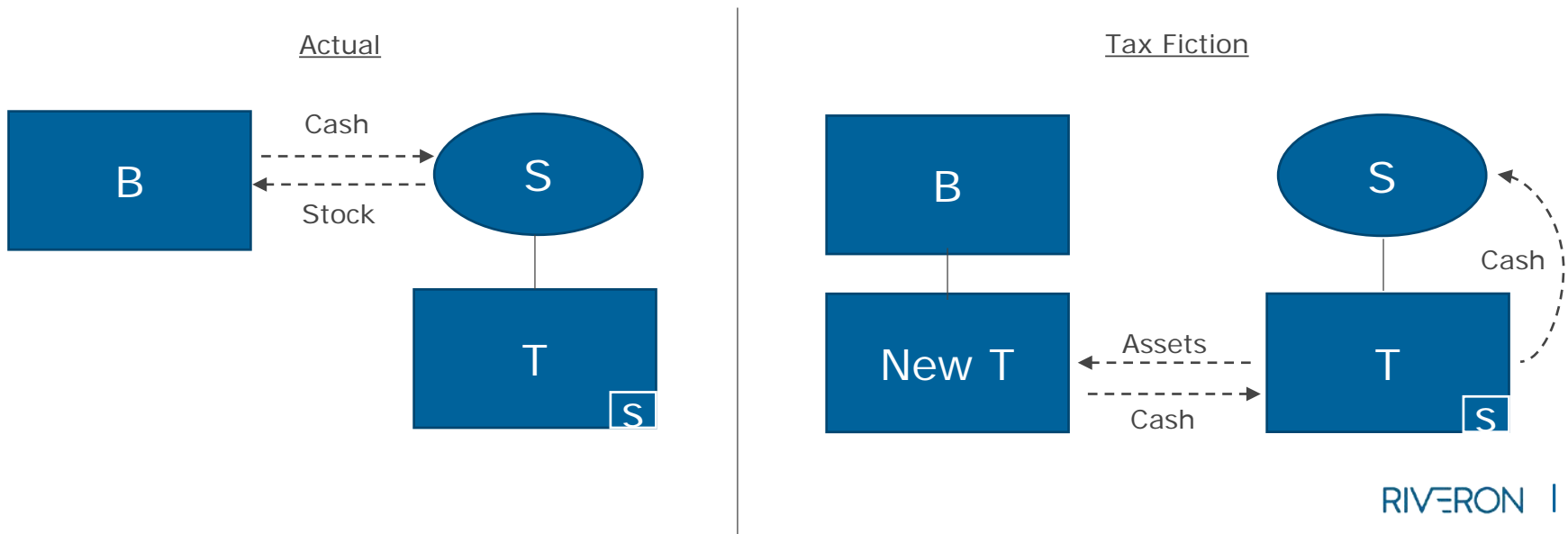
- ▶ Shareholder
 - ▶ Receives long-term capital gain (with exceptions)
 - ▶ Possible additional state taxes
- ▶ Buyer
 - ▶ Receives tax basis step up
 - ▶ Avoids S corporation status risk (compared with section 338(h)(10))



S CORPORATION ACQUISITIONS (CONT'D)

Stock Purchase (Section 338(h)(10) Election)

- ▶ Shareholder (must join election with Buyer)
 - ▶ Receives long-term capital gain (with exceptions)
 - ▶ Rollover limited to 20% of the S corporation stock
- ▶ Buyer (must elect)
 - ▶ Receives step up in tax basis of target's assets (deemed asset sale)
 - ▶ Maintains FEIN of target
 - ▶ Must acquire at least 80% of voting power and equity value of target



S CORPORATION ACQUISITIONS (CONT'D)

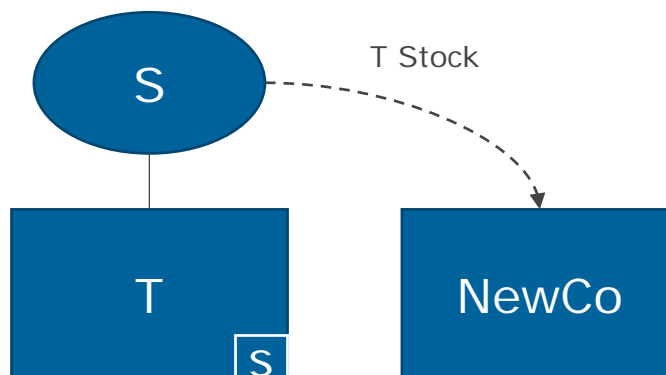
F Reorganization

- ▶ Shareholder
 - ▶ Receives long-term capital gain (with exceptions)
 - ▶ Defers gain recognition with respect to rollover
 - ▶ Maintains passthrough structure for rollover
- ▶ Buyer
 - ▶ Obtains step-up in tax basis of target's assets
 - ▶ Avoids S corporation status risk with respect to the step up in tax basis
 - ▶ Maintains FEIN of Target
 - ▶ Maintains passthrough structure

S CORPORATION ACQUISITIONS (CONT'D)

