Planning For Taxable Acquisitions of **S CORPORATIONS** Involving Equity Rollover for Sellers

KNOW YOUR

A relatively common characteristic of the acquisition of a closely-held business is to have all or certain of the sellers retain or receive equity positions in the business, which are often colloquially referred to in the market by bankers and deal lawyers as "rollover equity." This practice is particularly prevalent in acquisitions of S corporations.

When an S corporation sale with rollover equity for the sellers is implemented, the transaction's structural elements will affect the parties' tax treatment, as well as their interests in the continuing target business.

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S corporation targets by definition must be closely-held corporations, and in practice they are often controlled and operated by the founding principals. In order to successfully transition ownership of the S corporation target to the new buyer, founding principal and management sellers are often required by buyers to continue to work for the target after the sale transaction. This common paradigm makes post-transaction seller equity retention or acquisition structures, including use of rollover equity, a common commercial tool of S corporation target buyers to align seller and buyer objectives for successful financial performance after the S corporation's purchase.

Of course, the tax treatment of the sale and rollover transaction will depend on the form of the transaction actually implemented, which is often dictated by the tax objectives and profiles of the selling and buying parties. This article addresses certain tax and other commercial aspects of taxable S corporation acquisitions involving rollover equity for the sellers, in order to provide a general framework for thinking about associated tax structuring issues for these types of transactions.

Tax Structuring Issues for Equity Rollover Transactions

As a preliminary matter, the nature of the S corporation eligibility rules affects the possible forms that may be adopted to implement a sale with rollover equity.[1] An S corporation is an eligible "small business corporation" that makes an election pursuant to Section 1362 to be subject to the tax regime of Subchapter S of the Internal Revenue Code, which generally subjects S corporation earnings to a single level of tax at the shareholder level (rather than a C corporation's separate levels of tax at the entity and shareholder levels).[2] Among the various initial and continuing S corporation eligibility requirements, an S corporation must be a domestic entity classified as a corporation and may only have a single class of stock, all of the shares of which must be held by not more than 100 shareholders, each of whom fits within a category of eligible shareholders.[3]

To be an eligible shareholder, the shareholder must be either an individual (not including a nonresident alien), a decedent's estate, estate of an individual in bankruptcy, certain trusts, certain tax-exempt organizations, or a qualifying ESOP. A single-member LLC that is disregarded for tax purposes may hold S corporation stock if its member is an eligible shareholder. Single class of stock determinations under the S corporation eligibility rules are generally based on the shareholders' relative rights to company economics (both operating distributions and liquidating proceeds); and, consequently, S corporations cannot issue an economically preferred class of stock.[4] Additionally, S corporation-issued financial instruments not expressly labeled as stock (such as promissory notes or warrants) may nonetheless be treated as an impermissible second class of stock.[5]

By operation of these eligibility requirements, a valid S corporation often reflects a closely held operating company controlled by its founders. This S corporation organizational and operational structure often proves to be a prime candidate for having sellers remain beneficial equity holders in their existing business, through a rollover equity structure, following an acquisition by an unrelated third party.

Commercial Reasons. Sellers and buyers each have their own set of commercial reasons for using rollover equity structures for S corporation sale transactions. Buyers (particularly financial buyers such as private equity funds) may desire to use rollover equity structures as a means of retaining and incentivizing the sellers for continuing service to the business on a longstanding and more concrete basis than a short time horizon earnout or employment contract. Sellers may prefer the greater return associated with an equity position in the ongoing business, particularly as compared to a capped return associated with seller transaction financing (for example, an interest-based return as a creditor rather than a true entrepreneurial stake in the ongoing company). Moreover, the retained equity position associated with a rollover may be combined with other commercial arrangements like a put or call option for the sale or redemption of the rollover equity that could replicate earnout type arrangements.[6] A rollover equity component can also assist in bridging a deal pricing gap in seller and buyer valuations of the business being sold.

As with all business tax planning, the commercial objectives of the constituent parties and their tax profiles typically drive the tax form of the transaction implemented. S corporation sale rollover transactions are no different and the tax form of the transaction implemented most often depends on a set of tax profile and commercial objectives of the parties, including those addressed below.

Asset vs. Stock Sale Tax Treatment. From the buyer's perspective, the issue of whether the transaction will be treated as an asset sale for tax purposes pertains to whether there will be a *stepup in the basis* of the target's assets caused by the purchase. This asset basis stepup provides buyers with the ability to effectively amortize their purchase price for tax purposes through tax deductions to offset future company taxable income (or, potentially, other income of the buyer). Assuming a majority of the sold business's value is attributable to amortizable "Section 197 intangibles" (such as going concern value and goodwill), the purchase price will largely be amortizable as deductions recognized over a 15-year period. Facing this amortization schedule, strategic buyers with a longer hold time horizon often place a greater value premium on a basis stepup associated with an asset sale than financial buyers with an anticipated shorter hold time horizon (except to the extent the short hold financial buyers anticipate a sale price premium for the stepped up basis or a structural ability to provide a further stepped up basis for buyers on an exit transaction).

