CHAPTER 4

Structuring the Acquisition of an S Corporation to Achieve an Asset Basis Step Up

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Synopsis

¶ 400 SCOPE

The focus of this article is to discuss structuring alternatives for the acquisition of the business conducted by an S corporation where the parties would like to achieve a step up in the basis of the target company's assets. We will compare the federal income

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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)[1] ("338 Election"). Under a 338 Election, the stock sale is treated as an asset sale for federal income tax purposes.[2] The second alternative is selling the units of a limited liability company ("LLC") (the "LLC Transaction").[3] 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. We will also discuss several key tax issues faced by the parties to these transactions.

¶ 401 THE DEAL TERMS

As with most deals, the buyer would prefer to buy assets while the seller would prefer 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,[4] and leaving behind unwanted corporate liabilities.[5] Some significant advantages the seller achieves by selling stock include

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[1] All "IRC § " references herein are to the Internal Revenue Code of 1986, as amended, ("IRC") and all "Treas Reg § " references are to the regulations thereunder. All "IRS" references are to the Internal Revenue Service.

[2] The focus of this article is a target S corporation. An election under IRC § 338(h)(10) is also available to subsidiary members of a consolidated group or subsidiary members of a domestic affiliated group. Treas Reg § 1.338(h)(10)-1(c). An election under IRC § 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 pursuant to IRC § 336(e) seller can elect to treat a stock sale as an asset sale for qualifying stock dispositions of a domestic target.

[3] For purposes of this document, we will assume the LLC has not elected to be taxed as a corporation and therefore Treas Reg § 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.

[4] 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.

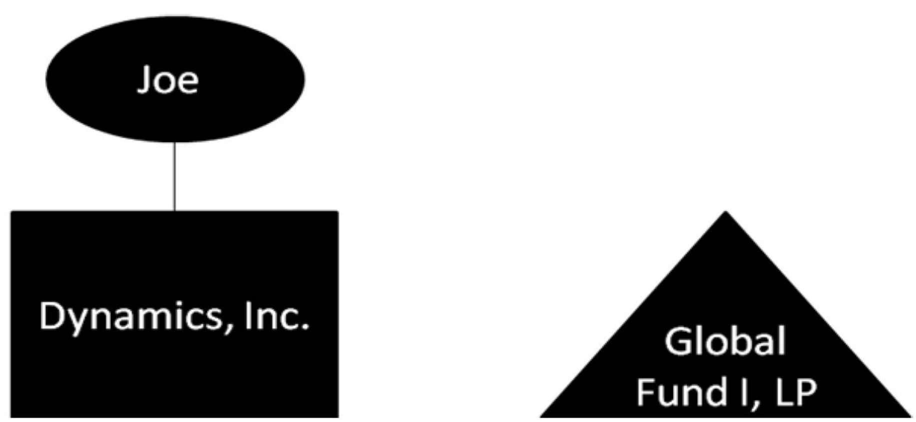
[5] Certain liabilities may carry over in a bulk sale. A buyer should consult an attorney. Also, be mindful that members of a consolidated group have joint and several liability under Treas Reg § 1.1502-6 for income taxes owed by the group for any year during which they were a member. Buyers can avoid 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 from exposure under Treas Reg § 1.1502-6. Treas Reg § 1.338-1(b)(3); FSA 200052003. Even if the buyer has contractual protections from the seller, the IRS can assess the target, in which case the buyer would have to pursue the seller for an indemnity claim.

treating the gain on the sale as capital gain,[6] not being primarily responsible for historic liabilities, and not having to transfer and re-title each asset and license.[7]

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 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 operates 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.

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[6] If the sale was an asset sale, some portion of the gain may be characterized as ordinary income. For example, recapture of depreciation and amortization, IRC § 1231 recapture, zero-basis assets (e.g., cash basis accounts receivable), inventory, and copyrightable assets (for example, see *David D. Levy v. Commissioner*, TC 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.).

[7] In addition, transfer and sales taxes may result from an asset sale.

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 enough additional cash to compensate him for any incremental taxes incurred as a result of the deemed asset sale treatment. Fund I agrees to make both Joe and Dynamics whole for added taxes from the deemed asset sale compared with a straight stock sale.

