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Shishir Lagu
Partner, US Taxation

This thought leadership deals with various tax aspects to be considered while acquiring S-corporations in the US.

For US corporations, there are special provisions under the tax laws wherein certain corporations can elect to be treated as small business corporations commonly referred to as S-Corporations for tax purposes. We have come across several acquisitions in the US of S-corporations and through this article, we are sharing some practical pointers when conducting buy side due diligences of target S-corporations.

What is S-Corporation and how is it taxed?

An S-Corporation is defined as a 'small business corporation' for which an election, made under § 1362(a), is in effect. A 'small business corporation' is defined in § 1361(b)(1) as a domestic corporation that:

- Is not an ineligible corporation *(as defined in § 1361[b][2])*;
- Does not have more than 100 shareholders;
- Does not have shareholders other than individuals, estates, certain trusts, and certain tax-exempt organizations;
- Has no non-resident shareholders; and
- Does not have more than one class of stock.

S-corporations are not taxed at the corporate level. The profits or losses of S-corporations flow through and are reported on the shareholder's individual tax returns. Taxes, if any on the share of profits received from an S-corporation are borne directly by the shareholder. Thus, though S-corporations are corporations from legal stand point, they are treated as flow through partnerships for federal tax. Although in many respects, state income taxation of S-corporations and their shareholders parallels federal income taxation principles, there are several major aspects of state income taxation that do not arise for federal income tax purposes and that create much of the complexity and traps for the unwary.

What are the key aspects which need consideration when acquiring S-corporations?
Validity of S-corporations:

The first and the most important aspect to be considered when conducting the due diligence for S-corporations is the very validity of S-corporations. You need to see if you are acquiring a 'good' S-corporation. Corporations found not to be valid S-corporations face potentially severe adverse tax implications such as:

(a) Substantial income tax liability as well as interest and penalties for tax years from the date the election was terminated. If determined post-acquisition, the buyer will become responsible for historic tax liabilities; &

(b) If an IRC Section 338(h)(10) or Section 336(e) election is made to treat the purchase of S-corporation stock as a purchase of assets for income tax purposes *(discussed later in this document)*, the election will be invalid and the buyer will lose the expected step-up in tax basis of the target's assets.

The various factors to be considered while doing this evaluation include:

<u>Valid and timely S-corporation election:</u> ***Evaluate whether Form 2553 was timely filed, whether the same was signed by all the shareholders and consent was received from the IRS.***	(a) A corporation makes an S election by filing a completed Form 2553, election by a Small Business Corporation, on or before the 15th day of the third month of the election year, or at any time during the preceding tax year; (b) This form must be signed by an authorized corporate officer and must include signed consents by each of the corporation's shareholders at the time of the election. When examining all shareholders' requirement, it is also necessary to take cognizance of who the shareholder is for this purpose. For example, if a shareholder resides in a community property state *(currently there are 9 community property states examples being California and Texas),* shareholder's spouse is considered a shareholder and needs to consent —even if the spouse does not directly own any shares of the corporation; & (c) Generally, the IRS notifies the corporation of the acceptance or rejection of an S election and its effective date within 60 days of the Form 2553 filing.
<u>Shareholder limit:</u> ***Number of shareholders not to exceed 100.***	An S-corporation may have a maximum of 100 shareholders. Although this eligibility requirement appears fairly straight forward, S-corporations must carefully examine the same given the aggregation rules applicable while determining this number.
<u>Single class of stock:</u> ***Though it may appear simple, this requirement is very tricky and complex to evaluate. We have seen situations where certain shareholder arrangements are ignored by the corporation which may lead to invalidation of S-corporation status.***	(a) Only corporations with one class of stock are eligible to elect S status. An S-corporation has one class of stock if all outstanding shares confer identical rights to operating and liquidating distributions; & (b) Various types of shareholder arrangements which may lead to violation of this requirement are: ▪ Certain stock options; ▪ Certain incentive compensation arrangements; ▪ Certain fees and other payments made to shareholders, if they exceed the arm's length amount; & ▪ Certain debt owed by corporation to shareholders.
<u>Permissible types of shareholders:</u> ***Status of each of the shareholders should be evaluated in detail.***	Each shareholder must be a permissible S-corporation shareholder. An S-corporation shareholder must be an individual *(who is not a non-resident alien)*, an estate, a domestic trust described in Section 1361(c)(2), or a tax-exempt organization described in Section 1361(c)(6).

