College of William & Mary Law School
William & Mary Law School Scholarship Repository

William & Mary Annual Tax Conference | Conferences, Events, and Lectures

2012

Introduction to M&A Tax: Due Diligence Traps in S Corp Acquisitions (Slides)

Robert G. McElroy

William M. Richardson
William & Mary Law School, wmrichardson@wm.edu

Repository Citation
McElroy, Robert G. and Richardson, William M., "Introduction to M&A Tax: Due Diligence Traps in S Corp Acquisitions (Slides)" (2012). *William & Mary Annual Tax Conference.* Paper 675.
http://scholarship.law.wm.edu/tax/675

Copyright c 2012 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
http://scholarship.law.wm.edu/tax

William & Mary Tax Conference
November 8, 2012

Robert G. McElroy
McGuireWoods LLP
(804) 775-1067
rmcelroy@mcguirewoods.com

William M. Richardson
William & Mary Law School
(757) 221-1083
wmrichardson@wm.edu

Introduction to S Corp Acquisitions

- S corps present unique due diligence issues.
- Target’s failure to qualify as an S corporation can have significant adverse implications to Buyer:
  - Liability for prior year C corporation taxes; and
  - Failure to secure basis step-up (assuming a “qualified stock purchase” and IRC § 338(h)(10) election), and
- Seller indemnifications may offer some protection – but escrows often are insufficient to cover Acquiring’s tax risk.

Examples: Assumptions

- Target is a Virginia corporation;
- Target shareholders are U.S. persons;
- Target has filed tax returns as an S corporation;
- Target has never been subject to a federal or state tax examination;
- Acquiring is a Virginia corporation; and
- Parties are negotiating an acquisition with an IRC § 338(h)(10) election.

Example 1: Nonconsenting Spouse

Facts:

During due diligence, Acquiring's tax advisor discovers that one of Target's shareholders is married (and has been since before she acquired that stock). The stock has always been titled solely in her own name. The shareholder resided in a community property state when she acquired her Target stock and when Target's S election was made. There is no evidence the shareholder's husband consented to the S election.

Example 1: Nonconsenting Spouse

a) What is the problem?

- S corp election not effective unless, among other requirements, all shareholders consent. IRC § 1362(a)(2). Spouses of shareholders residing in community property state must consent and sign Form 2553. Treas. Reg. § 1.1362-6(b)(2)(i).

b) Is there a solution?

- Rev. Proc. 2004-35 provides automatic relief for late consents to S corporation elections in community property states.
- Relief available only if:
    - The S election is invalid solely because the Form 2553 failed to include the signature of a community property spouse who was a shareholder "solely pursuant to state community property law," and
    - Both spouses reported all items of income, gain, loss, deduction, or credit consistent with the S corporation election on all federal income tax returns.

c) Is the solution practical?

Example 2: Nongrantor Trust as Shareholder

<u>Facts</u>:

One of Target's shareholders is a trust that purports to be a grantor trust of which Target's chief executive officer is the sole owner. The trust has owned some of the Target stock for many years. During due diligence, Acquiring's tax advisor examines the relevant trust documents and concludes that the trust is not a grantor trust but meets all requirements to elect to be a qualified subchapter S trust ("QSST"). However, no QSST election ever was made.

Example 2: Nongrantor Trust as Shareholder

a) What is the problem?

- Qualified Small Business Trusts (QSSTs) may be S corp shareholders, but only if the trust's current income beneficiary makes a QSST election. IRC § 1361(d)(3).
- Election made by filing statement with IRS Service Center where corporation files its income tax return.
- Statement due within 2 months and 16 days after trust receives S corporation stock (assuming QSST does not own stock on day corporation elects S corp status). Treas. Reg. § 1.1361-1(j)(6).
- Failure to timely file QSST election will invalidate or terminate S corp status.

Example 2: Nongrantor Trust as Shareholder

b) Is there a solution?