¶ 403 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.[8] 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 and avoids the need to legally assign each of the target's assets.[9]

To qualify for the 338 Election, the seller must be an S corporation shareholder and the target must be a valid S corporation.[10] 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.[11] 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.[12] 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

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[8] 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 § 1374. Note that the recently enacted PATH Act reduced the length of time following such a conversion or transaction that a corporation will be subject to the built-in gains tax to five years. Thus far, California has not conformed to this change and the period remains ten years for California income tax purposes.

[9] Also, the Federal ID number carries over and the payroll and benefit plans can remain unchanged.

[10] Treas Reg §§ s 1.338(h)(10)-1(c)(1) and -1(b)(4).

[11] 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 (such as disproportionate distributions), 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*).

[12] Treas Reg § 1.338(h)(10)-1(c)(5).

company.[13]

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.[14] 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 318(a).[15]

In addition, the buyer must be a corporation.[16]

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

¶ 404 SELLING THE STOCK

Fund I forms a new corporation ("Newco") to buy the stock and funds it with cash.[17] 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 purposes of qualifying to make a 338 Election.[18]

The following is an illustration of the resulting ownership:

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[13] 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.

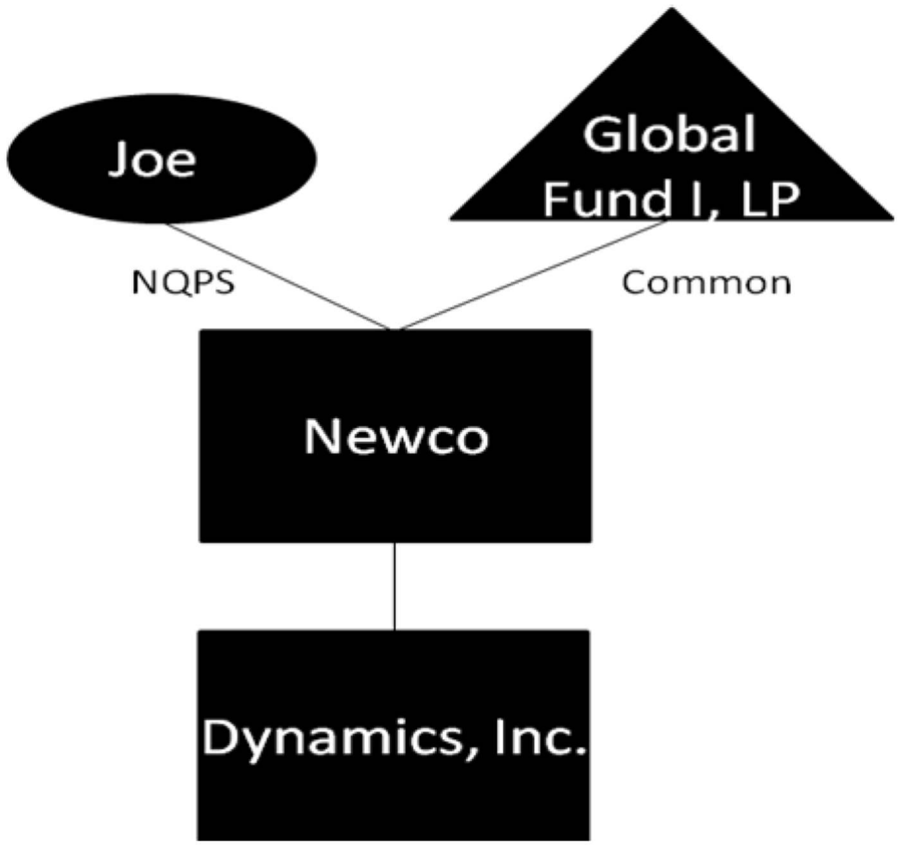
[14] IRC § 338(d)(3).

[15] IRC § 338(h)(3).

[16] IRC § 338(d)(1).

[17] 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 § 1.338(h)(10)-1(c)(2). If acquirer desires a non-corporate acquirer, IRC § 336(e) may provide a better structure than a stock sale with a 338 Election.

