

# Selling an S Corporation – How to Choose the Right Tax Structure

Tom Maier  
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## *The Basics*

- Sellers like a stock sale
  - Easy capital gain treatment on sale of stock
  - No corporate-level tax
  - No need to re-title assets in acquiring company
  - Can be taxable transaction or tax-deferred reorganization

## ***The Basics***

- Buyer likes an asset sale
  - Leave behind target corporation's liabilities
  - Can be taxable or tax deferred reorganization
  - If taxable, stepped-up basis in operating assets
  - No succession to seller NOLs, but seller NOLs rarely useful

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## ***S Corporations – Sale of Entity and Basis Step-Up for Operating Assets***

- S corporations are generally “flow-through” entities for tax purposes
- S corporations may permit both simplicity of stock sale and tax benefit of basis step-up
- Default rule, in the absence of tax election or structural effort, is a simple choice between basic stock sale or asset sale – and either can be a tax-deferred reorganization

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### ***S Corporations – Sale of Entity and Basis Step-Up for Operating Assets***

- Three methods of obtaining basis step-up on sale of S corporation entity:
  - Section 338(h)(10) election
  - Section 336(e) election
  - F reorg/LLC conversion
- Some tax costs to basis step-up structures, but tax costs to seller are normally smaller than tax benefits to buyer of stepped-up basis
- Watch out for B-I-G tax at corporate level

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### ***Old School – 338(h)(10) Election***

- With corporate purchase of at least 80% of S corporation target stock, acquiring corporation and selling SHs can jointly elect 338(h)(10) treatment
- Deemed sale of assets by “old” S corporation is followed by deemed liquidation of “old” S corporation, and “new” S corporation continues as sub of acquiring corporation

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## ***Old School – 338(h)(10) Election***

- Sellers' first problem: ordinary income assets
  - On deemed sale, with assets like accounts receivable and depreciation recapture, gain can flow through as ordinary income
  - Consider gross-up adjustment, under which sale consideration is increased based on incremental tax liability borne by sellers
  - In gross-up, remember that increased consideration is itself taxable
  - Sample gross-up language in Exhibit A

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## ***Old School – 338(h)(10) Election***

- Seller's second problem: corporate-level tax
  - B-I-G issues can undercut benefits of 338(h)(10)
  - California tax of 1.5% tax on corporate-level profits applies on deemed sale of assets under 338(h)(10)
  - No sales tax on deemed corporate sale of assets
  - Again, consider gross-up adjustment to make sellers whole – benefit of basis step-up to buyer is normally sufficient to make gross-up worthwhile

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## ***Old School – 338(h)(10) Election***

- Seller's third problem: installment reporting
  - Timing distortions resulting from deemed sale, liquidation, and distribution to selling SHs
  - See Exhibit B for illustration of gain acceleration
  - Remember that escrow holdback as well as conventional deferred payment can create this problem
  - Possible fix – the “one-day installment note” – still accelerate 1.5% corporate-level tax – and economic substance issues under Section 7701(o)?

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## ***Noncorporate Buyers -- 336(e) Election***

- In 2013, IRS exercised authority under IRC Section 336(e) to provide an additional deemed-asset-sale election on acquisition of an S corporation
- Principal difference from 338(h)(10) involves acquirer – under 336(e), can be noncorporate or individual buyer(s)
- Mechanics are almost identical to 338(h)(10), except that sellers unilaterally file the election
- California? Probably conforms to 336(e)

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## ***F Reorg/LLC Conversion***

- After Revenue Ruling 2008-18 approved QSub F reorg, there has been increasing use of an alternate structure for S corporation sale of entity with basis step-up
- F reorg/LLC conversion permits simplicity of entity sale and avoids Section 338(h)(10) timing distortions for deferred payment sales
- See Exhibit C for diagram of F reorg/LLC conversion structure

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## ***F Reorg/LLC Conversion***

- Three steps:
  - S corporation SHs contribute all shares to corporate Newco
  - S corporation, now a subsidiary, files a QSub election
  - QSub converts from corporation to LLC under state law
- Newco then sells membership interest in LLC to buyer
- See Exhibit D for sample recitals in sale document, describing restructuring prior to sale of membership interest

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## ***F Reorg/LLC Conversion***