In general, the relative seller cost of an S corporation asset sale (as opposed to a stock sale) compared to the significant tax benefit associated with a buyer's asset basis stepup can economically support asset sale tax treatment, where a C corporation business asset sale could not be supported. This is due to the general flow-through tax structure for S corporation earnings, which can allow for shareholders to receive the proceeds from the corporation's sale of its assets with only a single imposition of tax. Specifi-

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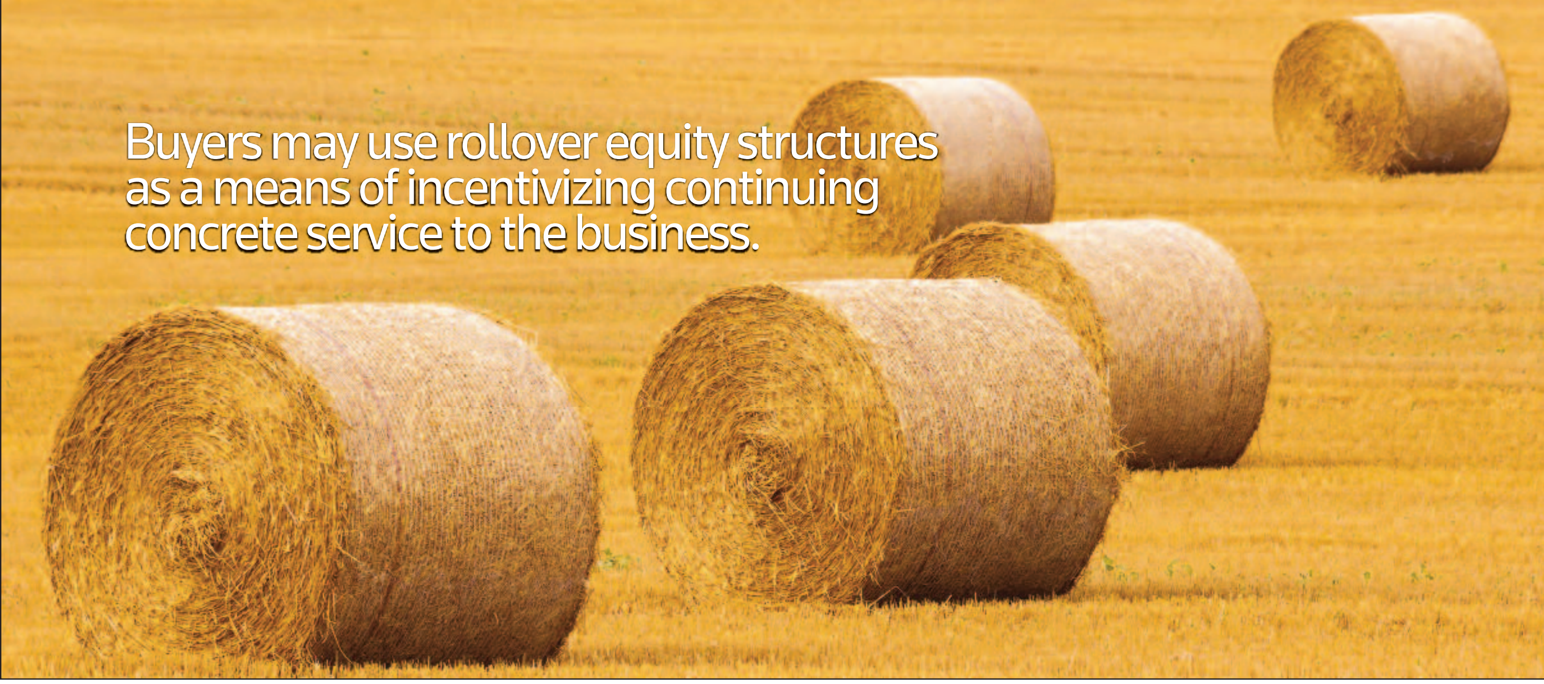

cally, the gain or loss attributable to the taxable portion of the actual or deemed asset sale transaction flows through from the selling S corporation to its shareholders.[7] Any gain passed through to the shareholders increases their "outside" basis in their S corporation shares, which is available to allow for the proceeds from the asset sale to be distributed to the shareholders without the imposition of additional tax.[8] An S corporation asset sale structure, however, does have the potential to produce additional tax costs to the selling shareholders when compared to a stock sale structure.

As a baseline for measuring against asset sale treatment, a taxable sale of S corporation stock produces gain for the seller measured by the difference between the seller's basis in the sold stock and the consideration received, which is generally subject to tax at preferential long-term capital gains rates if the stock was held for more than one year.[9] For a disposition of an S corporation taxable as an asset sale, by contrast, the character of gain on the S corporation's sale of its assets flowing through to its shareholders will correspond to the nature of the S corporation's assets sold.[10] This means that the selling shareholders may recognize ordinary income attributable to certain types of assets held by the S corporation, including cash method accounts receivable, appreciated inventory, and depreciation recapture on equipment.[11]

Additionally, an S corporation target with a C corporation history (including to the extent assets held by the S corporation had been held in a C corporation predecessor or transferor and received in a tax-deferred exchange) may be subject to entity-level corporate tax in respect of an asset sale transaction as Section 1374 "built-in gains" tax.[12] An S corporation shareholder also may have an "outside" basis in its stock that exceeds the S corporation's corresponding "inside" basis in its assets, thereby creating additional gain from the sale of assets from such shareholder's perspective. S corporation shareholders who purchased their S corporation stock after formation from an existing shareholder often have this outside-inside basis disparity.[13] Although beyond the scope of this article, there may be additional state and local tax impact of an S corporation asset sale. Finally, an asset sale transaction involving installment note consideration may have an unintended detrimental impact on expected tax deferral associated with the seller's use of the installment method of accounting on an actual or deemed liquidation of the S corporation.[14]

These possible additional seller tax costs associated with an asset sale must be carefully reviewed to inform whether an asset sale structure is economically viable and establish the basis for negotiating a purchase price increase or other commercial accommodation. Parties to a transaction will often perform extensive modeling in order to quantify these additional costs to sellers and resulting tax benefits to a buyer. This modeling may form the basis of computing any negotiated gross-up payment to the sellers for additional taxes imposed for an asset sale structure as compared to a stock sale structure. That being said, it is typically the case for an S corporation target with no C corporation tax status or successor asset history that the tax benefits to a buyer of an asset sale structure will significantly exceed the associated increased tax costs of the sellers. Thus, astute sellers of S corporations and their advisors often focus on the tax benefit to a buyer of an asset sale structure rather than the tax costs to sellers in negotiating a purchase price premium for such a structure.

