Valuation Analyst Considerations in the S Corporation Sale Transaction

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Valuation analysts ("analysts") are often asked to assist with the pricing and structuring of private company sale transactions. Analysts will often perform particular due diligence procedures with regard to the sale of the S corporation private company. These due diligence procedures often include the analyst's review of the private company buy/sell agreements, stock redemption agreements, and other shareholder agreements. This due diligence may relate to the concern that the shareholder agreement (particularly the shareholder agreement share pricing provisions) may have created a second class of company stock. Such a second class of company stock could possibly invalidate the private company's S election. Such a concern would affect both the corporate acquired and the individual sellers of the S corporation private company. This discussion focuses on the analyst's review of such shareholder agreements, particularly during the structuring of the S corporation/private company sale transaction.

Introduction

Valuation analysts and other financial advisors (collectively referred to herein as "analysts") may be retained by private company owners (or by the company's legal counsel or other transactional advisers) to assist in the pricing and structuring of a business sale transaction.

These analysts often provide such transaction advisory services by working as part of a team of professionals. That transaction team may include corporate counsel, tax counsel, financial accountants, and others. Accordingly, analysts do not provide legal, accounting, or taxation advice related to the potential business sale transaction. Instead, other professionals are retained to provide such transactional advice.

However, analysts are expected to be knowledgeable enough about these legal, accounting, or taxation areas to both:

1. identify the relevant transactional issues and
2. work with the appropriate professionals in order to protect the client's interests.

Analysts may be asked to provide such transaction pricing and structuring services to private company owners in all industry sectors.

This discussion uses the term private company instead of the term closely held company. In this discussion, the term private company simply means that the target company securities are not publicly traded.

In many merger and acquisition ("M&A") transactions, the target company can be quite large. Such large target companies may have 100 or more shareholders, many of whom may not be current employees (or otherwise involved in the management) of the private company. With such a large number of shareholders, such target companies are not closely held. However, such large companies are still private companies.

S Corporation Sale Transactions

Many private companies have elected S corporation status for federal income tax purposes. That is, many of these private companies are tax pass-through entities.

An S corporation does not recognize taxable income at the company level—including with regard to any gain (or loss) on the sale of the company assets. Rather, the S corporation's income is "passed through" to the company shareholders. The individual shareholders recognize their share of the S corporation income (including any gains or losses on the sale of the company assets) on their personal income tax returns.

Many private companies are owned by members of what is often called the Baby Boomer generation. These private company owners are now reaching retirement age.

As part of their retirement planning and/or other personal financial planning, these company owners may have to consider an ownership transition related to their private company. Such an ownership transition is often implemented through the sale of the private company, with the company sale structured as some type of an M&A transaction.

This trend in Baby-Boomer-owned private company M&A transactions has been strong in the last several years. Due to the aging of those Baby Boomer private company owners, this trend of private company M&A transactions (in many industry sectors) is expected to continue for the next several years.

The Sale of the S Corporation and the Section 338(h)(10) Election

These private companies may be attractive acquisition candidates for larger corporate acquirers. This conclusion is true whether the acquirer is a private company or a publicly traded company. Because of the target company's S corporation tax status, many corporate acquirers will consider making an Internal Revenue Code Section 338(h)(10) election with regard to the private company acquisition.

Through this tax election, the corporate acquirer can treat the purchase of the target company stock as if it was the purchase of the target company assets. For S corporation acquisitions, this Section 338(h)(10) election may provide significant income tax benefits to the corporate acquirer, often at a relatively little income tax cost to the target company sellers.

In an M&A transaction regarding an S corporation target company, both the buyer and the seller typically perform due diligence procedures to ensure that there are no problems with regard to the target company's S corporation tax status.

In an M&A transaction, the corporate acquirer may be particularly concerned about the validity of the target company's S election status. This tax status concern is particularly relevant for a corporate acquirer that intends to make the Section 338(h)(10) election.

This concern is why the corporate acquirer often requires the private company seller to indemnify the buyer with regard to the target company's S corporation income tax status. And, this concern is why the seller also wants to identify any S election issues or concerns prior to negotiating the M&A transaction. Analysts can assist the private company seller with these due diligence considerations.

S Corporation Shareholder Agreements

Analysts should be aware that the typical private company often has a shareholder agreement with each of the company owners. There are numerous operational and legal reasons why a private company may have such shareholder agreements.