[18] There are several other ways to "fail" IRC § 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 Rev Rul 84-44, 1984-1 CB 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 and most buyers prefer to have seller own at the Newco level.



The buyer and seller must make a joint election on Form 8023 to qualify for asset sale treatment.[19] 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.[20] The IRS does provide relief in certain cases where an election is late.[21] Some states do not recognize federal S corporation status. The advisors to the transaction should review the corporation's status in each state in which it does business to understand the impact of

[19] All S corporation shareholders must consent. Treas Reg § 1.338(h)(10)-1(c)(3).

[20] Treas Reg § 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.

[21] See Rev Proc 2003-33, 2003-1 CB 803.

the 338 Election from a state tax perspective for both buyer and seller.

¶ 405 THE EFFECT OF THE 338 ELECTION

The 338 Election creates a series of fictional transactions for federal income tax purposes.[22] First, Dynamics sells all of its assets and transfers all of its liabilities to a fictional "New Dynamics", an unrelated party,[23] receiving cash.[24] 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.[25] Finally, Newco buys the stock of New Dynamics, which now has a new cost basis in the assets.[26]

Because Dynamics is an S corporation, the gain flows through to Joe, who recognizes the income and pays the tax.[27] 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.[28]

- We first allocate the purchase price to Class I assets up to their fair market value. Class I assets include cash and general deposit accounts.[29]
- 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.[30]
- Next, we allocate the purchase price to Class III assets up to their fair market

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[22] See IRC § 338(a); Treas Reg § 1.338(h)(10)-1(d)(4); Treas Reg § 1.338(h)(10)-1(d)(4); and Treas Reg § 1.338(h)(10)-1(e), *Example 10*.

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

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

[25] Treas Reg § 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 § 1.1502-76(b)(1).

[26] Treas Reg § 1.338(h)(10)-1(d)(2); Treas Reg § 1.338(h)(10)-1(e), *Example 5(v)* and *(vi)*.

[27] IRC § 1366(a).

[28] Treas Reg § 1.338(h)(10)-1(d)(2); Treas Reg § 1.338(h)(10)-1(d)(3).

[29] Treas Reg § 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.

[30] Treas Reg § 1.338-6(b)(2)(ii).

value. Class III assets include accounts receivable, certain debt instruments, and assets that are marked-to-market each year.[31]

- 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.[32]
- 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.[33]
- 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.[34]
- Finally, we allocate the residual purchase price to Class VII assets, which are goodwill and going concern value.[35]

When total purchase price available for allocation is exhausted, the allocation is complete. 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.[36] If the price changes, one allocates the re-determined price using the residual method.[37]

We recommend the buyer and seller agree on the purchase price allocation for each category of assets and attach an allocation statement to the agreement.[38] Please note the purchase price calculated by the buyer will often not match the sale price calculated by the seller because of transaction costs.[39] As a result, the allocations to the

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[31] Treas Reg § 1.338-6(b)(2)(iii).

[32] Treas Reg § 1.338-6(b)(2)(iv).

[33] Treas Reg § 1.338-6(b)(2)(v).

[34] Treas Reg § 1.338-6(b)(2)(vi).

[35] Treas Reg § 1.338-6(b)(2)(viI).

[36] Treas Reg § 1.338-6(b)(2)(i).

[37] See Treas Reg § 1.338-7.

[38] 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).

[39] Treas Reg § 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 § 1.338-6(a)(2)(ii).

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.[40]

After dividing the purchase price, Joe uses the basis in each asset to compute 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.

¶ 406 MAKING THE SELLER WHOLE FOR ADDED TAXES THAT RESULT

¶ 1 General Considerations

In our transaction, Fund I has agreed to make the seller whole for incremental taxes that result from the 338 Election.[41] 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.[42] Some of the important items to consider when comparing a stock sale to an asset sale include:

- Because Dynamics operates in California, 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);[43]
- Because Dynamics operates in California, Joe will be subject to California income tax on the gain allocated to him;[44]

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[40] 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.

[41] 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.