A buyer should also be mindful that a properly structured asset sale transaction may not provide it with the full purchase price amortization benefits it anticipates. For instance, for equity rollover structures with the sellers holding more than 20% of the sold business directly or indirectly through an affiliate, buyers must consider the potential operation of the intangible asset "anti-churning" rules of Section 197(f)(9). Additionally, for situations involving a seller receiving partnership interest rollover equity on a pre-tax (that is, tax-deferred) basis, a buyer may not receive amortization benefits commensurate with the full purchase price depending on the Section 704(c) method adopted with respect to a Section 704(b) book account-tax account disparity created by the transaction. These concepts are further discussed below.

Receipt of Rollover Equity On a Pre- or Post-Tax Basis. Sellers may receive rollover equity on a tax-deferred or "pre-tax" basis, meaning that they will only pay tax on the portion of the consideration received in the transaction as non-rollover equity consideration. Alternatively, sellers may receive rollover equity on a "post-tax" basis, which means that they pay tax with respect to the sale of 100% of the company, including the portion of the company considered sold for the rollover equity. In general, a post-tax equity rollover deal signifies that sellers are effectively putting new equity into the entity issuing the rollover equity. Assuming the sellers are in a taxable gain position with respect to their sale of the S corporation business, the sellers would recognize "phantom" taxable gain on a post-tax rollover attributable to the value of the rollover equity, albeit they likely will have cash proceeds from the non-rollover equity piece of the transaction to pay this additional tax. As discussed below, the ability to implement a "pre-tax" or "post-tax" rollover structure is not formally an elective one and requires careful attention to the form and substance of a transaction.

Whether Post-Transaction Business Operations Will Be Taxed on Flow-Through Basis. If the post-acquisition target business is operated as an S corporation or partnership (or disregarded entity with an S corporation or partnership parent), the target business operations will continue to be subject to a single level of tax imposed on its owners on a flow-through basis, as reported to the owners on Schedules K-1. If the post-acquisition target business is instead taxed as a C corporation, future company earnings will become subject to two levels of tax, one at the corporate entity level on earnings and another at the shareholder level on distributions.

A buyer may require that a C corporation rollover equity structure be implemented for a variety of reasons. Investment funds or other financial buyers with foreign or institutional investors may require a post-acquisition C corporation structure to avoid effectively connected income (ECI) or unrelated business taxable income (UBTI) issues for their investors.[15] Additionally, a strategic buyer will most often be a C corporation (such as would be required if the buyer's stock is publicly traded) and be deeply motivated to avoid minority ownership of its subsidiaries for a variety of commercial, accounting, and legal reasons. Although some strategic buyers prefer an identical tax profile for the target (for example, so that the target can join the buyer's consolidated group), these issues can be overcome with LLC subsidiary structures, which would not limit tax consolidation based on the percentage of rollover equity owned by the target sellers.[16] A C corporation buyer and target operating structure may not provide much (if any) tax leakage for the shareholder level of tax on distributions from the buyer's perspective, depending on the percentage of target stock the buyer holds.[17]

Of course, the rollover sellers will not be able to maintain their pre-sale flow-through tax treatment for the target business if it becomes operated as a C corporation. These rollover sellers holding C corporation stock following the sale transaction will economically bear the burden of a second level of tax on company earnings distributed to them as taxable dividends out of earnings and profits in addition to the tax imposed at the C corporation level. While detrimental from an effective tax rate on earnings management perspective, rollover sellers may actually prefer this structure for certain practical reasons. First, the rollover sellers will not be burdened with the extra reporting and administrative burdens associated with continuing as minority members in a tax flow-through entity. That is, because the direct results of company operations would no longer be reported on their individual tax returns, the rollover sellers would not be affected, from a direct tax standpoint, by target company cash flow decisions that they likely no longer control as minority owners (such as negotiating for and policing company tax distributions). This structure would also reduce tax administration and compliance burdens associated with receiving and reporting the tax operations of the company reported to them on Schedules K-1 and similar state and local tax forms.

Thus, if the buyers anticipate expanding the operations of the target into new states and locales, operating in a C corporation structure could significantly reduce the tax compliance burden for the company itself as well as for the rollover sellers. Additionally, rollover sellers may have an exit objective over the short or medium term horizon. These rollover sellers may prefer that the company retain rather than distribute company earnings with the goal that they benefit from the appreciation in company value on a deferred basis upon the eventual sale of rollover stock at capital gains rates.

Post-Acquisition S Corporation Eligibility. For S corporation businesses intended to be operated as tax flow-through entities after the acquisition, the form of the acquisition may depend on the continuing ability of the target to maintain its valid S corporation election

1 By contrast, rollover equity sales of target entities classified as partnerships, such as multi-member LLCs not making a check-the-box election to be classified as a corporation, do not exhibit some of the complexities associated with the S corporation rollover matters described in this article. Many of these S corporation-specific complexities stem from the formal S corporation election and the Section 338(h)(10) and 336(e) election eligibility rules.

2 Section 1366.

3 Section 1361(b).

4 Reg. 1.1361-1(l)(1).

5 Reg. 1.1361-1(l)(4).

6 Note, however, that such equity purchase rights can raise concerns over whether sellers are truly equity owners with respect to their rollover equity for tax purposes depending on the terms of such purchase rights and other relevant facts and circumstances.