- Rev. Proc. 2007-62 and Rev. Proc. 2003-43 provide simplified procedures for relief – but are they applicable?
- Rev. Proc. 2007-62 grants relief, but only if failure arises because of failure to file a timely Form 2553 and, among other requirements, (i) the entity has not yet filed its corporate tax return for the first year in which the election was intended, and (ii) a completed Form 2553 is filed within 6 months of original due date of the corporation's tax return (excluding extensions).
- Rev. Proc. 2003-43 grants relief, but only if, among other requirements, less than 18 or 24 months (depending on the situation presented) have passed since the original due date of the election.
- Private letter ruling. Service may grant relief for a late QSST election (and the resulting inadvertent termination of S corp status or the inadvertent invalid S corp election) if the standard described in IRC § 1362(f) is satisfied.

c) Is the solution practical?

Example 3: Disproportionate Tax Distributions

Facts:

During due diligence, Acquiring's tax advisor discovers that Target has made "withholding tax" payments to Virginia on behalf of nonresident shareholders under Virginia Code § 58.1-486.2, that those payments have been ignored by Target when calculating the amount of distributions it has made each year to its shareholders, and that there is no evidence the nonresident shareholders are obligated to reimburse Target for the amount of those tax payments.

Example 3: Disproportionate Tax Distributions

a) What is the problem?

- To qualify and maintain S status, corporation must have one class of stock. IRC § 1361(b)(1)(D).
- Generally, a corporation is treated as having only one class of stock if all outstanding shares confer identical rights to distribution and liquidation proceeds. Treas. Reg. § 1.1361-1(l)(2)(i).
- A binding agreement by which a corporation increases distributions to shareholders with heavier state tax burdens violates the "one class of stock" requirement. Treas. Reg. § 1.1361-1(l)(2)(v), *Example 6.*
- However, the "one class of stock" requirement is not violated if state law requires a corporation to withhold and remit state income taxes on behalf of nonresident shareholders, provided:
  - i. Resident shareholders have the right (under state law, by organizational document or agreement) to an equivalent *pro rata* distribution, or
  - ii. The corporation treats state tax payments as advances to nonresident shareholders and the governing documents require repayment or offset. Treas. Reg. § 1.1361-1(l)(2)(v), *Example 7.*

Example 3: Disproportionate Tax Distributions

b) Is there a solution?

- Determine if facts fit within Treas. Reg. § 1.1361-1(l)(2)(v), *Example 7*.
- If the facts do not satisfy *Example 7*, consider a private letter ruling under IRC § 1362(f). Relief under IRC § 1362(f) is available if, among other requirements, the S election was:
    i. Ineffective by reason of failure to meet requirements of IRC § 1361(b) (including the one class of stock requirement) or to obtain shareholder consents, or
    ii. Terminated under IRC § 1362(d)(2) or (3). *See,* Ltr. Rul. 200730009; Ltr. Rul. 200722011; Ltr. Rul. 200933021; and Ltr. Rul. 201006026.

c) Is the solution practical?

Example 4: Target Debt vs. Equity

Facts:

Target has a large amount of debt owed to its majority shareholder, and Target is thinly capitalized (its debt-to-equity ratio is 100:1). The debt owed to the majority shareholder is evidenced by several promissory notes each of which is for a fixed amount, has a fixed maturity date, provides for interest payable annually at a fixed rate, and is not convertible into Target stock. Acquiring's tax advisor concludes that the debt should be treated as equity under general federal income tax principles.

Example 4: Target Debt vs. Equity

a) What is the problem?

- There is none. Under IRC § 1361(c)(5)(A), "straight debt" is not treated as a second class of stock for purposes of determining whether a purported S corporation meets the "one class of stock" requirement of IRC § 1361(b)(1)(D).
- "Straight debt" is defined as "any written unconditional promise to pay on demand or on a specified date a sum certain in money if:
    i. the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors;
    ii. there is no convertibility (directly or indirectly) into stock; and
    iii. the creditor is an individual (other than a nonresident alien), an estate, a permitted trust, or a person actively and regularly engaged in the business of lending money." IRC § 1361(c)(5)(B).
- All those elements are satisfied here? *See*, Treas. Reg. § 1.1361-1(l)(5)(iv).

b) Is there a solution? None required.

