

CHAPTER 4

Structuring Alternatives for Buying and Selling Privately Held Businesses

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Synopsis

¶ 400	SCOPE
¶ 401	THE DEAL TERMS
¶ 402	TAX AND ACCOUNTING CONSIDERATIONS
¶ 403	THE FACT PATTERN
¶ 404	STRUCTURING THE TRANSACTION TO QUALIFY FOR A 338 ELECTION
¶ 405	SELLING THE STOCK
¶ 406	THE EFFECT OF THE 338 ELECTION
¶ 407	MAKING THE SELLER WHOLE FOR ADDED TAXES THAT RESULT
¶ 408	THE BUYER'S MOTIVATION
¶ 409	HOW TO USE LLCs TO ACHIEVE MORE TAX EFFICIENCY THAN A 338 ELECTION
¶ 410	CONCLUSION
¶ 400	SCOPE

The expected tax increases in 2011 should help breathe life back into mergers and acquisitions.¹ The focus of this article is to discuss structuring alternatives that are

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¹ Absent new legislation, several changes occur on January 1, 2011. The maximum federal income tax

available in taxable acquisitions and dispositions of privately held businesses. We will compare the federal income tax results under two alternatives. The first alternative is selling the stock of an S corporation and making an election under IRC Section 338(h)(10)² (“338 Election”). Under a 338 Election, the stock sale is treated as an asset sale for federal income tax purposes.³ The second alternative is selling the units of a limited liability company (“LLC”) (the “LLC Transaction”).⁴ As discussed in this article, the use of an LLC Transaction can provide significant advantages over a stock acquisition that is treated as an asset sale.

¶ 401 THE DEAL TERMS

As with most deals, the buyer would like to buy assets while the seller would like to sell stock. An asset purchase provides the buyer with several advantages while the stock purchase provides the seller with several advantages. Some significant advantages the buyer achieves by buying assets include getting a cost basis in tangible and intangible assets for tax purposes,⁵ and leaving behind unwanted corporate liabilities.⁶ Some significant advantages the seller achieves by selling stock include treating the

rate for net long-term capital gains increases from 15 percent to 20 percent; the maximum federal income tax rate for qualified dividends increases from 15 percent to 39.6 percent; and the holding period for the built-in-gains tax for S corporations reverts to 10 years. See IRC Sections 1(h)(1), 1(h)(11), and 1374(d)(7).

² All “IRC Section” references herein are to the Internal Revenue Code of 1986, as amended, (“IRC”) and all “Treas. Reg. Section” references are to the regulations thereunder. All “IRS” references are to the Internal Revenue Service.

³ The focus of this article is a target S corporation. An election under IRC Section 338(h)(10) is also available to subsidiary members of a consolidated group or subsidiary members of a domestic affiliated group. Treas. Reg. Section 1.338(h)(10)-1(c). An election under IRC Section 338(g) is available for stand-alone C corporations. The latter is most useful when the target C corporation is foreign or has significant net operating losses. Also, note the IRS has finally issued proposed regulations under IRC Section 336(e) that would allow a seller to elect to treat a stock sale as an asset sale.

⁴ For purposes of this document, we will assume the LLC has not elected to be taxed as a corporation and therefore Treas. Reg. Section 301.7701-3(b)(1) would cause the LLC to be a disregarded entity (if it has a single owner), or a partnership (if it has more than one owner that is regarded) for federal income tax purposes.

⁵ For income tax purposes, the buyer maintains a carryover basis when the transaction is simply a stock purchase. That is, a stock purchase without a 338 Election (“straight stock purchase” or “straight stock sale”). Note that Generally Accepted Accounting Principles (“GAAP”) provide the buyer with a cost basis in assets whether the acquisition is a stock or asset purchase. This causes significant differences between GAAP and tax reporting for the buyer in a straight stock purchase.

⁶ Certain liabilities may carry over in a bulk sale. A buyer should consult an attorney. Also, be mindful that members of a consolidated group have joint and several liability under Treas. Reg. Section 1.1502-6 for income taxes owed by the group for any year they were a member. Buyers can avoid this liability only by buying the assets in an arm’s length transaction. That is, a 338 Election or buying a single member LLC will not protect the buyer. Treas. Reg. Section 1.338-1(b)(3); FSA 200052003. Even if the buyer has

gain on the sale as capital gain,⁷ not being primarily responsible for historic liabilities, and not having to transfer and re-title each asset and license.⁸

The buyer and seller have different goals when negotiating a transaction. Because each transaction represents its own set of facts, it is important to have all members of the advisory team involved in reviewing the terms of a memorandum of understanding, letter of intent, and purchase agreement.

