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Subchapter S Corporation Targets in M&A Transactions

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The potential pitfalls involved in the acquisition of, or merger with, an entity that has elected to be taxed under Subchapter S of the Internal Revenue Code, often referred to as an S corporation, should not be underestimated or overlooked. While an S-corporation seller or target can provide significant tax benefits in a transaction, an improper election to be taxed as an S corporation by the target, also known as an invalid election, or the unintentional failure to comply with the requirements of an S corporation, also known as an inadvertent termination, can have even more significant negative consequences.

For example, if an S corporation made an invalid election or caused an inadvertent termination, it or its successor may be liable for the taxes it would have paid in the previous three years had it been taxed as a C Corporation. Further, and less obviously, if a company acquires a qualified subchapter-S subsidiary, often referred to as a QSUB, from an S Corporation, it may seem as though any potential risks associated with an invalid S corporation would remain with the seller if that seller continues to exist following closing. However, the tax treatment of certain transaction structures involving S corporations can change depending on whether the seller is a valid S corporation. For example, the acquisition of a QSUB is generally treated as an asset transaction for tax purposes, but if the seller is not a valid S corporation, then the transaction could be taxed as a stock purchase, which could mean a loss of any step-up in basis in the underlying assets—an unwelcome surprise for any client.

To avoid risks that may arise from an invalid election or an inadvertent termination, counsel should conduct thorough diligence of matters related to an entity's status as an S corporation. For example, counsel should confirm that the entity has met the requirements of an S corporation at all times since its election to be taxed as such. Careful analysis is required in determining whether all owners are eligible shareholders and that the ownership structure does not violate the one class of stock rule. Further, counsel should ensure that the seller or target properly completed and filed the election to be taxed as an S corporation and that all elections for its subsidiaries were properly filed with the IRS. Additionally, counsel should review the history of the entity's status as an S corporation since a conversion to an S corporation within the last five years could subject the entity to "built-in gains" tax. These diligence items are illustrative only and not exhaustive. Counsel may wish to seek the advice of tax specialists.

If the seller or target may have inadvertently terminated its status as an S corporation, counsel can, among other remediation techniques, request a private letter ruling from the IRS stating that any such inadvertent termination did not result in the entity losing its status as a valid S corporation, which requires the entity to provide information concerning the potential issue, company history, shareholder information, and other matters related to the S election as well as affidavits from shareholders making certain attestations. The IRS is generally lenient in providing favorable rulings in the case of inadvertent terminations; however, such letters can take six months or longer to obtain, which often does not align with desired transaction timelines. If there are potential issues concerning S corporation validity or if the purchaser does not wish to take on any risk associated with an inadvertent termination, the purchaser can shift the S corporation risk to the seller by requesting indemnification and placing a portion of the consideration in escrow specifically for such issues. Generally, such funds would be released following the receipt of a favorable private letter ruling from the IRS or once the statute of limitations lapses. Alternatively, the parties may agree to obtain tax insurance specifically covering S corporation matters. With the recent rise in representation and warranty and tax insurance, insurance for S-corporation matters has become more popular with premiums decreasing as insurance companies become more comfortable with the process. Insurance may not be practical for smaller transactions because many insurers have minimum premiums in the low six figures; however, some sellers are receptive to such a cost when the alternative may be a holdback equal to C corporation tax liability for the past three years or the potential loss resulting from no step-up in basis.

While the solutions and risk tolerance of clients related to S-corporation issues can vary considerably, it is imperative that counsel identify and communicate the potential risks associated with S corporation sellers or targets; the risk can be fairly remote, but the consequences can be very significant. **HN**

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