Example 5: IRA as Shareholder

Facts:

One of Target’s shareholders is a physician. During due diligence, Acquiring’s tax advisor discovers that the physician transferred his shares of Target stock to his individual retirement account two years ago. Target’s Shareholders Agreement prohibits transfers to anyone that is not an eligible shareholder for an S corporation. The transfer to the IRA was not questioned by Target, and the custodian for the IRA is listed as the owner of those shares of Target stock in Target’s stock ledger.

Example 5: IRA as Shareholder

a) What is the problem?

- An IRA is not an eligible shareholder for an S corporation, except for certain banks and depository institution holding companies in which (and only to the extent to which) an IRA held stock on October 22, 2004. *See,* IRC § 1361(c)(2)(A)(vi); Treas. Reg. § 1.1361-1(h)(1)(vii). See also Taproot Administrative Services, Inc. v. Commissioner, 133 T.C. 202 (2009); Rev. Rul. 92-73.
- Although IRC § 1361(c)(6) permits tax-exempt organizations described in IRC § 401(a) or 501(c)(3) to be S corporation shareholders, an IRA described in IRC § 408(a) does not qualify.

Example 5: IRA as Shareholder

b) Is there a solution?

- Target probably could obtain a private letter ruling granting relief under IRC § 1362(f) for an inadvertent termination of its S status, but that would require:

    i. the IRA promptly to cease owning any Target stock; and

    ii. the parties to treat the IRA's beneficiary (the doctor) as owning the Target stock for the entire time it was owned by the IRA, except any taxable year for which Target reported a net loss. *See*, Ltr. Rul. 201119022; Ltr. Rul. 200915020.

- For the IRA to cease owning any Target stock, it could distribute the stock to the doctor; that would be taxable to the doctor.
- Alternatively, Target could redeem the stock from the IRA, or the IRA could sell the stock to an eligible shareholder, provided the sale would not be a prohibited transaction under IRC §§ 408(e)(2) and 4975.

c) Is the solution practical?

Example 6: Questionable IRC §1374 Appraisal

Facts:

Target, a calendar-year taxpayer, was a C corporation until six years ago. When Target converted from C to S status, Target obtained an appraisal that concluded the total fair market value of Target's assets did not exceed the total federal income tax bases of the assets. Accordingly, Target has always indicated on Form 1120-S, Schedule B, that it has no net unrealized built-in gain for purposes of IRC § 1374. Upon examining the appraisal report, Acquiring's tax advisor concludes that it is full of holes, especially because it ignored all off-balance-sheet assets. A large part of the fair market value of the Target stock is attributable to Target's goodwill and going concern value.

Example 6: Questionable IRC §1374 Appraisal

a) What is the problem?

- Having ignored off-balance-sheet assets (especially goodwill and going concern value), the appraisal does not support the position that Target had no net unrealized built-in gain for purposes of IRC § 1374 when Target converted from C to S status six years ago. *See,* Notice 2003-65 2002-2 C.B. 747.
- Consequently, all of Target's existing net unrealized built-in gain for purposes of IRC § 1374 is subject to tax, except to the extent Target can show that the gain did not exist when Target converted to S status. IRC § 1374(d)(2).

Example 6: Questionable IRC §1374 Appraisal

b) Is there a solution?

- One cannot make the built-in gain go away. Instead, one needs to determine the amount of net unrealized built-in gain as of the date Target converted to S status by means of a new, comprehensive appraisal, and ascertain the amount of IRC § 1374 tax potentially payable on that gain.
- Then one needs to devise a mechanism, probably an escrow, to protect Acquiring against the potential (probable?) tax, or reduce the acquisition price payable by Target by the amount of such tax.
- This may very well make the IRC § 338(h)(10) election undesirable.

c) Is the solution practical?

