

**Cleveland Tax Club****February 7, 2022**

**Special Considerations For Corporate Buyers of S Corp.  
and Pre-Acquisition Restructuring Solution  
by Francesco Ferrante and Kevin Tabor  
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**I. Considerations Favoring Pre-Closing Restructuring of Target S corp.  
and purchasing Ownership Interests in SMLLC, rather than S corp.  
shares and 338(h)(10) Election.**

A. Rev. Rul. 2008-18 Permitted Restructuring.

1. See Diagrams.
2. Timing of QSUB Election and State Law Conversion of QSUB to LLC.

B. Common Reasons for Restructuring:

1. One Class of Stock Concerns to Achieving Tax Basis Step Up (Red Herring?).
  2. Section 1374 Amount for Built-In Gain Assets—surfaces with merger of C corp. into S corp. within 5 years and calculation of gain amount.
  3. Avoid Gain on Distribution of Unwanted Assets by S corp.
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4. Rollover of partial amount.

C. Additional Reasons for Restructuring (not connected to S corp. qualification and related issues) -*Essence of this Presentation.*

1. *Buyer's Review of final 1120S.* Alleviates Buyer's officer signing the final S corp. 1120S, which requires Buyer to review reporting on such final return, even though income/gain flows through to the Sellers.

2. *Selling Entities Success-Based Broker's Fee.* IRS position is that Target S corp. 70% ordinary deduction safe harbor (Rev. Proc. 2011-29) is not available on 338(h)(10) Deemed Asset Sale. However, IRS position goes on to state that Target S corp. is allowed an ordinary deduction to extent that broker documentation show services (and related fee) based on timeline.

In Section 338(h)(10) election context, Buyer reviews and signs final 1120S tax return and could be difficult to obtain proper broker documentation. **Rev. Rul. 2008-18 restructuring allows Seller to pursue this issue without Buyer's involvement because deduction (and supporting documentation) shown on New HoldCo S Corp. tax return (signed by Sellers).**

a. Reg. 1.263(a)-5(e)(3)(i) and Rev. Proc. 2011-29 provide a 70% deduction against ordinary income for "success-based" fees associated with "covered transactions."

b. For pass-through entities where individuals are the owners, this provides benefit at 37% tax rate.

c. In general, if sale transaction is not a “covered transaction,” within the meaning of Reg. 1.263(a)-5(e)(3), success-based fee is a capitalized cost. In the context of an asset sale, capitalized costs reduce the Sellers’ capital gain, which means that the tax benefit is at 20% tax rate, rather than at the higher ordinary income tax rate.

d. On a 338(h)(10) election (treated as an asset sale), IRS position is that transaction is not a “covered transaction” to the Sellers. IRS Chief Counsel Advice Memo 201624021; LBI Process Unit-Transaction Costs-Success-Based Fees. However, in surprisingly favorable fashion, CCA 201624021 permits ordinary deduction to extent that portion of success-based fee is allocated prior to the “bright line.”

Following link provides further explanation and counter points to IRS position, but not commonly accepted.

<https://www.thompsonhine.com/publications/sellers-success-based-transaction-costs-and-irs-cca-201624021->

**3. Claiming Deferred Compensation Deduction on New HoldCo. 1120S.** In Section 338(h)(10) Context, Timing of Tax Deduction for “Deferred Compensation” flows to Buyer’s Tax Return, even if cash paid on closing date. **Rev. Rul. 2008-18 restructuring allows deferred compensation deductions to be claimed on New HoldCo. S corp. tax return and used as ordinary deductions by Sellers.**

a. Section 404(a)(5) and Reg. 1.404(a)-12(b) and 1.404(b)-1T state that with respect to “deferred compensation,” deduction

claimed on employer's tax year in which employee's tax year ends and in which the deferred compensation is included in income.

For example, if have "deferred compensation" and an S corp. stock purchase closes on June 1, compensation deduction is claimed on target corp. tax year ending December 31 (because employee's tax year ends December 31). This is true even if the deferred compensation is paid at closing.

b. Common example of nonqualified deferred compensation arrangement in S corp. context is where agreements provide for transaction bonuses payable on a change in control and the bonus vesting occurred in tax year preceding closing year. In this arrangement, the employee can terminate employment at any time and still be entitled to payment ("vested amount").