¶ 402 TAX AND ACCOUNTING CONSIDERATIONS

Some important tax and accounting considerations in negotiating a transaction include:

- Is the transaction a stock purchase or an asset purchase?
- Is the buyer responsible for making the selling group economically whole for any added taxes that result from an asset sale compared with a straight stock sale?
- Will the seller have to represent that the financial statements follow GAAP?⁹
- What is in working capital and EBITDA¹⁰ and how will we calculate an adjustment?
- Which party is responsible for any transfer taxes?
- How is “earn-out” defined to prevent post-closing dilution or distortion that may arise from continuing business?
- Which party is responsible for paying tax on the interest that accrues in escrow?¹¹
- Which party should benefit from any tax refunds related to prior year taxes?

contractual protections from the seller, the IRS can assess the target, so the buyer would have to pursue the seller.

⁷ If the sale was an asset sale, there may be ordinary income. For example, recapture of depreciation and amortization, IRC Section 1231 recapture, zero-basis assets (e.g., cash basis accounts receivable), inventory, and copyrightable assets. As an example, see *David D. Levy v. Commissioner*, T.C. Memo 1992-471, where the Tax Court held that gain on the sale of software was ordinary income to the developer because software is a copyrightable asset.

⁸ In addition, transfer and sales taxes may result from an asset sale.

⁹ Unless a reputable accounting firm has audited the financial statements, this representation will be difficult to provide. In some transactions, a GAAP representation with an exceptions list is fitting.

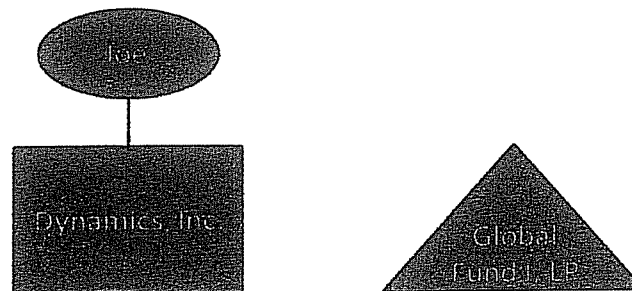
¹⁰ The usual meaning of EBITDA is earnings before interest, taxes, depreciation, and amortization. However, it is not a defined term and in some industries, rent is an additional adjustment item.

¹¹ Prop. Reg. Section 1.468B-8(c) provides the buyer should report the interest income.

- Which party is entitled to deduct closing day expenses?¹²
- Which party is responsible to prepare, file, and pay for the short period tax returns?
- How will the parties allocate the purchase price?
- Which party will file necessary election forms (for example, Form 8023, *Elections Under Section 338 for Corporations Making Qualified Stock Purchases*)?

¶ 403 THE FACT PATTERN

To help explain our analysis, we will work with the following fact pattern:



Joe owns 100 percent of the stock of Dynamics, Inc. (“Dynamics”), which has been an S corporation since formation. Dynamics is in California and provides software solutions to its customers through the Internet. When necessary, employees travel to customer locations to help train them on using the software, and travel to other states to solicit sales.

Joe is ready to monetize a portion of his investment. Global Fund I, LP (“Fund I”) is a private equity firm that invests in technology companies. Fund I wants to buy a controlling interest in Dynamics.

Joe and Fund I agree that Fund I will buy 80 percent of the stock and Joe will retain 20 percent. Joe will continue to manage the business. Joe is willing to treat the stock sale as an asset sale for income tax purposes if he receives more cash. Fund I agrees to make both Joe and Dynamics whole for added taxes from the deemed asset sale compared with a straight stock sale.

¹² See Treas. Reg. Sections 1.338-1(d)(5) and 1.1502-76(b)(1).

¶ 404 STRUCTURING THE TRANSACTION TO QUALIFY FOR A 338 ELECTION

The 338 Election treats the sale of stock as the sale of assets for federal income tax purposes without triggering double tax provided the entity was always an S corporation.¹³ With the 338 Election, the legal transaction is the sale of stock, but the income tax treatment is a sale of assets. This structure is important because it allows licenses and intangibles to stay intact.