[42] This assumes buyer allows Joe to keep his stock and does not force Joe to trade his stock for stock in another corporation. For example, a public buyer would insist that Joe trade his shares for publicly traded stock, which is a taxable exchange.

[43] 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. Many states have slower depreciation, which would create higher basis in assets and lower gain for state tax purposes.

[44] Although this would also be true in a straight stock sale if Joe is a California resident, this would not be the case in a straight stock sale if Joe were a non-California resident. For example, if Joe were a resident of a state that does not have a personal income tax, such as Florida, Joe would not pay any state income tax on a straight stock sale, whereas the 338 Election would cause him to incur California income tax on the gain from the deemed asset sale (at rates approaching 14 percent under current law). See the discussion below under the heading *Residency Issues*.

- The gain on the sale of assets can result in ordinary income;[45]
- 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 deduction under the economic performance rules;[46]
- 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;[47]
- Transfer taxes and/or reassessment of real property for property tax purposes may result;[48]
- Local taxes may apply;[49]
- Any future consideration may be eligible for installment sale treatment;[50]
- If future consideration does not bear enough interest, some of the capital gain would become interest income under the imputed interest rules;[51]
- If future consideration is more than $5,000,000 there is an interest charge on the deferred tax;[52]
- The seller may be in alternative minimum tax and may not be able to deduct state taxes; and
- Seller may have more gain in an asset sale as a result of having an outside basis that is higher than the target's inside basis in its assets.[53]

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[45] This determination primarily depends on the purchase price allocation and the seller's method of accounting. *Supra footnote 6*.

[46] See Treas Reg 1.461-5; *James M. Pierce Corporation*, 326 F2d 67 (8th Cir 1964); *Commercial Security Bank*, 77 TC 145 (1981). This deduction can significantly reduce the impact of ordinary income where the seller is a cash basis taxpayer.

[47] IRC § 1374.

[48] 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 because of an indirect change in control.

[49] Certain cities assess tax based on gross receipts.

[50] But see the discussion below under the heading *Installment Sale Issue*.

[51] IRC § 483.

[52] IRC § 453A. See TAM9853002 (holding that each spouse has a separate limit for purposes of IRC § 453A).

[53] For example, seller may have bought the stock of a C corporation and then converted it to an S corporation. Note that this is generally not an issue so long as the target liquidates in the same tax year as the asset sale (including a deemed liquidation resulting from a 338 Election).

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 (often referred to as a "gross-up" calculation). 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 it is important that the parties decide the method and facts used to calculate the gross-up amount before closing.

¶ 2 Common Issues

All of the issues listed above can increase the seller's tax cost in a deemed asset sale structure as compared to a straight stock sale and all are important to consider.[54] However, two common issues that merit further discussion are the impact of the residence of the selling stockholders on the feasibility of a gross-up and, separately, the interplay between the installment sale rules and the rules that apply to a liquidation of the target (including a deemed liquidation of the target S corporation in connection with a 338 Election).

A. Residency Issues

In a typical transaction, the tax benefit to the buyer of the basis step-up will exceed the incremental costs incurred by the seller as the result of the asset sale structure, such that a gross-up can make economic sense. However, one increasingly common scenario in which the costs to the seller of structuring the transaction for asset sale treatment can exceed the potential tax benefits to be realized by the buyer is where the S corporation itself is subject to tax in one or more high tax states, but the selling S corporation shareholders are resident in a state that imposes little or no personal income tax. The prototypical example is an S corporation whose business is conducted entirely in California, and that has a sole shareholder who resides in Florida or Texas.[55]

In a straight stock sale, this shareholder would not pay California or any other state income tax.[56] However, gain from the sale of business assets by an S corporation,

[54] An actual asset sale will have similar costs to a deemed asset sale. However, an actual asset sale will involve more legal work and it can trigger additional taxes, such as sales tax and transfer tax. In addition, in an actual asset sale, the target S corporation may or may not liquidate immediately following the sale; whereas the target S corporation in a 338 Election will undergo a deemed liquidation for tax purposes immediately following the deemed asset sale.