In contrast, if the transaction bonus requires employee to continue employment through the closing date (or thereafter), the arrangement is not "deferred compensation" because the arrangement remains unvested until payment date. In such case, an accrual basis taxpayer can claim the deduction on the S corp. tax year ending on the closing date because the special Section 404(a)(5) rule is not applicable.

c. If execute 338(h)(10) election where have S corp. deferred compensation and deduction flows to the Buyer's tax year, Buyer could negotiate to reimburse Sellers for "deferred compensation" deductions, with the following points to be addressed:

- i. How reimbursement payment to Seller is calculated?  
Corporate Buyer's effective tax rate will be lower than S corp. shareholders' 37% (or proposed 45%) tax rate.
- ii. When reimbursement payment is to be made?
- iii. Assuring that deferred compensation is not treated as assumed liability for tax purposes, which impacts timing of Buyer's tax deduction.
- iv. Assuring that Buyer can claim tax deduction for payment in 338(h)(10) context. Note that, in general, target corp. is treated as a new entity.
- v. Schedule M deferred compensation reporting on prior S corp. tax return and on Buyer's tax return.
- vi. Tax indemnity for return of reimbursement payment if Deferred Comp deduction is challenged.
- vii. Consideration regarding S corp. final tax return showing Deferred Comp amount as a non-deductible expense that reduces shareholder's tax basis.  
1367(a)(2)(D). Otherwise, Sellers receive benefit from increased tax basis in S shares.

**Rev. Rul. 2008-18 restructuring allows deferred compensation deductions to be claimed on Target S corp. tax return and used as ordinary deductions by Sellers.**

**4. Tax Deductions associated with Structuring Transaction Bonuses Payable to S corp. workforce.**

Situation: Assume transaction bonus arrangement requires employees of Target S corp. to continue working through fixed date following closing to receive bonuses. Arrangement is to avoid immediate departure of rich, experienced workforce, which departure would be an impairment to the acquired workforce asset.

Assume also that transaction bonuses are held back from purchase price with amount payable after required post-closing employment period is met. Any forfeited bonus for failing to meet post-closing employment requirement is paid to Sellers. Buyer never receives back any of the designated amount.

Who gets the compensation tax deduction?

In typical Section 338(h)(10) election setting, the acquired corporation claims the deduction when post-employment requirement and payment occur. The corporation is the only entity available, the payment obligation is with the acquired target, and the cash is run through the acquired corporation's payroll.

Sellers could be expecting compensation deductions (because their purchase price is being redirected to its employees), but situation has deduction in the Buyer's consolidated tax return with negotiation required on how to pay Sellers.

**Alternative: Rev. Rul. 2008-18 restructuring with obligation at New HoldCo S corp. could allow compensation deductions to be claimed on the New HoldCo S corp. tax return and flow through to the shareholders of New HoldCo S corp. as an ordinary deduction.**

**First Question: Claw-Back Approach or Delayed Payment Approach.**

**Claw-back Issues to Avoid:**

Employee has immediate income when received and any forfeiture and return might not be deductible because of 2017 Act suspension of miscellaneous deductions.

If no restructuring, acquired target corporation has income to reverse prior compensation deductions. Buyer would need to receive reimbursement from Sellers for prior tax benefit.

If have restructuring, New HoldCo S Corp. has income as reversal of prior compensation deductions, which flows to S corp. shareholders. Restructuring could be simplest approach in situation where bonus payments are made at closing and employees work for continued period without any claw-back occurring.

**Additional Steps to Consider if transaction bonuses are delayed:**

- New HoldCo S corp. assumes compensation obligation.
- Cash Amount placed in Escrow with New HoldCo S corp. as possible recipient with payout to employees if continued

employment met. Should escrow be subject to indemnity claims to avoid immediate New HoldCo gain?

- Compensation payments run through New HoldCo S corp. payroll, which should be newly established procedure.
- Attempt to have Seller's capital gain from remaining sale proceeds offset with deduction on New HoldCo S corp. final return. Not as beneficial as ordinary deduction for the Sellers at closing, which could be used to offset ordinary income for such year.

**Critical Accounting Issue:** Review whether compensation reflected as earnings charge to Buyer because payout is dependent on workforce continued employment with the acquired target owned by Buyer.

Arrangement can arise for (i) transaction bonuses first considered in connection with sale discussions or (ii) delaying payment under existing agreements of transaction bonuses originally payable based on continued employment through closing (409A exception).

D. Rev. Rul. 2018-18 Restructuring and Buyer's purchase of LLC interests still carries over any pre-restructuring target corp. federal income tax liabilities if the S corp. status is impaired and is not resolved through inadvertent termination IRS procedure, but subject to statute of limitations. Retain tax indemnity against Sellers regarding proper S status, if not covered by RWI.