To qualify for the 338 Election, the seller must be an S corporation shareholder and the target must be a valid S corporation.¹⁴ We meet these requirements in our facts; however, the buyer and seller should not take this lightly. The buyer would be wise to conduct diligence on the validity of the status of the S corporation because there are many ways a corporation can lose its S corporation status and become a C corporation.¹⁵ If the company is not a qualified S corporation, the 338 Election is void—causing the buyer to fail to obtain a step-up in the basis of the assets, and the seller to breach its representations and warranties under the sale contract.¹⁶ At a minimum, the buyer should get a copy of the letter of acknowledgment from the IRS (and relevant state authorities) and review the equity-related transactions of the company.¹⁷

The stock purchase must be a “qualified stock purchase” to be eligible for the 338 Election. A qualified stock purchase is a purchase of stock constituting 80 percent (or more) of the vote and value of the target corporation over a twelve month period.¹⁸ The statutory definition of “purchase” uses transactions that are not “purchases” to set the boundary. Such nonpurchases are carryover basis transactions, acquisitions where the basis is determined under IRC Section 1014, exchanges to which IRC Sections 351, 354, 355, or 356 apply; and acquisitions from a related party under IRC Section

¹³ Entities that convert from a C corporation to an S corporation, or acquire assets from a C corporation in a tax-free transaction, are subject to the built-in gains tax of IRC Section 1374.

¹⁴ Treas. Reg. Sections 1.338(h)(10)-1(c)(1) and -1(b)(4).

¹⁵ Pitfalls include failure to get signature of spouses in community property states, issuing options or stock to nonresident shareholders, failing to make separate state elections where applicable, issuing more than one class of stock or having different economic arrangements between shareholders, having ineligible shareholders (for example, charitable remainder trusts), and failing to elect to treat an eligible trust as an S corporation shareholder (for initial elections, see Part III, Form 2553, *Election by a Small Business Corporation*).

¹⁶ Treas. Reg. Section 1.338(h)(10)-1(c)(5).

¹⁷ The IRS issues a letter to notify that it received the election; however, this does not confirm the entity has met all the requirements to be an S corporation.

¹⁸ IRC Section 338(d)(3).

318(a).¹⁹

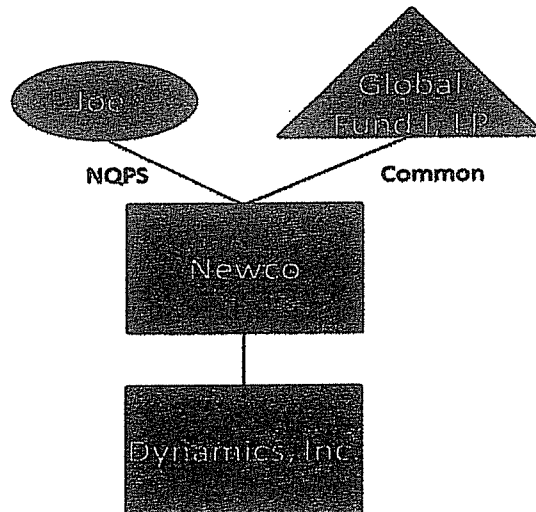
In addition, the buyer must be a corporation.²⁰

We can meet this test in our facts if structured properly.

¶ 405 SELLING THE STOCK

Fund I forms a new corporation (“Newco”) to buy the stock and funds it with cash.²¹ Next, Joe would transfer his stock in Dynamics to Newco in exchange for cash and nonqualified preferred stock (“NQPS”), as defined in IRC Section 351(g). The use of NQPS causes Joe’s stock transfer to not be a transfer under IRC Section 351. Therefore, the transaction qualifies as a “purchase” for a 338 Election.²²

The following is an illustration of the resulting ownership:



The buyer and seller must make a joint election on Form 8023 to qualify for asset

¹⁹ IRC Section 338(h)(3).

²⁰ IRC Section 338(d)(1).

²¹ The acquirer’s existence must be respected. Therefore, it cannot be transitory and it should not liquidate shortly after the acquisition. However, the buyer can liquidate the target (or convert it to an LLC) post-acquisition, if necessary. Treas. Reg. Section 1.338(h)(10)-1(c)(2).

²² There are several other ways to “fail” IRC Section 351. For example, after Fund I forms Newco and funds it with cash, Newco can form a subsidiary corporation (“Buyco”) and fund it with Newco common stock and cash. Buyco would use the Newco common stock and cash to buy all of Joe’s stock in Dynamics. See Revenue Ruling 84-44, 1984-1 C.B. 105. Another alternative under our facts is to have Joe exchange 80 percent of his stock in Dynamics for cash and keep 20 percent; however, this results in Joe owning stock in Dynamics while Fund I would own stock in Newco.

sale treatment.²³ The buyer and seller must make the election by the 15th day of the ninth month beginning after the month in which the purchase occurs.²⁴ The IRS does provide relief in certain cases where an election is late.²⁵ Some states do not recognize federal S corporation status. You should review the corporation's status in each state in which it does business.