In particular, an S corporation typically has a shareholder agreement with each of its owners. One reason for this is to ensure that a party that is not qualified to be an S corporation shareholder does not become an owner of the company stock. In other words, one reason for such a shareholder agreement is to protect the private company's S election tax status.

However, the private company owners—and the analyst—should be concerned that the shareholder agreement does not create a second class of company stock. Such a second class of company stock could possibly invalidate the company's S election. For this reason, corporate acquirers may devote particular due diligence efforts to the review of any shareholder agreements associated with S corporation acquisition.

Accordingly, in preparing for the acquirer's acquisition due diligence, the private company sellers—with the analyst's assistance—should also review any shareholder agreements. This seller's (and analyst's) review is intended to ensure that there are no second class of stock concerns.

This discussion focuses on the due diligence considerations related to the S corporation shareholder agreement.

Stock Purchase versus Asset Purchase Transaction Structure

In the private company M&A transaction, the corporate acquirer typically prefers to structure the transaction as an asset purchase rather than as a stock purchase. There are both legal reasons and taxation reasons for this transaction structure preference.

The Asset Purchase Structure

In an asset purchase transaction structure, the acquirer will allocate the total purchase price consideration paid to the acquired tangible assets and intangible assets. Following the purchase price allocation rules of Section 1060, the acquirer allocates the transaction purchase price based on the fair market value of the acquired tangible assets and intangible assets.

Any residual purchase price (above the total fair market value of the tangible assets and the identifiable intangible assets acquired) is allocated to the acquired goodwill.

Accordingly, the acquirer gets to "step up" the depreciable tax basis in all of the acquired assets—up to the total amount of the consideration paid. Even the residual goodwill amount is amortizable (i.e., the buyer enjoys an amortization expense income tax deduction) over a statutory 15-year amortization period. This is because the purchased goodwill is a Section 197 intangible asset.

The Stock Purchase Structure

Alternatively, in the purchase of C corporation stock, the acquirer typically maintains the carryover depreciable tax basis in the target company's assets. So, let's assume a stock purchase transaction where the acquirer pays a $100 million total consideration for a target company, and the target company currently has a tax basis in its assets of $40 million.

In that case, the acquirer would continue to depreciate the $40 million carryover tax basis of the target company assets.

In such a transaction, the C corporation selling shareholders would recognize capital gain on the difference between:

1. their tax basis in their shares of the company stock and
2. their pro rata allocation of the $100 million purchase price.

In such a C corporation stock purchase transaction, the Section 338(h)(10) election would have positive income tax consequences to the acquirer but negative income tax consequences to the selling shareholder. After making such an election, the acquirer would be able to step up the depreciable tax basis in the target company's assets to the total amount of the purchase price consideration. However, the selling shareholder would recognize significantly negative income tax consequences.

As it would with an actual sale of the company's assets, the C corporation itself would recognize a taxable gain on the Section 338 deemed sale of its assets (resulting in a reduced amount of net after-tax sale proceeds available to distribute to the sellers). In addition, the selling shareholders would also recognize gain on the distribution of the remaining transaction net proceeds.

Effectively, such a transaction structure results in two levels of taxation to the selling shareholders: first at the C corporation level and again at the selling shareholder level.

The Section 338(h)(10) Election Deemed Asset Purchase

In contrast, in the purchase of S corporation stock, the Section 338(h)(10) election has fewer negative income tax consequences to the target company sellers The corporate acquirer gets to step up the depreciable tax basis in the acquired assets to the total purchase price paid. But, as a tax pass-through entity, the target company does not recognize taxable income on this deemed asset sale. The gain from the deemed asset sale is passed through to the selling shareholders.

Typically, only a portion of that gain is recognized as ordinary income by the selling shareholders (e.g., depreciation recapture income, the sale of cash basis receivables, the sale of inventory).

Therefore, most of the gain on the sale transaction is recognized as capital gain by the selling shareholders. And, if the target company shareholders negotiate effectively, the corporate acquirer may be willing to compensate the selling shareholders for the tax on the ordinary income recognized on the deemed asset sale.

Accordingly, the target company's S corporation status allows the corporate acquirer to make the Section 338(h)(10) election—an election that would typically not make taxation sense (at least to the selling shareholders) in the case of a C corporation acquisition. That is, the target company's S corporation status allows the acquirer to structure the M&A transaction as a purchase of stock (and enjoy the associated legal protections of that deal structure)—but also get the income tax benefits of a deemed purchase of assets.

