DUE DILIGENCE REGARDING SHAREHOLDER AGREEMENTS IN S CORPORATION M&A TRANSACTIONS

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In an M&A transaction regarding an S corporation target company, both the buyer and the sellers should perform reasonable due diligence procedures to ensure that there are no problems with regard to the target company's S corporation tax status. This article focuses on the due diligence considerations related to the S corporation shareholder agreement.

Introduction

Valuation analysts and other financial advisors (hereinafter "analysts") are often retained by private company owners to assist them in the pricing and structuring of a business sale transaction. These analysts typically provide financial advisory services as part of a team of professionals that often include legal counsel, financial accountants, tax advisors, and others. Accordingly, the analyst is not expected to provide legal, accounting, or taxation advice to the private company owners. Other specialists provide such professional advice. Nonetheless, the analyst is expected to be sufficiently knowledgeable about these areas both (1) to identify the relevant issues and (2) to work with the appropriate professionals to protect the client's interests.

Analysts may be asked to provide transaction pricing and structuring advice to sellers of private companies operating in all industry sectors. Analysts should be aware that, across all industries, 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. As an S corporation, this means that the company does not recognize taxable income at the company level—including with regard to the gain (or loss) on the sale of 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 company assets) on their personal income tax returns.

Many private companies are currently owned by members of the so-called Baby Boomer generation. These company owners are now reaching retirement age. Therefore, as part of their retirement planning and personal financial planning, these company owners may now be considering an ownership transition related to their private company.

Such an ownership transition is often implemented through the sale of the private company, with the sale structured as some type of a merger and acquisition (M&A) transaction. There have been quite a number of Baby-Boomer-owned private company M&A transactions in the last several years. Due to the aging of those Baby Boomer generation business owners, this trend of private company M&A transactions (across many industry sectors) is expected to continue for the next several years.

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These private companies are often attractive acquisition candidates for larger corporate acquirers (whether the acquirer is a private company or a publicly traded company). Because of the S corporation income tax status of the target company, many corporate acquirers consider making a Section 338(h)(10) election with regard to the private company acquisition. Through this election, the corporate acquirer can treat the purchase of the target company stock as if it was a purchase of the target company assets. For S corporation acquisitions, this Section 338(h)(10) election often provides significant income tax benefits to the corporate acquirer, at 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 sellers should perform reasonable 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 is particularly concerned about the validity of the target company's S election.

This concern is particularly relevant for a corporate acquirer that intends to make the Section 338(h)(10) election. This is why the corporate acquirer often requires the sellers to indemnify the buyer with regard to the target company's S corporation income tax status. Moreover, this is why the sellers also want to identify any S election issues or concerns prior to negotiating the M&A transaction. Analysts often assist the private company sellers with many of these due diligence considerations.

It is very typical for a private company to have a shareholder agreement with each of its owners. There are numerous operational and legal reasons why a private company would have such shareholder agreements. In particular, an S corporation frequently has a shareholder agreement with each of its owners. One reason for such an agreement is to ensure that a party that is not qualified to be an S corporation shareholder does not become an owner of the private company's stock. In other words, one reason for such a shareholder agreement is to protect the private company's S election.

However, the private company owners—and the private company's various professional advisers—should be concerned that the shareholder agreement does not create a second class of company stock. Such a second class of company stock could invalidate the company's S election. For this reason, corporate acquirers devote particular due diligence efforts to the review of any shareholder agreements in S corporation M&A transactions.

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. Such a due diligence review is intended to ensure that there are no second class of stock concerns. This article focuses on the due diligence considerations related to the S corporation shareholder agreement.

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 is not publicly traded. In many M&A transactions, the target company can be quite large. Such a large target company may have 100 or more shareholders, most of whom are not employees or founders of the private company. With such a large number of shareholders, such a target company is not closely held. However, it is still a private company.

Stock purchase versus asset purchase transaction structure

In a 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 the corporate acquirer's transaction structure preference.

In an asset purchase transaction structure, the acquirer gets to allocate the total amount of the purchase price consideration paid to the acquired tangible assets and intangible assets.

Because of the S corporation income tax status of the target company, many corporate acquirers consider making a Section 338(h)(10) election with regard to the private company acquisition. Through this election, the corporate acquirer can treat the purchase of the target company stock as if it was a purchase of the target company 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—and amortizable—goodwill.

The corporate acquirer entering into a Section 338(h)(10) transaction will perform reasonable due diligence procedures to ensure that the target company has a valid S election.

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 in the transaction. That means that even the residual goodwill amount is amortizable (i.e., the acquirer enjoys an amortization expense income tax deduction) over a statutory 15-year amortization period. This is because the purchased goodwill qualifies as a Section 197 intangible asset.