¶ 406 THE EFFECT OF THE 338 ELECTION

The 338 Election creates a series of fictional transactions for federal income tax purposes.²⁶ First, Dynamics sells its assets and transfers its liabilities to New Dynamics, an unrelated party,²⁷ receiving cash.²⁸ Next, Joe adjusts his basis by the flow-through items from Dynamics including the gain from the sale. Then, Dynamics liquidates and distributes the cash from the sale to Joe in exchange for his stock in Dynamics.²⁹ Finally, Newco buys the stock of New Dynamics, which now has a new cost basis in the assets.³⁰

Because Dynamics is an S corporation, the gain flows-through to Joe, who recognizes the income and pays the tax.³¹ Therefore, it is important to determine the character of the gain on the sale. And, the character of the gain depends on what he sold, and for how much. To do that, one has to allocate the purchase price among the assets. The Treasury Regulations require this division using a residual method.³²

- We first allocate the purchase price to Class I assets up to their fair market

²³ All S corporation shareholders must consent. Treas. Reg. Section 1.338(h)(10)-1(c)(3).

²⁴ Treas. Reg. Section 1.338(h)(10)-1(c)(3). Form 8023 is filed with the Internal Revenue Service, Submission Processing Center, P.O. Box 9941, Mail Stop 4912, Ogden, UT 84409.

²⁵ See Revenue Procedure 2003-33, 2003-1 C.B. 803.

²⁶ See IRC Section 338(a); Treas. Reg. Section 1.338(h)(10)-1(d)(4); Treas. Reg. Section 1.338(h)(10)-1(d)(4); and Treas. Reg. Section 1.338(h)(10)-1(e), *Example 10*.

²⁷ However, new target is a continuation of the old target for certain purposes (e.g., benefit plans, income tax liability, and payroll taxes). Treas. Reg. Section 1.338-1(b). Also, note the legal transaction is still a stock purchase so the historic liabilities carry over to the buyer.

²⁸ Although selling only 80 percent of the stock, the fictional asset sale considers 100 percent of the assets and liabilities transferred.

²⁹ Treas. Reg. Section 1.338(h)(10)-1(d)(4). The liquidation causes a short period for income tax purposes. The federal income tax return is due two and one-half months after the end of the month in which the sale occurs. A six-month extension is available. If the buyer files a consolidated return, the result is the same. The 338 Election deems the selling corporation liquidates and does not join a consolidated group. Treas. Reg. Section 1.1502-76(b)(1).

³⁰ Treas. Reg. Section 1.338(h)(10)-1(d)(2); Treas. Reg. Section 1.338(h)(10)-1(e), *Example 5(v)* and *(vi)*.

³¹ IRC Section 1366(a).

³² Treas. Reg. Section 1.338(h)(10)-1(d)(2); Treas. Reg. Section 1.338(h)(10)-1(d)(3).

- value. Class I assets include cash and general deposit accounts.³³
- Next, we allocate the purchase price to Class II assets up to their fair value. Class II assets include actively traded personal property, certificates of deposit, and foreign currency.³⁴
 - Next, we allocate the purchase price to Class III assets up to their fair market value. Class III assets include accounts receivable, certain debt instruments, and assets that are marked-to-market each year.³⁵
 - Next, we allocate the purchase price to Class IV assets up to their fair market value. Class IV assets include inventory, stock-in-trade, and assets held primarily for sale to customers in the ordinary course.³⁶
 - Next, we allocate the purchase price to Class V assets up to their fair market value. Class V assets include all assets other than those in Classes I, II, III, IV, VI, and VII, and include furniture, fixtures, equipment, machinery, and leasehold improvements.³⁷
 - Next, we allocate the purchase price to Class VI assets up to their fair market value. Class VI assets include all intangible assets listed under IRC Section 197 (for example, covenant not to compete, custom software, customer based intangibles, patents, workforce in place) except for goodwill and going concern value.³⁸
 - Finally, we allocate the residual purchase price to Class VII assets, which are goodwill and going concern value.³⁹

If there is not enough allocated purchase price to assign up to the fair value of all assets in a particular class, the allocation is proportional among the assets in such class.⁴⁰ If the price changes, one allocates the re-determined price using the residual method.⁴¹

We recommend the buyer and seller agree on the purchase price allocation for each

³³ Treas. Reg. Section 1.338-6(b)(1). If the purchase price is less than Class I assets, the new target (that is, the buyer) immediately recognizes ordinary income and there is no allocation to other classes.