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Built in gain tax implications:

The acquired target S-corporation may owe additional tax if it was formerly a C corporation and if it sells assets within 10 years *(or certain shorter statutory periods)* after the effective date of the conversion to S status. If it held any assets on the conversion date with 'built-in gain', then it must pay tax on that gain to the extent the gain is realized upon the asset sale. This rule may lead to higher tax cost, and hence assessing the history of target is extremely important.

What are the various modes of acquiring S-corporations?

Type	**Tax implications for seller**	**Tax implications for buyer**
Pure stock acquisition:	One level tax – Shareholders get taxed on sale of stock as capital gains.	No step-up in basis of assets but entitled to tax attributes at entity level.
Pure asset acquisition:	Two steps in Asset Acquisition: Step 1: Recognition of gain on sale of assets by S-Corp to the buyer. Step 2: Deemed Liquidation of S-corporation. It is to be noted here that since the corporation is an S-corporation, the capital gains flow through to the individuals and are charged to tax at the rate of 20%. Thus there is a difference in tax liability for seller to the extent of ordinary income recognized by S-Corp.	The buyer shall get stepped up basis in the assets acquired equivalent to the purchase price. Any excess of consideration over & above the fair value of assets *(including Intangibles arising on acquisition)* acquired shall be treated as an acquired goodwill. Acquired goodwill and intangibles being IRC section 197 intangibles shall be eligible for tax amortization over a period of 15 years.
IRC section 338(h)(10) election:	Section 338(h)(10) treats a stock acquisition as a deemed asset acquisition. The tax consequences are the same as in case of a pure asset acquisition, mentioned above. 338(h)(10) needs to be consented by all shareholders *(including minority shareholders)*.	Section 338(h)(10) treats a stock acquisition as a deemed asset acquisition. The tax consequences are the same as in case of a pure asset acquisition, mentioned above. The risk for the buyer is that if the S-corporation is invalidated by the IRS at any later date then any liabilities assessed due to such invalidation may have to be borne by the buyer *(hence need to have a good S-Corp in place if this option is to be explored)*.
LLC dropdown:	This involves two steps: Merger of S-Corp into LLC: The merger of S-Corporation into LLC qualifies as F reorganization under IRC 368 *(revenue ruling 2008-18)*. Accordingly, there will be no tax implications to the S-corporation shareholders and LLC will receive the	The buyer purchases the membership interest in LLC from the holding S-corporation. For tax purposes, acquisition of membership interest of the LLC is treated as a deemed asset acquisition and hence buyer will receive step-up basis in the assets similar to that in case of a pure asset acquisition. The benefit of LLC drop down for buyer is that the future invalidation of S-corporation status will not cause any

	same basis in the assets as the S-corporation. <u>Sale of membership interest:</u> The sale of membership interest of LLC will be considered as a deemed sale of assets for the seller and deemed acquisition of assets by the acquirer. Accordingly, the seller *(target shareholders)* will recognize gain on deemed sale of assets and the acquirer will receive step-up basis on the acquired assets. The tax implication in this case shall be similar to that in case of pure asset acquisition.	additional liability to the buyer but it has to be borne by the target shareholders' assets.

Some interesting state tax considerations:

As mentioned in the initial part of this article, the state taxes can also play an important role in M&A of S-corporations. Though states do generally conform with federal tax treatment, there can be certain variances swhich need to be evaluated, since they can have a significant bearing on the deal. Couple of unique issues we have faced on state tax front are as under:

(1) Certain states do not confirm to the pass through treatment for S-corporations i.e., there is an entity level tax in these states. Examples of such states are CA, MA, PA and TN. In such cases, tax impact arising at an entity level on account of asset sale or deemed asset sale needs to be examined carefully; &

(2) Certain states do not conform to the IRC section 338(h)(10) election. Examples of such states are DC, NJ, PA, and TN. In such cases, the benefit of stepped up basis shall not be available to the buyer and the tax impact of the same needs to be considered.

Conclusion:

Tax due diligence is an extremely critical piece if the target is an S-corporation. The buyers should review the validity of a target's S-corporation status given the potential adverse tax consequences if the S-corporation status is found to be invalid. Additionally, the way acquisition is structured is also important since it can have different tax implications for buyer and seller. Additionally, both sellers and buyers should always be mindful of state tax implications, since they can have a significant impact on the transaction.