- F reorg/LLC conversion can still trigger partial ordinary income and corporate-level taxes – still need to consider gross-up to make sellers whole
- Consider whether target company is legally permitted to operate as an LLC
- F reorg/LLC conversion structure does not require the transfer of assets to a new entity – though check change-of-control issues for ongoing contracts

## EXHIBIT A

### SALE AGREEMENT – SAMPLE PROVISION RELATED TO GROSS-UP CONSIDERATION

Gross-Up Consideration. Purchaser, the Parent Company, and the Selling Securityholders acknowledge that (i) the Stock Purchase is structured to permit the Purchaser to treat the Stock Purchase, for federal and state income tax purposes, as the purchase of the Company' assets (a "*Basis Step-Up Structure*") rather than as the purchase of the shares of the Company that were outstanding prior to the Reorganization (a "*Share Purchase Structure*"), and (ii) using the Basis Step-Up Structure will increase the federal and state income tax burden borne by the Parent Company and the Selling Securityholders as compared to a Share Purchase Structure. To induce the Parent Company and the Selling Securityholders to agree to the Basis Step-Up structure, Purchaser agrees to increase the aggregate consideration payable for the Company Capital Stock by a sum equal to the additional federal and state corporate and individual taxes borne by the Parent Company and the Selling Securityholders due to the use of a Basis Step-Up Structure as compared to a Share Purchase Structure (the "*Gross-Up Consideration*"). Schedule 1.10 attached hereto sets forth the model (the "*Model*") to be used to calculate the Gross-Up Consideration; the Model makes certain assumptions about the aggregate consideration to be paid for the Company Capital Stock, whereas the actual Gross-Up Consideration will be calculated using the Model but with the consideration associated with the Initial Stock Consideration and the Earnout Consideration as eventually determined. For purposes of clarity, the Gross-up Consideration will include not only the incremental tax burden on the Company and the Selling Securityholders, but will also include any tax liability the Company or the Selling Securityholders incur by reason of any increased payments associated with the Gross-Up Consideration. Any Gross-Up Consideration shall be paid and disbursed under the same terms and conditions associated with the underlying payment that gave rise to the Gross-Up Consideration payment obligation.

**[Gross-Up Formula: (supplemental payment) ÷ (1.00 – tax rate) = full gross-up payment]**



## EXHIBIT B

### ILLUSTRATION OF TIMING DISTORTION CAUSED BY INSTALLMENT OBLIGATIONS IN 338(H)(10) OR 336(E) TRANSACTION

#### 1. Assumptions

SH basis in stock of \$4,000,000

Corporation basis in assets of \$4,000,000

Total sale price of \$10,000,000, payable (i) \$5,000,000 at closing, (ii) \$2,000,000 release from escrow after 12 months, and (iii) \$3,000,000 deferred to second anniversary of closing.

#### 2. Computation of SH Gain in 338(h)(10) Deemed Asset Sale and Deemed Corporate Liquidation

Corporate Gain at Closing:	$\$5,000,000 - \$2,000,000^1 = \$3,000,000$
SH Basis after Corporate Gain:	$\$4,000,000 + \$3,000,000 = \$7,000,000$
SH Basis Allocated to Cash on Liquidation:	$\$7,000,000 \times (\$5,000,000^2 \div \$10,000,000) = \$3,500,000$
SH Gain on Deemed Corporate Liquidation:	$\$5,000,000^3 - \$3,500,000 = \$1,500,000$
Combined SH Gain on Sale and Liquidation:	$\$3,000,000 + \$1,500,000 = \$4,500,000$
SH Gain in Subsequent Years:	$\$5,000,000 - \$3,500,000 = \$1,500,000$
Total SH Gain:	$\$4,500,000 + \$1,500,000 = \$6,000,000$

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<sup>1</sup> One-half of overall \$4,000,000 in corporate asset basis is allocated to cash, because one-half of overall proceeds received in year of closing.

<sup>2</sup> Treasury Regulations require SH to allocate stock basis among assets received in liquidation based on relative FMVs of assets. No gain is recognized on S corporation distribution of installment note.

<sup>3</sup> Cash received on deemed liquidation of "old" S corporation.