³⁴ Treas. Reg. Section 1.338-6(b)(2)(ii).

³⁵ Treas. Reg. Section 1.338-6(b)(2)(iii).

³⁶ Treas. Reg. Section 1.338-6(b)(2)(iv).

³⁷ Treas. Reg. Section 1.338-6(b)(2)(v).

³⁸ Treas. Reg. Section 1.338-6(b)(2)(vi).

³⁹ Treas. Reg. Section 1.338-6(b)(2)(vii).

⁴⁰ Treas. Reg. Section 1.338-6(b)(2)(i).

⁴¹ See Treas. Reg. Section 1.338-7.

category of assets and attach an allocation statement to the agreement.⁴² Please note the purchase price calculated by the buyer will often not match the sale price calculated by the seller because of transaction costs.⁴³ As a result, the allocations to the various categories should match and the difference in total purchase price from the transaction costs likely would be in Class VII in most transactions. Another item that may create a difference is the allocation to a covenant not to compete.⁴⁴

After dividing the purchase price, Joe uses the basis in each asset to find out the amount and character of the gain from the fictional sale by Dynamics. Joe reports the gain and loss from the fictional sale of assets and pays the tax on his individual return.

¶ 407 MAKING THE SELLER WHOLE FOR ADDED TAXES THAT RESULT

In our transaction, Fund I has agreed to make the seller whole for incremental taxes that result from the 338 Election.⁴⁵ In a straight stock sale, Joe would recognize long-term capital gain from the sale of 80 percent of his stock in Dynamics and the 20 percent he did not sell would not trigger any gain. Some of the important items to consider when comparing a stock sale to an asset sale include:

- Because Dynamics is a California S corporation, the gain from the fictional asset sale is subject to California S corporation income tax at 1.5 percent (as of the writing of this article);⁴⁶
- The gain on the sale of assets can result in ordinary income;⁴⁷
- The 338 Election triggers full gain recognition and full basis increase for the buyer;
- Liabilities assumed increase the amount realized and may also result in a

⁴² Generally, the IRS respects an allocation of purchase price negotiated at arm's length between disinterested parties and does not allow parties to go back and reallocate purchase price once there is an agreed-to allocation. See *R. William Becker, et al. v. Commissioner*, T.C. Memo 2006-264 (2006).

⁴³ Treas. Reg. Section 1.263(a)-5(g)(2) provides that transaction costs reduce the purchase price in an asset sale and increase purchase price in an asset purchase. See also Treas. Reg. Section 1.338-6(a)(2)(ii).

⁴⁴ An individual, not the corporation, reports any consideration for a covenant. This amount would be part of the buyer's purchase price while the selling corporation would not include it in its amount realized.

⁴⁵ Although Joe has sold stock, the tax fiction is that Dynamics has sold assets and liquidated. Therefore, any amount needed to make the seller whole should include added tax that results to both Joe and Dynamics.

⁴⁶ Not all states tax S corporations. Therefore, one should analyze the state apportionment rules. Also, in situations where the S corporation does pay state tax, the federal tax benefit of the state tax deduction should be considered in calculating the amount needed to make the seller whole.

⁴⁷ This determination primarily depends on the purchase price allocation and the seller's method of accounting. *Supra* footnote 8.

deduction under the economic performance rules;⁴⁸

- Built-in gain taxes may apply if the company was previously a C corporation or it acquired assets of a C corporation in a tax-free manner;⁴⁹
- Transfer taxes may result;⁵⁰
- Local taxes may apply;⁵¹
- Any future consideration may be eligible for installment sale treatment;⁵²
- If future consideration does not bear enough interest, some of the capital gain would become interest income under the imputed interest rules;⁵³
- If future consideration is more than \$5,000,000 there is an interest charge on the deferred tax;⁵⁴
- The seller may be in alternative minimum tax and may not be able to deduct state taxes;
- Seller may have a higher outside basis than inside basis.⁵⁵

The buyer and seller will have to agree on a method to calculate the amount needed to make the seller whole for the 338 Election. This is not a perfect science and the parties have to work in good faith toward resolving their differences. To avoid post-closing disputes, it may be wise to complete the gross-up amount before closing. If not, then decide the method and facts used to calculate the gross-up amount before closing.