7 Section 1366.

8 Sections 1367, 1368.

9 Sections 1001, 1221, 1222.

10 Section 1366(b).

11 *Cf.* Reg. 1.751-1.

12 Recently, Congress permanently shortened the built-in gains tax "recognition period" to five years pursuant to the Protecting Americans from Tax Hikes (PATH) Act of 2015. The "recognition period" had previously been ten years, subject to shortened periods for tax years beginning after 2008.

13 This more factual scenario for S corporations is less common when compared to partnerships given the absence of a partnership taxation Section 754 election analogue under Subchapter S.

14 See Eustice, Kuntz, and Bogdanski, *Federal Income Taxation of S Corporations* ¶ 13.04[7][a][ii] (Thomson Reuters/Tax & Accounting, 5th ed., 2015).

15 In these situations, however, it may be possible to retain flow-through tax treatment for the rollover sellers while implementing an ECI/UBTI C corporation "blocker" structure for the buyer, including by adopting the drop-down LLC structure described below. However, these structures create structural conflicts of interests between buyers and sellers on exit planning and certain operational issues and often result in the negotiation of elaborate covenants to realign interests, leading many buyers to reject pursuing such structures.

16 Some strategic buyers in special industries employ "Up C" structures where the subsidiary tax partnership is used as a common acquisition tool (e.g., UPREIT structures), but this is a more prevalent paradigm for tax part-

or obtain qualified Subchapter S subsidiary (QSub) status through the sale. The tax profile of the buyer, the form of the acquisition financing, and the post-sale capital structure of the company all affect this issue. In particular, any financing obtained at the target level to fund the purchase (such as under a leveraged buy-out structure) may impact the ability of the target corporation to retain its S corporation or obtain QSub status under the S corporation eligibility rules that can consider financial instruments labeled as debt as an impermissible second class of stock.

Historical S Corporation Election Concerns. Issues concerning the validity of the target's historical S corporation status have the potential to affect deal pricing and the form of the transaction ultimately implemented. An invalid S corporation election can cause a host of complexities for the acquisition associated with two sets of risks for buyers. The first pertains to all transactions, regardless of form, that the buyer could bear risk for the target's historical unpaid corporate level taxes after the closing indirectly as the owners of the target corporation or directly as a transferee of all of the corporation's business assets imposed under the tax laws[18] or state law (for example, under a bulk sales or fraudulent conveyance statute). The second pertains to the risk that a buyer may not receive an asset basis stepup under a Section 338(h)(10)/336(e) election structure, which election is predicated on a valid S corporation target. In response, the parties may implement one of a set of structural solutions to mitigate this risk to the buyer's desired asset sale tax treatment, including an outright sale of the target's assets, as well as a drop-down LLC structure or a pre-sale LLC conversion structure described below.

Stock Purchase Transactions

For situations in which the parties agree that there will be no inside basis step up in the target company's assets for the buyer, the transaction will be implemented as a stock purchase for tax purposes. A stock purchase for tax purposes may take the transactional form of an outright purchase of shares of target stock, a "reverse" merger of a subsidiary of the buyer with and into the target corporation, or in the form of one of these transactions coupled with a redemption.[19]

Where rollover equity takes the form of the seller's retention of stock in the sold S corporation, the seller does not recognize gain or loss attributable to the stock. For rollover equity in the form of the buyer's or its affiliate's equity, whether the seller receives this equity on a pre-tax or post-tax basis generally depends on whether this portion of the acquisition transaction qualifies as a nontaxable capital contribution exchange under Section 351 (for corporation rollover equity) or Section 721 (for partnership rollover equity). The tax rules provide greater flexibility for tax deferral on partnership rollover equity under Section 721 due to there being no analogue to the post-transaction "control" requirement under Section 351 for corporations.[20] Thus, while pre-tax rollover transactions with partnership equity may involve existing partnerships,[21] a pre-tax rollover with a corporation buyer typically requires the formation of a new corporation to issue the rollover equity so that the rollover sellers could be considered members of a Section 351 control group with the ultimate buyer. Conversely, implementing a post-tax structure for the recipient of corporate stock rollover equity merely requires that the rollover equity exchange not qualify as a Section 351 exchange (or a Section 368 reorganization), which generally can be controlled by the form given the rigid requirements of these tax rules. A post-tax equity rollover structure using tax partnership equity, however, is a much harder result to achieve in a tax efficient manner given that Section 721 is both much more expansive than Section 351 or 368 for sell-

nership targets for a variety of tax reasons outside the scope of this article.

17 Earnings distributions from a subsidiary to its Section 1504 "affiliated" corporate parent generally is not subject to a tax at the shareholder level whether by operation of the Reg. 1.1502-13 and 1.1502-32 rules if the affiliates join in filing a consolidated income tax return, or the Section 243(a)(3) 100% dividend received deduction rules for affiliates reporting on a separate entity basis. A nonaffiliated parent corporation may receive a Section 243(a)(1) 70% dividends-received deduction for subsidiary corporation distributions to it taxed as Section 301 dividends.

18 See, e.g., Reg. 1.338-1(b)(3)(i) (new target resulting from a Section 338 election liable for old target's federal income tax liabilities).

19 See Zenz v. Quinlivan, 213 F.2d 914, 45 AFTR 1672(CA-6, 1954); Rev. Rul. 90-95, 1990-2 CB 67.

ers and much narrower than Section 1032 for corporate issuers.