Example 7: Omitted QSub Election

Facts:

A couple of years ago, Target transferred assets and liabilities of one of its divisions, representing approximately half the total net worth of Target, to a new, wholly-owned subsidiary corporation ("Newco"). Target was advised by its then, but now former, tax advisor that Newco would be a "qualified subchapter S subsidiary" and Target has always treated Newco as merely a division of Target for purposes of filing income tax returns. During due diligence, Acquiring's tax advisor finds documents showing that an election form for Newco to be a qualified subchapter S subsidiary was to be prepared by Target's former tax advisor, but there are no documents evidencing that the election was ever prepared or filed or received by the IRS.

Example 7: Omitted QSub Election

a) What is the problem?

- Newco is taxable as a C corporation unless a timely election is filed to treat Newco as a qualified subchapter S subsidiary ("QSub"). IRC § 1361(b)(3)(A).
- Election made on Form 8869.
- QSub election effective on date specified on the form, or on the date of filing if no date specified.
- Specified effective date may not be more than 2 months and 15 days prior to the date of filing (and may not be more than 12 months after the date of filing). Treas. Reg. § 1.1361-3(4).
- Again, absent the filing of a timely Form 8869, Newco will be taxable as a C corporation.

Example 7: Omitted QSub Election

b) Is there a solution?

- Rev. Proc. 2004-49 (if applicable), Rev. Proc. 2003-43, or a private letter ruling.
- Rev. Proc. 2004-49 applies when an S corp transfers 100% of the QSub stock (whether by sale or reorganization) to another S corp. *See,* Rev. Rul. 2004-85.
- Rev. Proc. 2003-43 grants relief if, among other requirements, less than 18 or 24 months (depending on the situation) have passed since the election's due date.
- Beginning after 2004, IRC § 1362(f) was made applicable to invalid or inadvertently terminated QSub elections. Treas. Reg. § 1.1362-4.
    i. Query: if no election was made, was it inadvertently terminated or invalid?
    ii. Treas. Reg. § 1.1361-3(b) indicates relief available under Treas. Reg. §§ 301.9100-1 and 301.9100-3.

c) Is the solution practical?

Example 8: Excess Passive Investment Income

Facts:

Target was a C corporation until 12 years ago, when it became an S corporation. Target has approximately $500,000 of undistributed earnings and profits that were accumulated while it was a C corporation. Because a flood interrupted its operations and caused Target to change its focus from manufacturing and sales to providing services, interest and dividends constituted a much larger percentage of its gross receipts for each of 2007, 2008, and 2009 than for any other year. Target never reported any tax due under IRC § 1375. During due diligence, Acquiring's tax advisor determines that Target's interest and dividend income constituted more than 25% of Target's gross receipts for each of the 2007, 2008, and 2009.

Example 8: Excess Passive Investment Income

a) What is the problem?

- Target's S status technically was terminated at the end of 2009.
- Why? Because (i) Target's interest and dividend income constituted more than 25% of Target's gross receipts for each of the 2007, 2008, and 2009, and (ii) Target has undistributed earnings and profits that were accumulated while it was a C corporation. IRC § 1362(d)(3).

b) Is there a solution?

- Target probably could obtain a private letter ruling granting it relief under IRC § 1362(f) for inadvertent termination of its S status if Target did not understand the effect of having too much passive investment income for three consecutive years. *See, e.g.*, Ltr. Rul. 201226013.
- However, to obtain such a ruling, Target would need to declare a deemed dividend as of the end of 2009 to disgorge all its earnings and profits. See Treas. Reg. § 1.1362-(f)(3). In addition, Target will need to pay tax under IRC § 1375 for 2007 and 2008.

c) Is the solution practical?

Questions or comments?