[55] It is quite common that the shareholder in this scenario will have left California specifically because of its high personal income tax rates. In such a case, avoiding the payment of California income tax on the gains from the sale of the S corporation is absolutely critical to the shareholder. We have assumed for purposes of this article that the shareholder is a bona fide non-resident and non-domiciliary of California for California income tax purposes. States which have no personal income tax as of the date of this article are: Alaska, Florida, Nevada, South Carolina, Texas, Washington and Wyoming. Note, however, that these no tax states may have death tax and higher rates for other taxes such as property tax.

[56] For state income tax purposes, gain from the sale of stock is generally sourced to the residence of the seller. RTC Section 17952.

including the deemed asset sale triggered by a 338 Election, is generally subject to apportionment, such that 100 percent of the gain realized by a target that operates and sells solely in California will be sourced to California.[57] The practical impact of these rules is that a shareholder in this position would pay no state income tax on a straight stock sale, but would pay full state income tax on all of the gain if a 338 Election is made. The incremental cost created by these additional state taxes can be so large that a buyer is unwilling to completely make the seller whole. Where you have a seller who moved out of California precisely to avoid California income tax on a sale of the business, and a buyer that computed the purchase price they would pay based on an assumption that they would obtain a basis step-up, this can be "deal killer." For that reason, it is critical that the correct expectations are set at the term sheet stage to avoid misaligned expectations in this scenario.

With some advance planning, and the right facts, it may be possible to mitigate the state taxes described above. For example, at the time of the shareholder's move out of California, the S corporation could engage in the "F" reorganization described in footnote 73. If the target company (now an LLC) were to issue an interest to another member (a profits interest to a key employee, for example), that would cause the target to be classified as a partnership for income tax purposes.[58] If, in a subsequent and separate transaction, all of the membership interests in the target LLC were sold to the buyer, the buyer could obtain a basis step up in the assets of the LLC, which would achieve the buyer's tax planning goal.[59] On the other hand, the shareholder's gain from the sale by the S corporation of its partnership interest may be sourced to the shareholder's state of residence, thereby avoiding California income tax.[60]

B. Installment Sale Issue

Another unexpected tax cost can arise due to the operation of the installment sale rules in the context of a liquidation (or deemed liquidation) of an S corporation. In most sale transactions, some portion of the purchase price will be payable in a taxable year following the taxable year of the sale, thereby bringing the installment sale rules into play. Common examples include transactions with deferred purchase price components (contingent or otherwise) such as earnouts or escrow arrangements, or

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[57] RTC Section 25128. The state sourcing and apportionment rules are complicated and vary by state.

[58] See Treas Reg § 1.197-2(k), *Example 19*.

[59] Rev Rul 99-6, *Situation 2*, 1991 CB 432. If less than 100 percent is purchased, the buyer can obtain a step-up in basis by making an election pursuant to IRC § 754.

[60] See *Valentino v. Franchise Tax Board*, 87 Cal App 4th 1284 (2001); see also *Appeal of Venture Communications, Inc.*, Cal State Bd of Equalization (Feb 5, 2003). Note that this outcome is not certain, and the California Franchise Tax Board commonly challenges this position based on an argument that the gain is trade or business income that must be apportioned.

transactions including seller financing where the seller agrees to accept a note from the buyer as a portion of the consideration.

In the normal application of the installment sale rules, the seller's basis would be recovered over the term of the installment payments in a relatively straightforward way such that the seller would only be taxed as of the closing date on the portion of their gain attributable to the purchase price actually received in cash at that time. Further, the installment sale rules contain a special rule that is intended to allow an S corporation to liquidate and preserve that treatment.[61] Unfortunately, that rule is not well coordinated with the rules governing liquidations of S corporations under IRC Section 331. As a result, if, as is typical, the closing date consideration is comprised of cash and an installment obligation, the selling shareholder is required to allocate their stock basis between the cash and the installment obligation, causing the shareholder to recognize immediate gain on receipt of the cash. The practical impact of this is to accelerate some portion of the gain that would otherwise have been deferred under the installment method, and the larger the installment obligation relative to the cash, the larger this issue becomes.[62]