For the target business's post-sale operations, flow-through tax treatment is only available when there are eligible S corporation shareholder buyers or S corporation buyers. For buyers that are eligible to hold S corporation stock (and any company leverage used to finance the deal does not risk being treated as an impermissible second class of stock),[22] the buying and selling shareholders can continue to operate the target as an S corporation. An S corporation buyer may also maintain flow-through tax treatment for the acquired business if it obtains all of the target stock (so that rollover equity is issued at the buyer entity level), and the buyer makes a QSub election for the target effective on the date of the acquisition.[23]

Stock acquisitions by non-S corporation entities are not eligible for a post-acquisition flow-through tax structure for the acquired business and result in the target corporation becoming classified as a C corporation. This results in a bifurcation of the target's tax year, with a short S corporation year ending on the day before the sale and a short C corporation year beginning on the day of the sale.[24] Target S corporations joining a buyer's consolidated group as a result of the transaction do so at the beginning of the day of the sale.[25]

Asset Purchase Transactions

S corporation sales treated as asset sales for tax purposes that provide buyers with an asset basis stepup may be implemented in a variety of ways. To reflect the structure of an actual sale of assets, the S corporation may simply sell all or a portion of its assets or the S corporation may merge with and into an acquiring entity as a "forward merger."[26] Nontax considerations, however, often make an outright sale of a target company's assets more challenging from an implementation perspective as compared to a stock sale. For example, the target may have contract assignment or regulatory consent issues that could delay and even impede an asset sale.

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20 Section 351(a) requires that "one or more persons" participating in the contribution exchange be in "control" of the corporation immediately after the exchange. The one or more persons constituting a "control group" are not required to participate in the property for stock exchange simultaneously, but the regulations indicate that "the rights of the parties [be] previously defined and the execution of the agreement proceed with an expedition consistent with orderly procedure." Reg. 1.351-1(a)(1). "Control," for purposes of Section 351, means the ownership of stock possessing at least 80% of: (1) the total combined voting power of all classes of stock entitled to vote; and (2) the total number of shares of all other classes of stock of the corporation.

21 See Section 707(a)(2)(B).

22 Given the dire consequences associated with an invalid S corporation election, taxpayers generally rely on qualification for the "straight debt" safe harbor of Section 1361(c)(5) to mitigate risk that company issued debt constitutes an impermissible second class of stock under the S corporation rules. Among other requirements, the straight debt safe harbor requires that the lender may only be a person eligible to hold S corporation stock or a person that is actively and regularly engaged in the business of lending money (e.g., a bank).

23 See Reg. 1.1361-4(a)(2)(ii), Example 1. This QSub election for the target should be treated as a nontaxable subsidiary liquidation into the buyer S corporation under Sections 332 and 337.

24 Sections 1362(d)(2), (e)(1).

25 This special exception to the "end of the day rule" negates the need to file a one-day C corporation return for the target. See Reg. 1.1502-76(b)(1)(ii)(A)(2).

26 See Rev. Rul. 69-6, 1969-1 CB 104.

27 An S corporation's distribution of equity in an entity to its shareholders triggers any unrecognized gain inherent in the equity value pursuant to Section 311(b) (for operating distributions) or Section 336(a) (for liquidating distributions).

28 Reg. 1.197-2(h)(6).

29 Of note, a purchase of S corporation stock subject to a Section 338/336(e) election generally cleanses a Section 197(f)(9) anti-churning taint for the sold business intangibles in the hands of the deemed "new corporation" acquiror in the transaction. Regs. 1.197-2(h)(8), -2(k), Example 23. However, this rule does not apply to the extent the persons subject to the anti-churning taint (here, the rollover sellers) are considered "related" to the new corporation. Thus, a situation with the sellers receiving more than 20% rollover equity in the buyer or its affiliates has the potential to create an anti-churning problem by operation of the constructive ownership rules incorporated under the anti-churning rules for testing relatedness.

30 Although Congress authorized an election under Section 336(e) for deemed asset sale treatment in 1986, the IRS did not promulgate final regulations authorizing taxpayers to make Section 336(e) elections until 2013. See

Thankfully, Congress has provided taxpayers with methods to deem a sale of stock of a corporation to be a sale of the corporation's assets solely for tax purposes via elections filed under Sections 338 and 336(e). Another alternative for implementing an asset sale tax structure in the form of an equity sale involves a "drop-down LLC" pre-sale restructuring to have the transaction take the form of an S corporation holding company selling equity in a disregarded entity subsidiary that holds the target business assets. Further, the parties could execute a pre-sale LLC conversion of the target company to effect an equity sale treated as an asset sale for tax purposes.

The parties may implement the corporate stock or tax partnership equity rollover consideration in the transaction on a pre- or post-tax basis as described above under the stock purchase paradigm, as well as under the additional methods described below. However, only a post-tax rollover equity structure may be employed when the selling S corporation will distribute (or be deemed to distribute) the rollover equity to its shareholders.[27] The post-sale operations of the target S corporation business may be operated in a flow-through tax structure or in a C corporation structure, depending on the tax classification of the buyer and any affiliate issuing rollover equity.

Additionally, buyers should remain aware of potential limitations on their ability to enjoy full purchase price amortization benefits associated with the asset sale basis stepup. The Section 197(f)(9) anti-churning rules can provide such a limitation for situations involving a rollover equity component that provides the sellers with a 20% direct or indirect equity interest in the sold business. These rules apply if a person "related" to the purchaser of an otherwise amortizable Section 197 intangible (or to the post-purchase user of the intangible) held or used the intangible prior to 8/10/1993. Generally, a person owning a direct or indirect 20% or greater interest in a corporation's stock (by value) or a partnership's capital or profits is treated as related to the corporation or partnership for the purposes of the anti-churning rules.[28] Thus, if the target S corporation holds intangibles subject to the anti-churning rules, the intangibles may similarly be unamortizable in the hands of the buyer depending on the relative size of rollover equity provided to sellers.[29]