F Reorganization

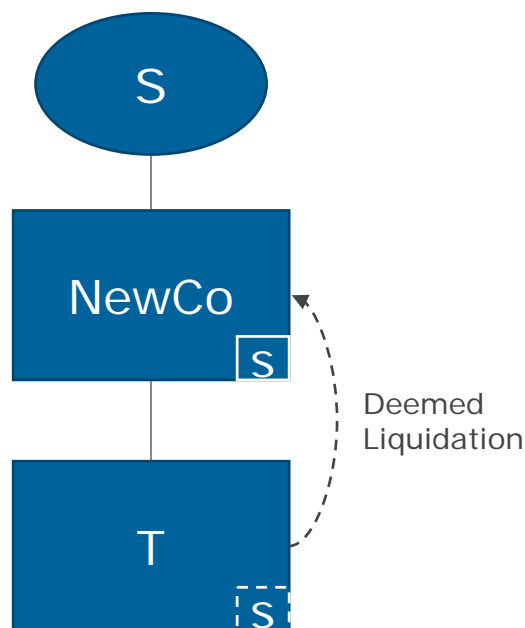
- ▶ Step 1: S forms a new S corporation ("NewCo") and contributes all of the T equity to NewCo in exchange for NewCo equity



S CORPORATION ACQUISITIONS (CONT'D)

F Reorganization

- ▶ Step 2: NewCo elects to treat T as a qualified subchapter S subsidiary (“QSub”). The contribution and QSub election are treated as a deemed liquidation. NewCo is a continuation of T for federal income tax purposes. NewCo is required to obtain a new FEIN and T retains its FEIN.



S CORPORATION ACQUISITIONS (CONT'D)

F Reorganization

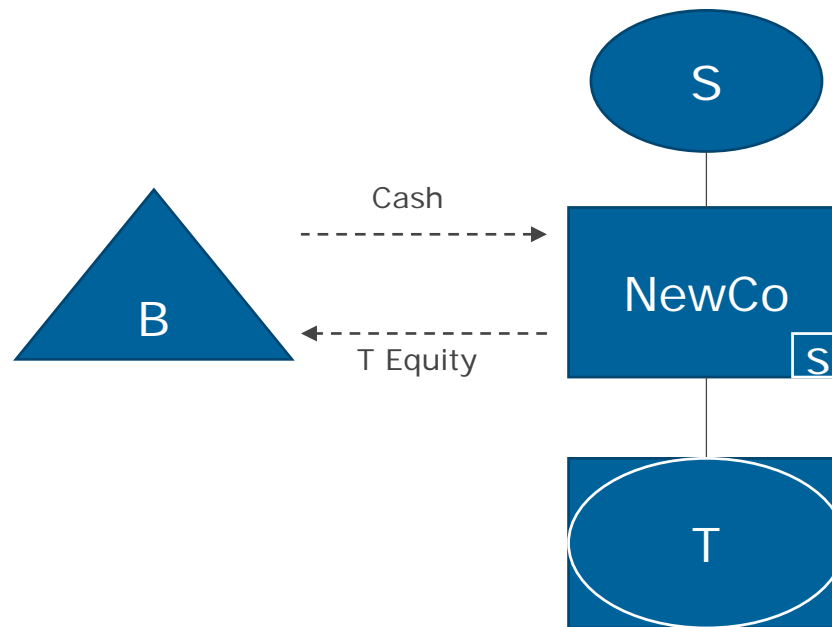
- ▶ Step 3: T converts to a limited liability company (LLC) under state law.



S CORPORATION ACQUISITIONS (CONT'D)

F Reorganization

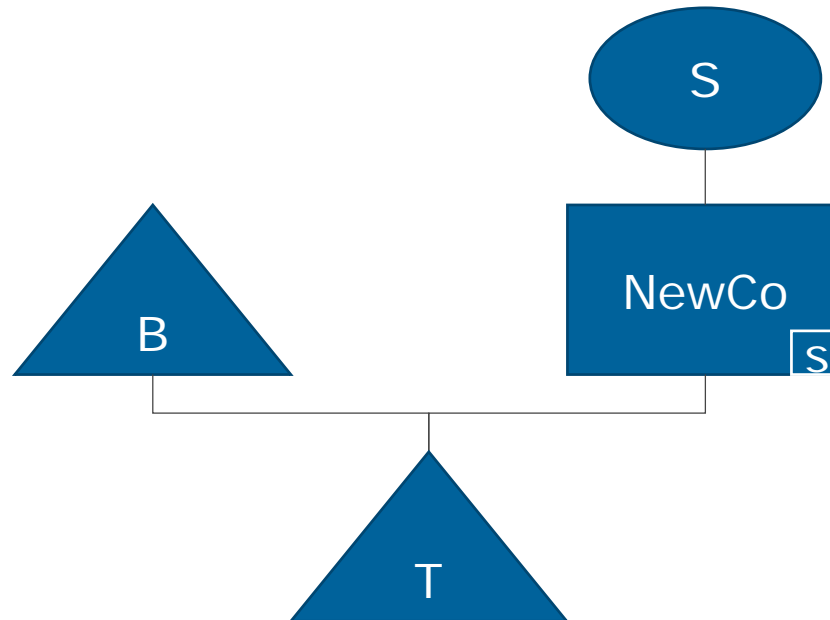
- ▶ Step 4: B acquires all (or non-rollover portion) of the equity of T.



S CORPORATION ACQUISITIONS (CONT'D)

F Reorganization

- ▶ Final Structure



Polling Question 4

Can an S corporation undertake an F reorganization with an invalid S corporation election?

- A. Yes
- B. No





Q&A