E. Consider having Buyer's corporate strategy group aware that restructuring should be considered for blanket inclusion in LOIs but push back will occur based on perceived complexity, slowing down discussion momentum, and placing restructuring work burden on Sellers.

**II. Section 338(h)(10) in S corp. Acquisition and Post-Closing Cash Payments --Impact to Sellers that could raise use of Short-Term Note for Purchase Price or Restructuring.**

A. Sellers issue when have post-closing payments in subsequent tax year(s), which can include (1) escrow amount or (2) earnout payments.

B. Seller has accelerated amount of gain on closing because of double application of installment sale gain calculation at corporate level and at the shareholder level based on closing date cash. This is typically only a timing issue.

Note: When have sufficient cash amount, this tax result might be ignored.

C. Use of short-term note (i.e., 30 days) at closing avoids issue.

D. Electing out of Installment Sale Avoids Issue.

E. Solely Sellers issue. Buyer's awareness of short term note and willingness to participate in possible collateral to be negotiated is important.

F. Short-term note does not avoid immediate depreciation recapture, inventory income, and 1374 BIG gain.

G. Consider whether short-term note reduces S corp. state level cost for nonresident shareholders.

**H. Consider Rev. Rul. 2008-18 Restructuring to Avoid Double Installment Sale Application to the Closing Sale Proceeds (provided New HoldCo S Corp is not liquidated prior to receiving all post-closing**

payments) and allows Cash Distribution to be Fully Absorbed by Increased Tax Basis of Shares.

**III. Purchase of S corp. Shares without 338(h)(10) Election when Becoming Member of Buyer’s Consolidated Tax Return.**

- A. Continued rule that S corp. tax year ends on day preceding the closing.
- B. Assure that closing date deductions are accelerated to final date of the S corp. tax year—consider transaction bonuses and broker fee that are normally conditioned on closing.
- C. Seller to take board action or revise broker agreement to authorize payments so that accrual can be claimed in advance of closing date.
- D. For Section 267(b) related persons (any S corp. shareholder), need to pay transaction bonuses in advance of closing date. In this situation, accrual on day preceding closing date is not sufficient. Same is true for cash basis S corporation.
- E. Same issues present (as discussed above) with respect to timing of “deferred compensation” deductions and delayed transaction bonuses and use of Rev. Rul. 2008-18 alternative. Target Corporation broker fee and Accelerated Income from installment sale reporting are not issues because (1) sale of S corp shares is a “covered transaction” and (2) sale of S corp shares applies installment sale reporting provisions only at selling shareholder level.



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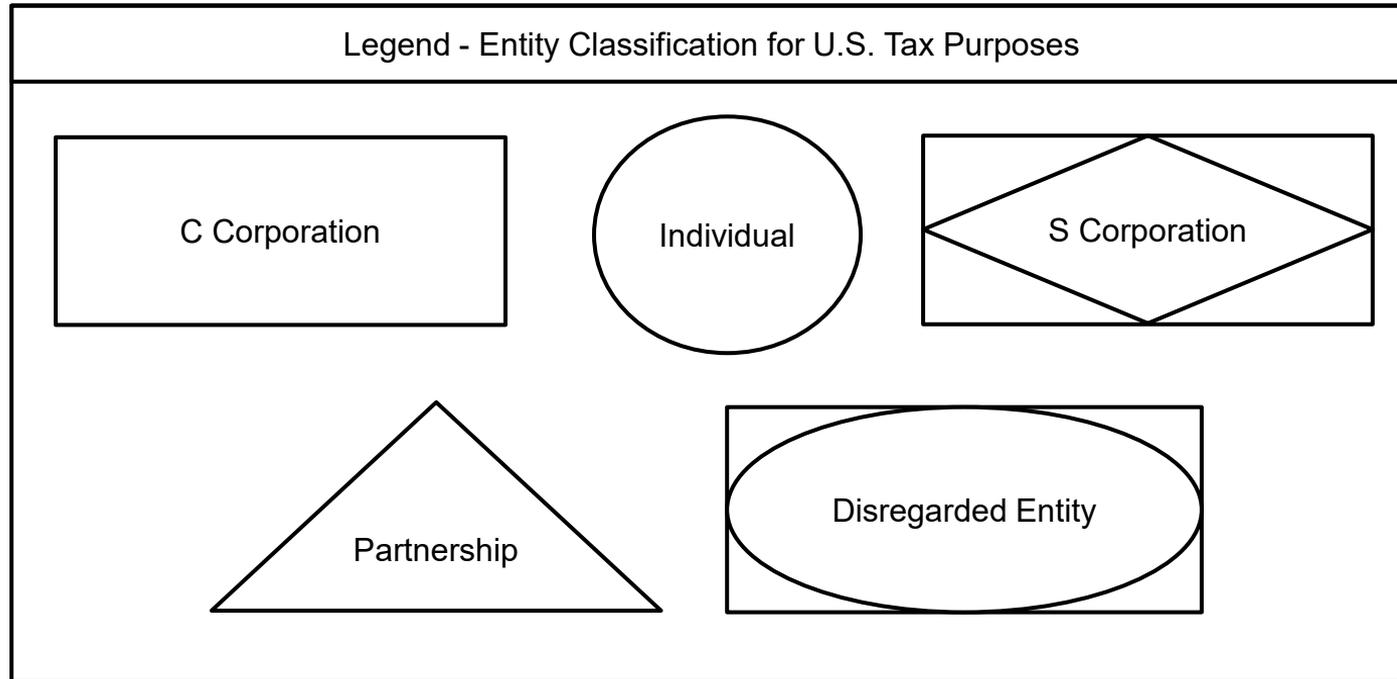
**Cleveland Tax Club**