Deemed Asset Sale—Section 338(h)(10)/336(e) Election. Section 338 includes two deemed asset sale elections for stock sales made to a corporation buyer, one under Section 338(h)(10) for sales of S corporation stock and stock of an affiliated subsidiary (under an 80% vote and value test) and another under Section 338(g) for other qualifying stock sales. An election under Section 336(e) provides asset sale treatment similar to a Section 338(h)(10) election for situations involving a transferee that is not a corporation.[30]

A Section 338(g) election for target corporations that are not S corporations or affiliated subsidiaries results in two levels of taxes—one at the target corporation level attributable to the deemed sale of all of its assets to a "new" target corporation and one at the shareholder level attributable to the actual sale of the target stock.[31] As for all asset sale structures involving two levels of tax, a Section 338(g) election rarely makes economic sense because the amortization benefits of the asset basis stepup for the buyers generally do not outweigh the additional tax cost associated with the imposition of a separate corporate level of tax on the sale.[32] By contrast, the deal economics often can support Section 338(h)(10) or Section 336(e) elections for S corporation and affiliated subsidiary targets. These elections deem the existing target entity to sell all of its assets and liabilities to a "new" target corporation with the existing target corporation liquidating immediately after the sale, generally resulting in a single level of tax (subject to any Section 1374 "built-in gains" tax).[33] Although there must be a qualifying purchase or disposition of only 80% of the target corporation's stock to be eligible for a Section 338(h)(10) or Section 336(e) election as described below, this election produces a fully taxable transaction for all of the pre-transaction shareholders under a deemed sale of all of the target's assets, even for any nonselling shareholders.[34] The tax rules accordingly require all of the target corporation's shareholders to consent to the filing of either of these elections.[35]

In order for a purchase to be eligible for a Section 338 or 336(e) election, it must be considered part of a Section 338 "qualified stock purchase" (QSP) or Section 336(e) "qualified stock disposition" (QSD). The QSP and QSD requirements generally mirror each other and, at a high level, necessitate that target stock meeting the requirements of Section 1504(a)(2) (80% of vote and value test) be acquired/disposed of within a 12-month period. Although superficially simple, this test can prove to be a trap for the unwary given that only certain acquisitions or dispositions of target stock may be taken into account for purposes of a QSP/QSD test.[36] In particular, the terms "purchase" and "disposition" for purposes of these rules do not refer to

August, "Final Section 336(e) Regs. Offer Taxpayers Flexible Benefits," 15 BET 14 (September/ October 2013).

31 Section 338(a); Reg. 1.338-1(a)(1).

32 In practice, Section 338(g) elections are generally only contemplated for targets with significant usable net operating losses to shelter the entity-level gain triggered by the election or for foreign corporations that are not subject to U.S. taxation (i.e., foreign corporations not engaged in a U.S. trade or business).

33 Regs. 1.336-2(b), 1.338(h)(10)-1(d).

34 Regs. 1.336-2(b)(1)(iii)(A), 1.338(h)(10)-1(d)(5)(i).

35 Regs. 1.336-2(h)(3)(i), 1.338(h)(10)-1(c)(3).

36 For more detailed discussion of these QSP/QSD qualification issues, see Rizzi, "QSPs and Other Formalities," 38 J. Corp. Tax'n 14 (September/October 2011), and Geracimos, "Target Shareholder's Investment May Jeopardize 338 Election in LBO Transactions," 35 J. Corp. Tax'n 5 (September/October 2008).

stock acquired/disposed of if (1) the basis of the stock in the hands of the acquiror is determined in whole or in part by reference to the basis in the hands of the transferor, (2) the stock is acquired in an exchange to which Section 351 applies or "is acquired in any other transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized in the transaction" or (3) the stock is transferred to a "related" person.[37]

These QSP/QSD requirements pose a challenge for implementing rollover equity for Section 338(h)(10)/336(e) election transactions. Initially, a pre-tax rollover transaction should not be available for sellers in this transaction given that a Section 338(h)(10)/336(e) election transaction triggers gain for even nonselling target shareholders. More crucial to the validity of the structure itself, however, the rollover equity has the potential to invalidate the Section 338(h)(10)/336(e) election if it could be considered to involve a Section 351 or Section 721 transaction.

Specifically, using buyer stock or partnership equity as rollover equity that is exchanged in a Section 351 or Section 721 transaction could invalidate the intended QSP/QSD because it could cause the entire transaction to be considered to be subject to Section 351 or 721, transactions explicitly excepted from QSP/QSD treatment.[38] A possible structural solution to this technical problem in a C corporation rollover equity structure could involve having the buyer's parent corporation issue the rollover equity in order to prevent Section 351 treatment at the acquiring entity level.[39] For tax partnership rollover equity, this structure is not generally feasible because there is no analogue to the Reg. 1.1032-3 rules for tax partnership equity consideration as compared to corporate equity consideration from the issuer perspspective. Moreover, rollover equity has the potential to invalidate an otherwise good QSP or QSD to the extent it causes the rollover sellers to be considered "related" to the buyer for Section 338/336(e) purposes.[40] Given these challenges associated with issuing seller rollover equity in a Section 338(h)(10)/ 336(e) election stock sale, these structures are generally not used for S corporation sales with rollover equity, as further described below.

Drop-Down LLC Structure. While a Section 338(h)(10)/336(e) election structure has the appeal of creating an asset sale that is accomplished in the form of a stock sale, there may be structural or commercial impediments to adopting this form. First, Section 338(h)(10)/336(e) election eligibility depends on the target being a valid S corporation. Consequently, buyers are often wary of entering into a Section 338(h)(10)/336(e) election acquisition when their diligence shows uncertainty with the validity of the target's S corporation election. Also, a Section 338(h)(10)/336(e) election may not be available due to the inability of the parties to implement a valid QSP or QSD, including due to the complexities associated with a rollover equity structure. Further, the parties may desire that the S corporation seller remain in existence

37 Section 338(h)(3)(A); Reg. 1.336-1(b)(5)(i). The government has not promulgated regulations addressing the quoted language.