⁴⁸ See Treas. Reg. 1.461-5; *James M. Pierce Corporation*, 326 F.2d 67 (8th Circuit 1964); *Commercial Security Bank*, 77 T.C. 145 (1981). This deduction can significantly reduce the impact of ordinary income where the seller is a cash basis taxpayer.

⁴⁹ IRC Section 1374.

⁵⁰ Under California law, the transaction is a stock sale and therefore the transaction does not result in sales tax withholding. CA SBE Sales and Use Tax Counsel Annotation 395.0074. However, real property transfer tax may apply and there can be a reassessment of value for property tax purposes.

⁵¹ Certain cities assess tax based on gross receipts.

⁵² However, in the deemed liquidation that results from the 338 Election, the shareholder must allocate his basis in the S corporation stock among the assets received (cash and installment note). This causes the gross basis to be split between cash and the installment note and triggers gain. Also, taxpayer's cannot defer gain under the installment sale method for purposes of computing the 1.5 percent California S corporation tax. CA Revenue and Taxation Code ("RTC") Section 24672.

⁵³ IRC Section 483.

⁵⁴ IRC Section 453A. See TAM9853002 (holding that each spouse has a separate limit for purposes of IRC Section 453A).

⁵⁵ For example, seller may have bought the stock of a C corporation and then converted it to an S corporation.

¶ 408 THE BUYER'S MOTIVATION

The reason a buyer agrees to make the seller whole is because in a straight stock purchase it would inherit the historic tax basis without a step-up.⁵⁶ Because of the 338 Election, the buyer can amortize and depreciate the cost basis of the assets, which will help shield future income from tax.

One barrier to the buyer's enjoyment of tax benefits is the "anti-churning" rule of IRC Section 197(f)(9). When buying goodwill of a business that began before August 11, 1993, these rules can apply to prevent amortization of the basis in goodwill and going concern value resulting from the purchase. The rules will apply if the business began before August 11, 1993 and the seller is related to the buyer (a 20 percent test),⁵⁷ the seller continues to use the intangible post-closing, or the buyer grants the right to use the intangible to the seller.⁵⁸ Therefore, it is important for the unrelated buyer to buy 80 percent or more from the seller if the business began before August 11, 1993. For businesses that began after August 10, 1993, the anti-churning rules do not apply.

Another important item the buyer should analyze and account for is the impact of any deferred revenue or unearned revenue that exists on the date of acquisition. The IRS has ruled that unearned revenue assumed by the buyer can cause gross income post-closing.⁵⁹

¶ 409 HOW TO USE LLCs TO ACHIEVE MORE TAX EFFICIENCY THAN A 338 ELECTION

While the 338 Election can work well in certain transactions, it does present certain tax inefficiencies. As discussed above, a sale of less than all the stock triggers all the gain. Also, Fund I is an ineligible shareholder under Subchapter S, and Joe owns a second class of stock. As a result, the income and loss from the business operations of Dynamics and the future appreciation of goodwill takes place inside a C corporation and is subject to double taxation.

Often, the use of an LLC can help achieve more tax efficiency than the use of a 338 Election. The disadvantages are that LLC agreements are difficult to draft and LLCs need more effort to manage than a C corporation does.

To explain the LLC Transaction using our facts above, Dynamics would form an LLC and transfer all the business assets to the LLC ("New LLC"). Then, Fund I would buy 80 percent of New LLC units from Dynamics.