The Target Company's S Corporation Tax Status

For the reasons summarized above, the corporate acquirer entering into a Section 338(h)(10) transaction will perform due diligence procedures to ensure that the target company has a valid S election. If the target company's S election is not valid, then the acquirer may have acquired a C corporation that has to pay income tax on the deemed asset sale at the corporation level.

In addition, the acquired C corporation (i.e., the target company with an invalid S election) may have a substantial income tax liability associated with prior years.

As part of its acquisition due diligence process, the corporate acquirer will want to verify the validity of the target company's S election. In particular, the acquirer's analyst will typically review all of the target company's shareholder agreements.

If there is a shareholder agreement (as is common in S corporations), the acquired professional advisers should confirm that the shareholder agreement does not create a second class of target company stock. This is because having a second class of stock could invalidate the target company's S election under Section 1361(b)(1)(D).

If the acquirer's analyst is concerned about this shareholder agreement issue, then the target company's analyst should also be concerned about this shareholder agreement issue. That is, the analyst (and the target company's other transaction advisers) should identify—and resolve—any shareholder-agreement-related S election issue before the target company is put up for sale.

The following section summarizes some of the shareholder agreement issues that the analyst should look for in the due diligence review process related to the target company. This due diligence review process should include the analyst's consideration of any stock buy-sell provisions, stock redemption provisions, and stock valuation provisions in the shareholder agreement.

Review of the Private Company Shareholder Buy-Sell and Redemption Agreement

To review the shareholder agreement's impact on the S corporation one-class-of-stock requirement, the acquirer and its advisers—and the target company and its advisers—should consider Regulation Section 1.1361-1(l)(2)(iii)(A).

This regulation states that S corporation shareholder buy-sell and redemption agreements are disregarded in determining whether the shares of stock confer identical distribution and liquidations rights, unless:

1. a principal purpose of the shareholder agreement is to circumvent the S corporation one-class-of-stock requirement of Section 1361(b)(1)(D) and
2. the shareholder agreement establishes a purchase price that, at the time that the agreement is entered into, is significantly in excess of—or significantly below—the stock's fair market value.

Regulation 1.1361-1(l)(2)(iii)(A) also provides a safe-harbor price range for the S corporation stock. The regulation provides that a stock price

set at book value per share or between book value and fair market value per share does not cause the shareholder agreement to establish a price that is significantly above—or significantly below—the stock's fair market value.

As part of the target company's due diligence, the analyst should review the buy-sell provisions, other redemption provisions, and share price determination provisions of any S corporation shareholder agreement.

Important to the target company (and to the analyst), Regulation 1.1361-1(1)(2)(v) provides a special rule related to a transaction involving a Section 338(h)(10) election. If the S corporation shareholders sell the company stock in a transaction for which a Section 338(h)(10) election is made, the receipt by the shareholders of varying price amounts per share will not cause the S corporation to have more than one class of stock.

However, this special provision only applies when the varying price amounts per share are determined in "arm's-length negotiations" with the corporate acquirer.

The Impact of Regulations and Letter Rulings

Regulation 1.1361-1(l)(2)(v) provides a special rule for the payment of a differing purchase price per share in S corporation acquisitions involving Section 338(h)(10) elections—under certain conditions.

The Internal Revenue Service has been willing to issue letter rulings on the impact of shareholder agreements on the S corporation one-class-of-stock requirement. The vast majority of these letter rulings are considered to be taxpayer-favorable.

One ruling, Internal Revenue Service Letter Ruling 9413023, addressed a shareholder agreement that provided for a stock price including a discount for lack of control (sometimes referred to as a minority interest discount).

Using similar logic to that implied in Regulation 1.1361-1(l)(2)(v), the Internal Revenue Service stated the following in Letter Ruling 9413023:

> The facts reveal that the buy-sell agreement . . . established a purchase price of fair market value less a minority discount. When a purchase price is the result of arm's-length business negotiations, the mere presence, or absence, of a minority discount does not cause an agreement to establish a purchase price that is significantly in excess of or below the fair market value of the stock. Therefore, the agreement will be disregarded in determining whether . . . shares of stock confer identical distribution and liquidation rights.