38 See Chudy and Reddy, 788-3rd T.M. (BNA), *Stock Purchases Treated as Asset Acquisitions —Section 338* § VI.C.5.; Rizzi, note 36, *supra.*

39 See Rev. Rul. 84-44, 1984-1 CB 105 (ruling that a merger of a target corporation into a subsidiary of an acquiring corporation with the target shareholders receiving acquiring corporation stock was not potentially characterized a Section 351 exchange because the shareholders did not transfer any property to the acquiring corporation in exchange for their stock).

40 A structure using tax partnership rollover equity in particular has the propensity to cause a relatedness problem for an intended QSP or QSD under the modified Section 318(a) stock ownership attribution rules applied under the Section 338/336(e) rules.

41 See Rev. Rul. 2008-18, 2008-1 CB 674.

42 Given its status as a "tax nothing," the QSub historical operating entity may itself be sold to the buyer in a transaction treated as an asset sale. However, the parties generally will desire for the QSub to become an LLC classified as a disregarded entity prior to the sale as a method to mitigate historical S corporation risk to the buyer's asset stepup and/or to allow for a post-sale flow-through tax structure for the purchased business as a partnership or disregarded entity rather than a C corporation.

43 Although a structure involving the historical operating entity becoming a disregarded entity (rather than a Qsub) was not at issue in Rev. Rul. 2008-18, the IRS has ruled that this transaction may nonetheless qualify as an F reorganization. See PLR 201314003.

44 Rev. Rul. 99-5, 1999-1 CB 434, Situation 1.

45 Regulations confirm the validity of using S corporation LLC subsidiary investment structures as a means to mitigate S corporation ineligible shareholder and second class of stock risks. See Reg. 1.701-2(d), Example 2.

46 Reg. 1.197-2(g)(4), (h)(12)(vii).

47 The remedial allocation election also generally accelerates property contributor goodwill gain and converts it from capital gain on an exit transaction into ordinary income.

48 Regs. 1.197-2(g)(3), (h)(12)(v)(A).

and/or retain certain unwanted assets, an impossibility under the deemed sale and liquidation of a Section 338(h)(10)/336(e) election. A seller may also desire to receive its rollover equity consideration on a pre-tax basis, which should be unavailable in a Section 338(h)(10)/336(e) election transaction. Finally, the parties may desire to maintain a flow-through tax structure for the rollover sellers while implementing a non-flow-through C corporation structure for the buyer, or to maintain a 100% flow-through tax structure following an acquisition involving ineligible shareholder buyers or target company-issued financial instruments that raise S corporation second class of stock concerns, in each case in a manner that would be practically difficult or impossible to implement under a Section 338(h)(10)/336(e) election transaction.

A commonly employed structural solution to achieve these objectives while retaining the flexibility associated with the sale of equity treated as an asset sale for tax purposes is for the parties to implement a "drop-down LLC" structure. Under this structure, the parties effect the transaction as a sale by an S corporation parent of an LLC disregarded entity subsidiary that holds the business assets and liabilities to be transferred to the buyer. The drop-down LLC structure thus requires the sellers and the S corporation to undergo a pre-sale restructuring. In its most simple iteration, this restructuring involves the S corporation transferring its business assets and liabilities desired to be sold to a newly formed subsidiary LLC in exchange for all of the LLC's membership interests.

Sellers desiring to avoid implementation issues associated with an outright asset transfer (for example, contract assignment consent issues) can achieve the same result through a Section 368(a)(1)(F) "F reorganization" structure. This involves the sellers forming a new S corporation holding company, transferring the existing S corporation's stock to the new S corporation and, effective immediately after this transfer, having the existing S corporation become classified as a disregarded entity for tax purposes.[41] How the existing S corporation is organized under state law dictates how this last step is accomplished. If the S corporation is a state law corporation, the entity will make a QSub election and then take steps to change its state law form to an LLC.[42] If the historical S corporation is organized as an LLC, the entity may file a check-the-box election on a Form 8832 to become classified as a disregarded entity.[43]

Upon completion of this preliminary restructuring, the S corporation parent, which is treated as the same entity as the pre-restructuring S corporation (aside from its new EIN in the case of an F reorganization structure), owns 100% of the equity in the subsidiary LLC disregarded entity that holds the business assets and liabilities desired to be transferred to the buyer. Then, the S corporation parent sells a portion or all of its LLC membership interest equity to the buyer. A sale of all of the LLC membership interest equity is treated as the S corporation's sale of all of the assets held by the LLC.

For a sale of less than all of the LLC membership interest equity (with the retained membership interest serving as rollover equity), the parties treat this transaction as the buyer's acquisition of an undivided proportionate interest in each of the LLC's assets and liabilities directly from the seller S corporation, and, immediately thereafter, as a contribution by the buyer and the S corporation seller of their respective interests in these assets and liabilities to the LLC entity in exchange for their respective membership interests in the LLC, which is now classified as a partnership for tax purposes.[44] Thus, a sale of less than all of the S corporation's equity in the disregarded entity LLC target provides a pre-tax rollover transaction for the S corporation shareholders and also permits them to maintain a flow-through tax structure for their continuing interest in the business through their interest in the operating company tax partnership and the S corporation holding company.[45]

While the drop-down LLC structure itself fits the asset sale paradigm with a full basis stepup with respect to the buyer's purchased interest in the business assets, it may not provide a buyer with full purchase price amortization deduction benefits. This is due to the operation of the partnership tax rules under Section 704(c) (specifically, potential operation of the Section 704(c) "ceiling rule"), and potentially due to the Section 197(f)(9) intangible "anti-churning" rules. While an in-depth discussion of these issues is beyond the scope of this article, the buyer can obtain full purchase price amortization benefits and avoid these limitations if the LLC tax partnership adopts the Section 704(c) remedial allocation method with respect to the purchase transaction.[46] However, adoption of this method is generally considered a zero sum game for buyers and sellers because the sellers are consequently allocated notional amounts of ordinary income from the LLC as phantom income (absent any associated LLC tax distributions) corresponding to the amortization deductions allocated to the buyer.[47] This issue can understandably become contentious in negotiating the purchase and LLC operating agreement documents in a transaction.