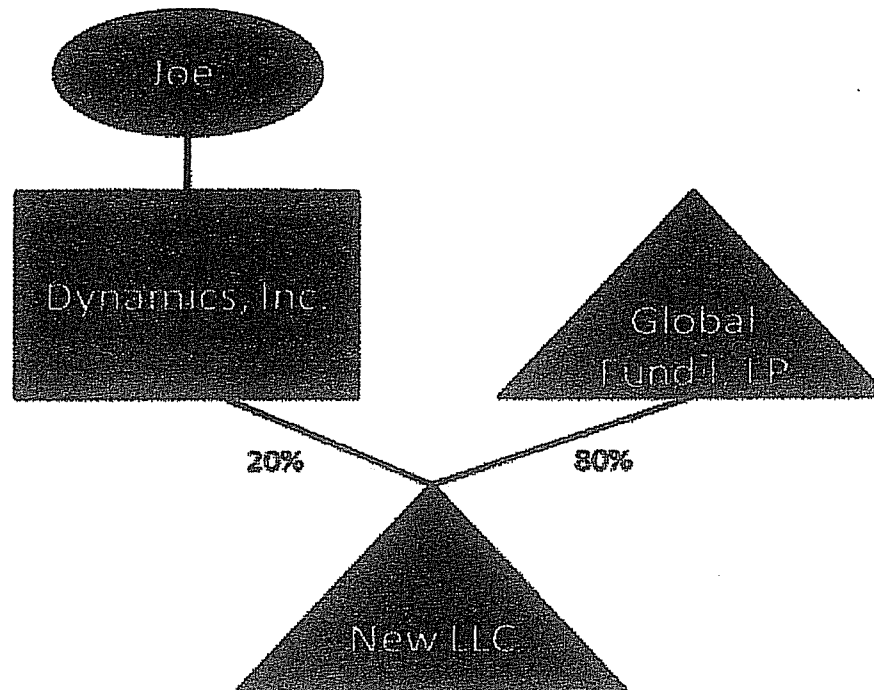
⁵⁶ Historic income tax methods also would carry over.

⁵⁷ IRC Section 197(f)(9)(C).

⁵⁸ IRC Section 197(f)(9)(A).

⁵⁹ Revenue Ruling 71-450, 1971-2 C.B. 78. See Also Revenue Ruling 76-520, 1976-2 C.B. 42; *James M. Pierce Corporation*.

The following is a diagram of the ownership after Fund I has bought the LLC units.



The IRS has ruled on this transaction. Under the ruling, the purchase of the LLC units by Fund I is, for income tax purposes, a series of fictional transactions. First, Fund I bought 80 percent of each asset and assumed 80 percent of the liabilities of the business. Then, Fund I and Dynamics formed New LLC and contributed their proportional shares of assets and liabilities to New LLC in exchange for New LLC units (the “LLC Transaction”).⁶⁰

There are some important differences in tax treatment between this LLC transaction and the 338 Election:

- The LLC Transaction triggers only 80 percent of the gain. The gain on the twenty percent undivided interest in assets contributed by Dynamics to New LLC is likely tax deferred.⁶¹ However, this creates complexity post close because there is built-in gain on those assets. And, those assets are in a tax

⁶⁰ Revenue Ruling 99-5, *Situation 1*, 1999-1 C.B. 434.

⁶¹ IRC Section 721. However, one must analyze the debt allocation and the impact of the disguised sale rules.

partnership subject to Subchapter K.⁶²

- In the LLC Transaction, the business stays in a flow-through entity. There will be just one tax layer imposed at the owner level. Also, the owners can offer a step-up in basis to a future buyer.
- Historic income tax liabilities stay with the seller (for example, built-in gain tax exposure, and state income tax exposure).⁶³ However, other liabilities that attach to the business under general corporate laws do carry over to the buyer (for example, environmental liability, product liability, payroll tax liability).⁶⁴
- In the LLC Transaction, the buyer and seller do not have to make an election to get a step-up in basis for the assets, because the buyer bought them from the seller in a Revenue Ruling 99-5 fictional transaction.

The following are other issues to consider in the LLC Transaction:

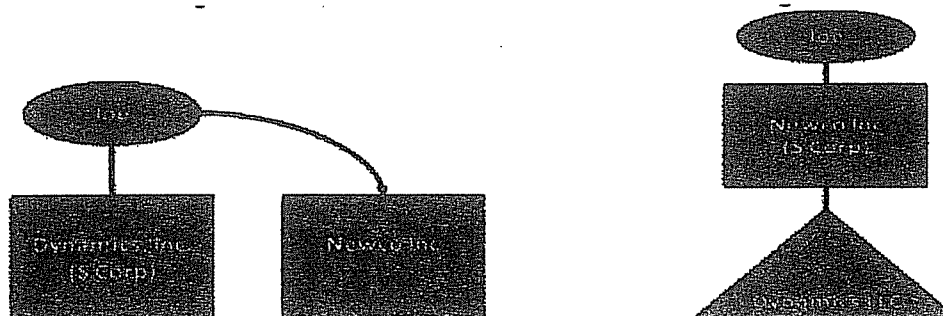
- If transferring title is a problem, the parties can use alternative structures.⁶⁵

⁶² The choice of 704(c) method (traditional, traditional with curative allocations, or remedial) will control how quickly the contributing partner recognizes the built-in-gain.