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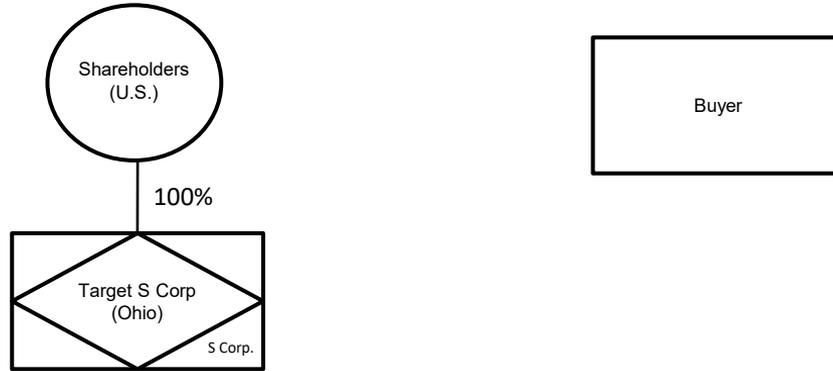
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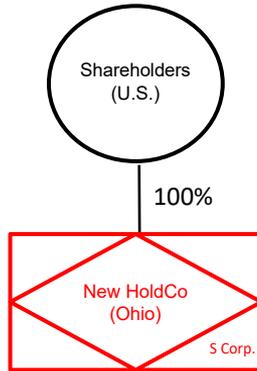
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# Beginning Structure



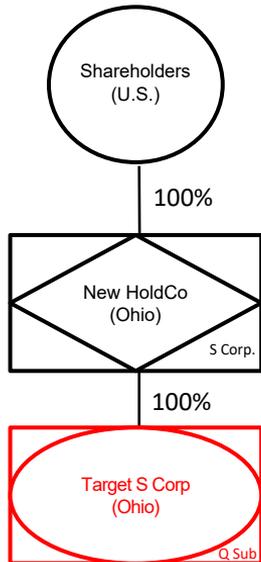
## Step 1: Form New HoldCo as an Ohio corporation and obtain an EIN for New HoldCo.



### Federal Income Tax Consequences

- Intended (when integrated with Step 2) to be a tax-free reorganization under Code Section 368(a)(1)(F) within the meaning of Rev. Rul. 2008-18.
- New HoldCo must obtain its own EIN.
- New HoldCo can (but is not required to) file a protective IRS Form 2553 (S Corporation election).

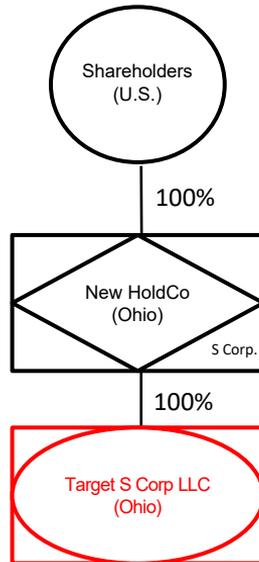
**Step 2: Shareholders contribute 100% of the stock of Target S Corp to New HoldCo in exchange for all of the stock of New HoldCo. New HoldCo files an IRS Form 8869 causing Target S Corp to be a “QSub” effective on the date of the contribution.**



### Federal Income Tax Consequences

- Intended (when integrated with Step 1) to be a tax-free reorganization under Code Section 368(a)(1)(F) within the meaning of Rev. Rul. 2008-18.
- Target S Corp should retain its EIN. See Rev. Rul. 2008-18.
- On IRS Form 8869 (QSub election), check Box 14 which references Rev. Rul. 2008-18 F-Reorganization.