### 3. Computation of SH Gain in Direct Stock Sale with No 338(h)(10) Election

SH Basis:	\$4,000,000
SH Basis Allocated to Cash at Closing:	$\$4,000,000 \times (\$5,000,000 \div \$10,000,000) = \$2,000,000$
SH Gain on Closing:	$\$5,000,000 - \$2,000,000^4 = \$3,000,000$
SH Gain in Subsequent Years:	$\$5,000,000 - \$2,000,000^4 = \$3,000,000$
Total SH Gain:	$\$3,000,000 + \$3,000,000 = \$6,000,000$

### 4. One-Day Installment Note

Corporate Gain at Closing:	\$0 <sup>5</sup>
SH Basis after Corporate Gain:	\$4,000,000
SH Basis Allocated to Cash on Liquidation:	\$0 <sup>6</sup>
SH Gain on Deemed Corporate Liquidation:	\$0 <sup>7</sup>
SH Basis Allocated to One-Day Note:	$\$4,000,000 \times (\$5,000,000 \div \$10,000,000) = \$2,000,000$
SH Gain on Payment of One-Day Note:	$\$5,000,000 - \$2,000,000 = \$3,000,000$
SH Gain in First Year:	\$3,000,000
SH Gain in Subsequent Years:	$\$5,000,000 - \$2,000,000 = \$3,000,000$
Total SH Gain:	$\$3,000,000 + \$3,000,000 = \$6,000,000$

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<sup>4</sup> One-half of overall stock basis.

<sup>5</sup> Corporation does not recognize any gain on deemed liquidation. Only assets distributed are installment notes.

<sup>6</sup> Corporation does not distribute any cash in deemed liquidating distribution – just installment notes.

<sup>7</sup> No gain recognized on receipt of installment note from S corporation.

**Comparison Table**

	SH Gain at Closing  (including gain from deemed asset sale and deemed corporate liquidation}	SH Gain on Payment of One-Day Note	SH Gain in Years after Year of the Closing	Total SH Gain
Conventional 338(h)(10) or 336(e) Election	\$4,500,000	n/a	\$1,500,000	\$6,000,000
Sale of Shares with No Basis Step-Up Election	\$3,000,000	n/a	\$3,000,000	\$6,000,000
338(h)(10) or 336(e) Election with One-Day Promissory Note Instead of Cash at Closing	\$0	\$3,000,000	\$3,000,000	\$6,000,000