This potential trap is avoided by ensuring that the S corporation does not hold any cash at the time it liquidates. This can be a problem where, as is almost always the case, a portion of the purchase price is to be paid in cash at the closing. The simplest and most common solution to this problem is to have the portion of the purchase price that was to be paid in cash at closing to instead be paid in the form of a short term note, for example, one that is payable a day or two after the planned liquidation of the S corporation. In this way, the S Corporation will hold only installment obligations at the time of its liquidation and the acceleration triggered on a liquidating distribution of cash will be avoided. This solves a tax problem but creates an economic problem because seller is forced to give up ownership without getting any cash at closing.[63] The LLC Transaction discussed below can help solve this tax problem without creating an economic burden, by allowing the S corporation to remain in existence following the asset sale.

¶ 407 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.[64] Because of the

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[61] IRC § 453B(h).

[62] Note, under the installment sale rules, a taxpayer is required to use the face amount of the obligation as the deemed price of the obligation. See Treas Reg § 15a.453-1(c)(2)(i).

[63] It is possible to mitigate this credit risk issue by utilizing a stand by letter of credit. This must be properly structured to qualify for installment reporting. See Treas Reg § 15a.453-1(b)(3)(iii).

[64] Historic income tax methods also would carry over.

deemed asset sale resulting from the 338 Election, the buyer may take the target's assets with an increased tax basis, which the buyer can amortize and depreciate over time, helping to 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, which is applied both before and after the transaction),[65] the seller continues to use the intangible post-closing, or the buyer grants the right to use the intangible to the seller.[66] 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. Because the relatedness test is applied both before and after the transaction, careful attention must be paid to any equity rollover that will result in target shareholders holding more than 20% of the resulting entity. 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.[67]

¶ 408 HOW TO USE LLCS TO ACHIEVE MORE TAX EFFICIENCY THAN A 338 ELECTION

While the 338 Election can work well in some transactions, it does present many tax inefficiencies. As discussed above, a sale of less than all of the stock triggers all the gain (e.g., in the example above, Joe sold only 80 percent of his stock, but recognized 100 percent of the built-in 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. 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.

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

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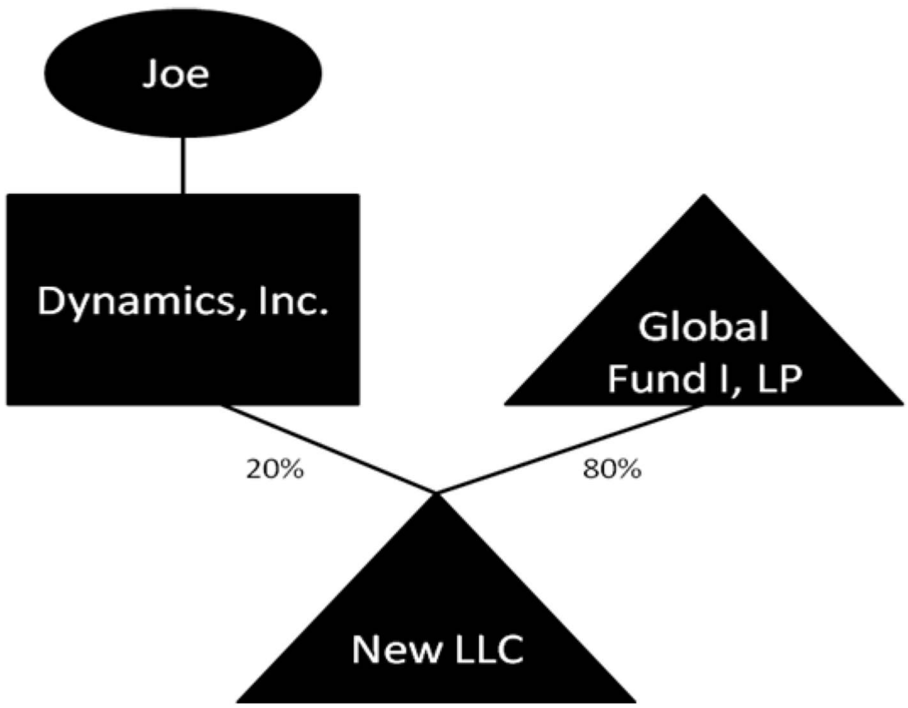
[65] IRC § 197(f)(9)(C).