"As part of the target company's due diligence, the analyst should review the buy-sell provisions, other redemption provisions, and share price determination provisions of any S corporation shareholder agreement."

Analysts should be aware that there are both taxpayer-friendly regulations and taxpayer-friendly letter rulings issued related to this issue. Therefore, acquirers should not automatically assume that shareholder buy-sell or redemption agreements that are reasonably entered into for valid business purposes will be disregarded in the analysis of whether an S corporation has a second class of stock.

Accordingly, a target company's shareholder agreement will not necessarily prohibit the corporate acquirer of an S corporation from making the Section 338(h)(10) election.

However, in practice, corporate acquirers often express concern about the provisions in the S corporation's shareholder buy-sell or redemption agreements. Corporate acquirers may express those concerns by asking for an increase in the amount of the deal funds to be held in escrow in order to:

1. cover any potential income tax exposure should the target company's S election be invalidated and/or
2. reprice or restructure the pending M&A transaction.

Given the importance of the target company's S status to the Section 338(h)(10) election, it is understandable why a corporate acquirer may take a hard line related to this particular taxation issue—even though there appears to be relatively little risk to the acquirer. If the target company's S election has been in effect for a long time, it may be difficult—if not impossible—for the corporate acquirer to verify that the S election has been valid for all of the years involved.

This corporate acquirer consideration is particularly important if there have been a large number of target company shareholders over the years, including trusts.

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The Target and the Acquirer Due Diligence Procedures

A target company's inadvertent misstep through the years could have caused its S election to be invalidated. If the purchase price of the M&A transaction is substantial, the corporate acquirer may not be willing to accept the risk, under any circumstances, that the target company's S election may be invalid.

Given this concern, the existence of a shareholder agreement is one reason for a corporate acquirer to create doubt about the target company's S election validity.

One solution that may be proposed by a corporate acquirer is to have the target company's seller enter into a tax-free F reorganization under Section 368(a)(1)(F). This transaction structure is accomplished by forming a new corporation ("Newco"). Newco becomes the parent corporation of the existing target S corporation.

A qualified subchapter S subsidiary ("QSub") election is then filed. That QSub election then terminates the existing S corporation for income tax purposes. Newco is then not required to file a new S election under the F reorganization. However, the corporate acquirer may insist that Newco go ahead and file a new S election anyway—just as a precaution.

The corporate acquirer may also look to increase the amount of funds to be included in the M&A transaction escrow account. The purpose of this escrow amount is to cover any corporate income tax that would be owed for open tax years in the event that the target company's S election is found to be invalid.

Alternative Transaction Structures

Other procedures are available to safeguard the corporate acquirer in the S corporation M&A transaction. Effectively, these other procedures put substantially all the risk of an invalid S election on the target company's selling shareholders.

One example of such a procedure is to convert the target S corporation to a limited liability company ("LLC") immediately prior to the transaction closing. In this structure, the target S corporation is considered to have liquidated in a taxable transaction as of the formation of the LLC.

The uncertainty of the target company's S corporation status should end at that point. The corporate acquirer purchases the units of the LLC immediately after the conversion. Any potential corporate income tax liability will then fall upon the target company's selling shareholders—who received the S corporation's assets in liquidation.

Summary and Conclusion

The private company shareholders—and the valuation analyst—should be prepared to verify the validity of the company's S corporation tax status once the owners decide to offer the company for sale.

The target company—and the analyst—should perform adequate due diligence procedures in order to provide the necessary documentation to a corporate acquirer in order to substantiate the company's S corporation tax status.

As soon as possible in the due diligence process, the analyst should inform the private company selling shareholders about this potential transaction issue. The analyst can assist the selling shareholders in the review of any private company shareholder agreement.

In particular, the analyst should review the valuation issues and the pricing issues with regard to any buy-sell or other redemption provisions in these shareholder agreements.

Alternatively, all of the parties to the potential M&A transaction may consider implementing an alternative transaction structure that does not involve the corporate acquirer making a Section 338(h)(10) election.

Without the forethought of the analyst—and of the private company's other transactional advisers—any consideration of the validity of the target company's S election often comes up fairly late in the M&A transaction due diligence process. At such a late stage in the pending M&A transaction, any uncertainty regarding the target company's S corporation tax status may cause the corporate acquirer to reconsider making the otherwise attractive acquisition.

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