For transactions in which this Section 704(c) remedial allocation method issue becomes a sticking point, parties may attempt to provide buyers with full purchase price amortization benefits without the phantom income pickup to sellers by having the target become classified as a partnership prior to the transaction. This would be accomplished by admitting a second member in the target LLC prior to the sale to the buyer. In this way, the transaction would be structured as a partnership equity purchase and the buyer could receive full purchase price amortization benefits through Section 743(b) adjustments reported on its Schedule K-1 and not Section 704(b) allocations with no impact on the seller.[48] This structure, however, is not without risk so that the parties should take appropriate measures to support the validity of the pre-sale partnership classification of the target.

Pre-Sale LLC Conversion Structure. A similar method for implementing an asset sale for tax purposes that is considered an equity sale for corporate law purposes is to convert the target S corporation into an LLC classified as a partnership or disregarded entity effective prior to the sale transaction. This state law entity and tax classification conversion may be implemented pursuant to a so-called "formless conversion" from a corporation to an LLC in states that permit such an action, such as Delaware, California, and *(Continued on page 47)*

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(Continued from page 13) Pennsylvania, or pursuant to a merger of the corporation into a newly formed LLC.[49] The conversion will trigger all of the potential asset level gain for the sellers as a taxable liquidation under Section 336(a).[50] The subsequent sale of some or all of the LLC equity would then presumably not result in additional taxable gain to the sellers beyond their initial S corporation liquidation gain. For the buyer, its purchase of LLC equity would be treated as a purchase of assets or tax partnership equity, which provides the intended asset basis stepup (assuming a Section 754 election is made in the case of a tax partnership equity purchase transaction).

The tax features of this structure for the parties are identical to those features under an actual asset sale paradigm described above. Thus, S corporation buyers and sellers opting for this type of equity sale structure rather than an actual asset sale or forward merger asset sale structure generally have nontax commercial reasons for doing so (for example, contract assignment issues or other issues associated with the target business not operating under the same EIN).

Of course, sellers will not want to undergo an LLC conversion prematurely without assurance that the deal will close due to the taxable gain triggered by this deemed liquidation. To mitigate this transaction implementation tax risk, sellers often wait to cause the target S corporation to undergo the LLC conversion until the actual closing. Parties following this commonly-employed path rely on the principles of Rev. Rul. 2004-59,[51] which treats a partnership to corporation formless conversion in the same manner as if this tax classification change had occurred pursuant to a check-the-box election. Treating the converse situation involved in an LLC conversion (corporation to partnership/disregarded entity tax classification change) in a similar manner,[52] the check-the-box election rules require that the election is effective as of the beginning of the election date so that the deemed taxable liquidation occurs as of the end of the day prior to the election date.[53] This rule that triggers the taxable liquidation on the day prior to the election effectively permits the sellers to implement the pre-sale LLC conversion structure at the same time they actually close the sale transaction. An alternate method for achieving the same result that does not rely on Rev. Rul. 2004-59 would be for the LLC conversion to occur on the day prior to the scheduled closing with the parties waiting until (or after) the closing to determine whether or not a check-the-box election should be made (effective as of the conversion).[54] That is, an election via Form 8832 for the target LLC to be classified as a corporation would be filed only in the event that the deal fails to close.[55]

Conclusion

The form of how an S corporation sale with rollover equity for the sellers is implemented has a great impact on the parties' tax treatment of the transaction, as well as their interests in the continuing target business. Thus, failure to consider all of the structural tax elements of a transaction has the potential to provide the parties with a tax result that diverges from their expectations. Well-advised buyers and sellers engaging in S corporation sales with a rollover equity component therefore should take particular care to ensure that the parties' commercial deal is effectively carried out in the tax structure of the transaction. ■

49 If the S corporation target entity is already organized as an LLC under state law and has not made a check-the-box election in the prior five years (not including any initial elective tax classification upon formation), this structure may be implemented by submitting a check-the-box election for the target to be classified as a disregarded entity or partnership (a "check and sell" structure).

50 See Reg. 301.7701-3(g)(1)(ii); CCA 200848036.

51 2004-1 CB 1050.

52 Given this factual distinction, Rev. Rul. 2004-59 technically does not apply to an LLC conversion structure. However, practitioners generally believe that the same reasoning underlying Rev. Rul. 2004-59 should similarly support check-the-box election treatment for an LLC conversion. Parties desiring to mitigate risk on this issue may adopt the alternative LLC conversion method detailed in the text.

53 Reg. 301.7701-3(g)(3)(i).

54 A check-the-box election may be made effective up to 75 days prior to the election filing date. Reg. 301.7701-3(c)(1)(iii).

55 In this situation, an additional S corporation election should not be necessary for the continuing LLC successor of the existing S corporation operating company, although the LLC members may opt to file a protective election if so desired. See Rev. Rul. 64-250, 1964-2 CB 333; PLR 200622025; PLR 9636007.