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Leveraging LLCs to Outperform 338 Transactions

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It is official: The current M&A market rivals the height of the 2007 market and makes it compelling for business owners to consider an exit. Many private businesses in Orange County are S corporations because owners can limit their liability and enjoy one level of tax on income. However, California does impose a 1.5 percent tax on S corporation profits. Buyers also favor S corporations over C corporations because they can acquire the stock and make a joint election with the seller to treat the transaction as an asset purchase for income tax purposes only pursuant to section 338(h)(10) of the Internal Revenue Code – often referred to as the "338 Election." This gives the buyer a stepped-up basis in the purchased assets which provides future income tax benefits.

When a target company has one owner, has been an S corporation since inception, and is being entirely sold in an all cash deal, the 338 Election can work well. However, deals today are complicated because there may be multiple shareholders that may have residences in different states, the company may have started as a C corporation before it became an S corporation, the buyer may require a 20 percent or larger rollover by the existing owners, the buyer may defer a portion of the payment through an escrow hold back, an installment note or an earn-out agreement, or the buyer may simply question the validity of the S corporation status of the target.

Many buyers and sellers can bridge their differences by introducing limited liability companies ("LLCs") into the transaction. This can be done in many ways. For example, we recently worked with a private business, structured as an S corporation, where the buyer was going to purchase only 80 percent of the company and wanted the seller to retain one of the two divisions of the business. We restructured the target company so that the shareholders ended up owning an S corporation that owned an LLC, which held the division that the buyer was interested in acquiring and retained the other division. The buyer paid cash to the S corporation, in exchange for 80 percent of the LLC units.

The result was that the buyer automatically obtained a stepped-up basis in the assets, and the S corporation was able to invest in the deal using pre-tax dollars and was able to retain the division the buyer did not want without triggering a taxable event. This structure also permitted the business to continue to operate in a flow-through structure. In contrast, if the buyer had forced the seller to distribute the unwanted assets, it would have been a taxable event. Additionally, if the buyer had purchased 80 percent of the stock and made a 338 Election, it would trigger 100 percent of the gain and force the seller to invest using after-tax dollars.

By using LLCs, buyers and sellers often obtain more favorable tax results than in transactions with a 338 Election.

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