**EXHIBIT C**

**DIAGRAMS ILLUSTRATING F REORG/LLC CONVERSION**

**EXHIBIT C**

**DIAGRAMS ILLUSTRATING F REORG/LLC CONVERSION**

*Existing Structure*

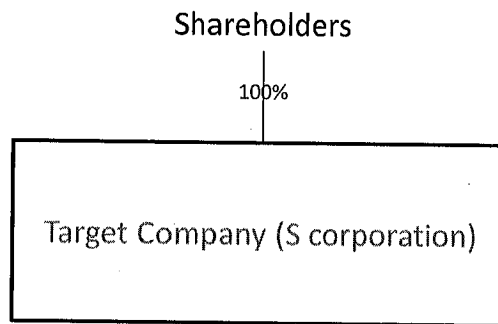


EXHIBIT C

DIAGRAMS ILLUSTRATING F REORG/LLC CONVERSION

*First Step – SHs contribute shares to Newco*

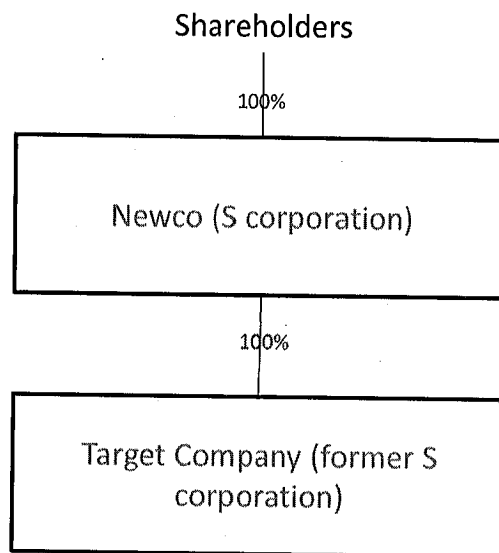


EXHIBIT C

DIAGRAMS ILLUSTRATING F REORG/LLC CONVERSION

*Second Step – Target Company files QSub election*

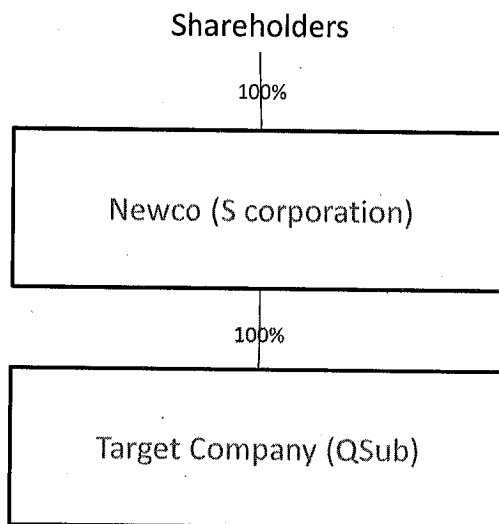
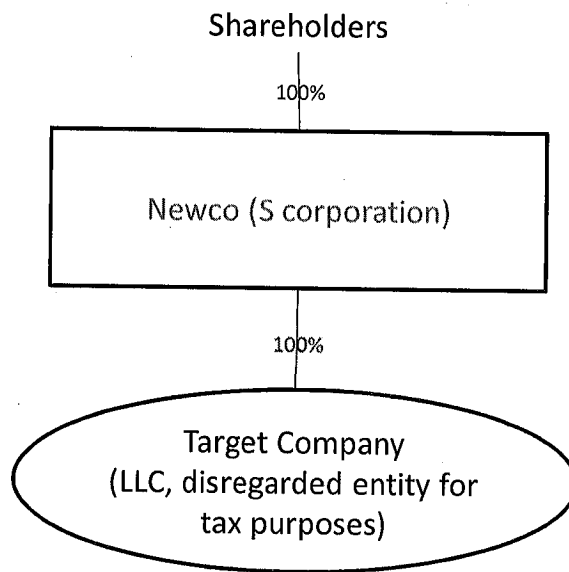


EXHIBIT C

DIAGRAMS ILLUSTRATING FREORG/LLC CONVERSION

*Third Step – Target Company converts to LLC*





## EXHIBIT D

### SALE AGREEMENT – SAMPLE PROVISIONS RELATED TO F REORG/LLC CONVERSION

#### RECITALS

The board of directors of the Company (the “*Company Board*”) and the board of directors of Purchaser have determined that it would be advisable, fair to and in the best interests of the securityholders of their respective companies that (i) prior to the Closing, the Company Stockholders transfer all of the issued and outstanding shares of Company Capital Stock held by the Company Stockholders to the Parent Company, after which the Company shall (A) become the wholly owned subsidiary of the Parent Company (B) make an election to be treated as a “qualified subchapter S subsidiary” as described in Code Section 1361(b)(3)(B), and thereafter (C) be converted into a Delaware limited liability company (the “*Reorganization*”); (ii) the Parent Company assume all of the Company Options in connection with the Reorganization, and the Company Options assumed by the Parent Company be cancelled upon consummation of the Reorganization, on the terms and subject to the conditions set forth in this Agreement; and (iii) the Parent Company sell to Purchaser all of the issued and outstanding shares of Company Capital Stock (the “*Stock Purchase*”), and, in furtherance thereof, have approved the Reorganization, this Agreement and the other transactions contemplated by this Agreement (collectively, the “*Transactions*”).

#### [Text of Agreement]

The Reorganization. Prior to Closing, the Company Stockholders shall (i) cause all shares of Company Capital Stock issued and outstanding as of immediately prior to consummation of the Reorganization to be transferred to the Parent Company in exchange for shares of common stock of the Parent Company on a one-to-one basis, (ii) cause the Parent Company to make a valid election to cause the Company to be treated as a “qualified subchapter S subsidiary” as described in Code Section 1361(b)(3)(B), (iii) cause the Company to file a certificate of conversion and certification of formation to be converted into a Delaware limited liability company effective after (ii) above, (iv) cause the Parent Company to assume all of the issued and outstanding Company Options, whether vested or unvested, on a one-to-one basis (so that each such option shall cover the same number of shares of common stock of the Parent Company as the number of shares of Company Capital Stock covered by such option immediately prior to the consummation of the Reorganization), each such Company Option to be otherwise subject to the same terms and conditions set forth in the Company Option Plan and the applicable stock option agreement in effect immediately prior to consummation of the Reorganization, and (v) cause the Company Options assumed by the Parent Company to be cancelled and the Company Option Plan to be terminated upon consummation of the Reorganization.