[66] IRC § 197(f)(9)(A).

[67] Rev Rul 71-450, 1971-2 CB 78. See also Rev Rul 76-520, 1976-2 CB 42; *James M. Pierce Corporation.*



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").[68]

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.[69] However, this creates complexity post close

[68] Rev Rul 99-5, *Situation 1*, 1999-1 CB 434.

[69] IRC § 721. However, one must analyze the debt allocation and the impact of the disguised sale rules.

because there is built-in gain on those assets. And, those assets are in a tax partnership subject to Subchapter K.[70]

- 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 without incurring a second level of tax.
- Certain historic income tax liabilities stay with the seller (for example, built-in gain tax exposure, and state income tax exposure).[71] 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).[72]
- 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. Importantly, buyer's step-up is not contingent on a valid S election.

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

- If transferring title or obtaining a new Federal ID number is a problem, the parties can use alternative structures.[73]
- 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

[70] 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.

[71] Note that PL 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. Note that in the "F" reorganization/conversion structure discussed in *footnote 73*, all historic tax liabilities would transfer to the buyer because the target as a legal entity would be the historic taxpayer. See CCA 200840001.

[72] In a consolidated group, the joint and several liability of Treas Reg § 1.1502-6 also carries over.

[73] 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 § 368(a)(1)(F). The S corporation election carries over to Newco Inc. Rev Rul 64-250, 1964-2 CB 333. The Employer Identification Number carries over to Dynamics LLC. Rev Rul 2008-18, 2008-13 IRB 674. See also, Rev Rul 2004-59, 2004-24 IRB 1050; and Treas Reg § 301.7701-3.

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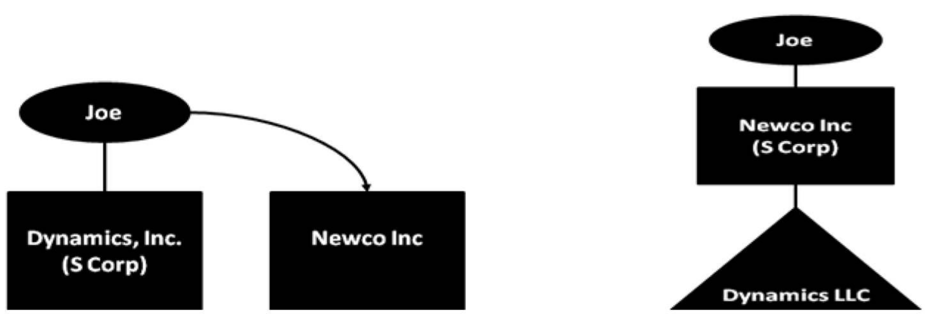
buyer can amortize the basis of the intangibles it bought.[74]

- Assets that are required to be removed from the company before the sale can be transferred from New LLC to Dynamics, Inc. in a tax efficient manner.
- The sale of LLC units is treated as an asset sale that can qualify as a tax deferred like-kind exchange pursuant to IRC Section 1031 assuming the seller can replace the sold property with like-kind property in a timely manner.[75]
- 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, although this would trigger the built-in gain in any "rollover" equity received.
- 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.[76]
- The seller in this transaction is Dynamics, Inc., an S corporation. Therefore, the sale should qualify for installment reporting and because there is no liquidation, there is no gain acceleration. The S corporation continues to file returns and can liquidate once all the sale proceeds are collected and reported. In other words, the timing of the final return can be controlled by seller.

The LLC Transaction does not do away with the need for a gross-up payment to the



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74 See Treas Reg § 1.197-2(k), *Example 19*.

75 See PLR 200118023; PLR 200807005; PLR 2001310014; 200521002; PLR 200151017.

76 RTC Section 395.1570.

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seller. However, it does help with certain of the other tax issues present in a 338 Election as discussed above, 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.

¶ 409 CONCLUSION

The parties to the sale of a business held in an S corporation have a variety of tax issues to consider. 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 and flexibility 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.