**Optional Step 3: At least one day after the IRS Form 8869 is filed, convert Target S Corp to an LLC classified as a disregarded entity for federal income tax purposes.**

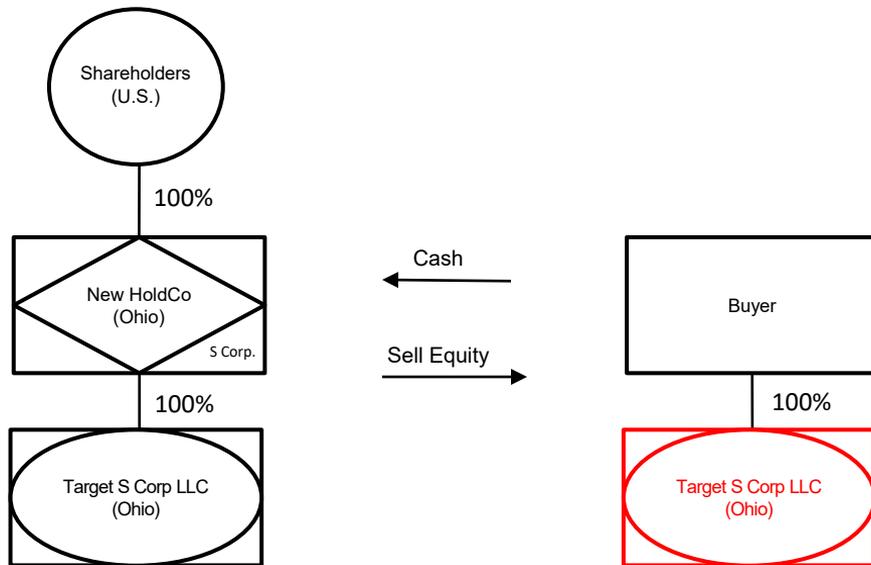


**Note:** Some states may require a tax clearance certificate to effectuate the conversion.

### Federal Income Tax Consequences

- Intended to be treated as a termination of Target S Corp's QSub status and a disregarded transaction for federal income tax purposes. See Treas. Reg. § 1.1361-5(b)(3) Example 2.
- Target S Corp (now an LLC) should retain its EIN pursuant to Treas. Reg. § 301.6109-1(i)(1). Will require correspondence with IRS and other governmental authorities (municipal, workers comp, unemployment insurance, etc.) because of change in name from Inc. to LLC.
- Integrated steps should not be a problem, but converting to LLC after QSub election is common practice.
- If Buyer would like Target to be a corporation post-closing, don't undertake this Optional Step 3 and purchase the Target shares while it is a QSub.

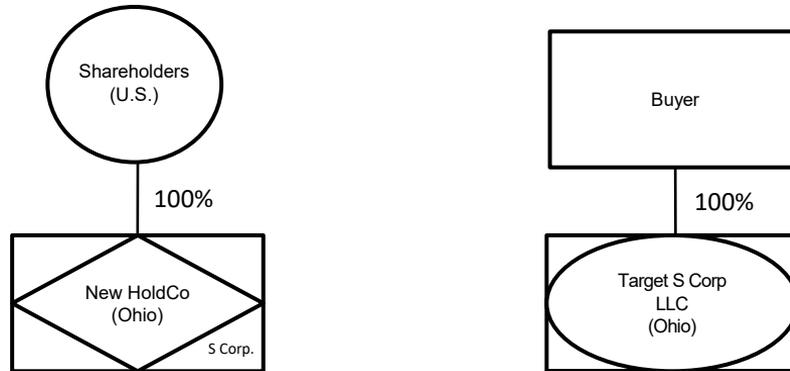
## Step 4: New HoldCo sells 100% of the equity of Target S Corp to Buyer.



### Federal Income Tax Consequences

- Treated as a taxable sale/purchase of the assets of Target S Corp by New HoldCo.
- Purchase price allocation needed.
- No need for 338(h)(10) or 336 election if Target S Corp is an LLC-Disregarded Entity at the time of the sale. Some have raised the idea of filing a protective 338(h)(10) election if Target S Corp is a QSub at time of the sale.
- If the Target S Corp shares are sold while Target S Corp is still a QSub (that is, it was not first converted to an LLC-Disregarded Entity), Target S Corp becomes a C Corporation immediately after the share acquisition.
- New HoldCo's tax year does not end as a result of the sale.

# Final Structure



## Presenters



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