⁶³ Note that while Public Law 86-272 does protect sales solicitation for tangible goods; however it does not protect sales solicitation of intangible goods. In our facts above, the traveling employees can create income tax nexus in other states. This would present an income tax liability, which would stay with the seller because the S corporation would continue to be the taxpayer for federal and state income tax purposes even after the disposition of the LLC.

⁶⁴ In a consolidated group, the joint and several liability of Treas. Reg. Section 1.1502-6 also carries over.

⁶⁵ As an example, Joe can form a new corporation ("Newco Inc"). Next, Joe will transfer all the Dynamics stock to Newco Inc and immediately convert Dynamics to a state law limited liability company using a Certificate of Conversion ("Dynamics LLC"). This likely qualifies as a reorganization under IRC Section 368(a)(1)(F). The S corporation election carries over to Newco Inc. Revenue Ruling 64-250, 1964-2 C.B. 333. The Employer Identification Number carries over to Dynamics LLC. Revenue Ruling 2008-18, 2008-13 I.R.B. 674. See also, Revenue Ruling 2004-59, 2004-24 I.R.B. 1050; and Treas. Reg. Section 301.7701-3.



- If Fund I has tax-exempt or foreign investors, those investors, or Fund I, could form a blocker corporation to buy the New LLC units.
- If the goodwill existed before August 11, 1993 and the seller wants to keep more than 20 percent ownership, there are other arrangements under which the buyer can amortize the basis of the intangibles it bought.⁶⁶
- The parties can form a holding company LLC above New LLC to offer flexibility for future acquisitions.
- If the seller has a high outside basis in the S corporation, he should consider dissolving the corporation in the same tax year.
- The flow-through nature of the LLC means the owners will have added tax filing responsibilities. They will have to file returns and pay taxes in each jurisdiction the LLC does business, unless composite returns are available.
- Provided there is proper documentation of a valid business purpose for the transaction, there would not be any California sales or use tax.⁶⁷

The LLC Transaction does not do away with the need for a gross-up payment to the seller. However, it does help with other tax issues present in a 338 Election and it does keep the business in a flow-through entity. Depending on the size of the particular transaction, these benefits may outweigh the added time and cost of working through the complexities presented by LLCs.

¶ 410 CONCLUSION

As discussed in this article, the parties should consider the use of an LLC in any business acquisition because it can provide significant tax advantages for both the buyer and seller. To recap, some major disadvantages of the 338 Election include full gain recognition even if selling less than all the stock, and the business operations are in a C corporation, which is subject to double taxation. By using an LLC, the business stays in a flow-through entity, which enjoys only one layer of taxation, and the seller defers gain recognition if selling less than all of the ownership.

⁶⁶ See Treas. Reg. Section 1.197-2(k), *Example 19*.

⁶⁷ RTC Section 395.1570.

PUBLICATION UPDATE

Route to: _____ _____ _____ _____
 _____ _____ _____ _____

University of Southern
California
Gould School of Law
2010 Tax Institute

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HIGHLIGHTS

• Matthew Bender and the University of Southern California Gould School of Law are pleased to present this new compilation of thirteen articles written by the biggest names in the field of taxation. The articles are divided into three areas: corporate and business; partnership and real estate; and estate planning.

CORPORATE — LARGE & PRIVATELY HELD: (5 articles): Tax Issues for Troubled Companies; The Unified Loss Rule: An Overview; Valuing Privately Held Assets in Troubled Times; Structuring Alternatives for Buying and Selling Privately Held Businesses; Primer on At-Risk Rules and Passive Loss Rules.

PARTNERSHIP AND REAL ESTATE TAX PLANNING (4 articles): Recent Developments in Partnership Taxa-

tion; Exiting a Partnership in Good Times and in Bad; Current Issues in Section 1031 Exchanges; Discounts and Valuations Inside the Courtroom.

ESTATE PLANNING (4 articles): Recent Wealth Transfer Tax Developments; Creative Alternatives to Fix “Bad” Estate Plans; Estate and Income Tax Planning for the Passage of Family Homes Using QPRTs, Split Interest Purchases, Family LLCs, Dynasty Trusts, Conservation Easements and Other Strategies (*Including a Discussion of Non-Tax Considerations*); Application of the “Change in Ownership” Rules Under California Property Tax Law to Estate Planning and Administration Matters: *Pacific Southwest Realty, Steinhart, and Beyond*.

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