Alternatively, in the purchase of C corporation stock, the acquirer typically maintains the carryover depreciable tax basis in the target company's assets. For example, let's assume a stock purchase transaction where the acquirer pays a $100 million total consideration for a target company, and that target company 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 stock purchase 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 sellers. After making such an election, the acquirer would be able to step up the depreciable basis in the target company's assets to the total amount of the purchase price consideration. However, the sellers would recognize significantly negative income tax consequences.

As it would in the case of 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 sellers: (1) first at the C corporation level and (2) again at the selling shareholder level.

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 amount of the purchase price paid. However, 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 accounts receivable, the sale of inventory). Therefore, most of the gain on the sale transaction is recognized as capital gain by the selling shareholders. In addition, if the target company shareholders are able to 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—a tax election that would typically not make economic 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 election status

For the reasons summarized above, the corporate acquirer entering into a Section 338(h)(10) transaction will perform reasonable due diligence procedures to ensure that the target company has a valid S election. If the target company's S election is not valid, the acquirer may have unintention-

ally 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 from 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 professional advisers will typically review all of the target company's shareholder agreements. If there is a shareholder agreement (as is typical in the case of an S corporation), the acquirer's professional advisers will confirm that the target's shareholder agreement does not create a second class of target company stock. This confirmation is important 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 advisers are concerned about this shareholder agreement issue, the target company's advisers should also be concerned about this shareholder agreement issue. That is, the analyst (and the target company's other advisers) should identify—and resolve—any shareholder-agreement-related S election issues before the target company is put up for sale.

The following section summarizes some of the shareholder agreement issues that the analyst will look for during the target company's due diligence review process. This review typically includes consideration of any buy-sell provisions, redemption provisions, and stock valuation provisions in the target company's 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 Reg. 1.1361-1(l)(2)(iii)(A). This regulation states that S corporation shareholder buy-sell agreements 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 shareholder agreement is entered into, is significantly in excess of—or significantly below—the stock's fair market value.

Reg. 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 due diligence regarding the target company, the analyst typically reviews the buy-sell provisions, any other redemption provisions, and any share price determination provisions of the S corporation shareholder agreement.

Important to the target company (and to its advisers), Reg. 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.

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Taxpayer-friendly regulations and letter rulings

Reg. 1.1361-1(l)(2)(v) provides a special rule for the payment of differing purchase prices per share in an S corporation acquisition involving a Section 338(h)(10) election—under certain conditions. The IRS 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 such ruling, IRS Letter Ruling 9413023, addressed a shareholder agreement that provided for a stock price that considered a discount for lack of control (sometimes referred to as a minority interest discount). Using similar logic to that presented in Reg. 1.1361-1(l)(2)(v), the IRS stated the following in this letter ruling:

> 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.

Analysts should be aware that there are both taxpayer-friendly regulations and taxpayer-friendly letter rulings issued related to this issue. Therefore, corporate acquirers should not assume that most 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 a Section 338(h)(10) election.

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However, in practice, corporate acquirers may still 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 (1) to cover any potential income tax exposure should the target company's S election be invalidated and/or (2) to 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 acquirer concern is particularly understandable if there have been a large number of target company shareholders, including trusts, over the years.

Target and 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. One 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 structure considerations

Other procedures are available to safeguard the corporate acquirer in the S corporation M&A transaction. These other procedures effectively

leave 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 situation, 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 status ends 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

Many Baby Boomer generation private company owners are now considering the sale of their companies as part of their retirement planning and personal financial planning. Many of these private companies, across all industries, are S corporations. Such S corporation private companies may be particularly attractive acquisition candidates for corporate acquirers (both private company and public company acquirers).

Private company shareholders—and their professional advisers—should be prepared to verify the validity of the company's S corporation status once the owners decide to offer the company for sale. The target company—and its professional advisers—should implement procedures to provide the necessary documentation in order to substantiate the company's S corporation status. The analyst should inform the selling shareholders about this potential transaction issue as soon as possible. The analyst will typically assist the selling shareholders in the due diligence review of any private company shareholder agreements. In particular, the analyst typically reviews the valuation and pricing issues related to any buy-sell or other redemption provisions in the target company's shareholder agreements.

Alternatively, all of the parties to the potential M&A transaction may consider implementing a 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 other professional advisers—the consideration of the validity of the target company's S election often comes up very late in the M&A transaction due diligence process. At that late stage in the pending transaction, any uncertainty regarding the target company's S corporation status may cause the corporate acquirer to reconsider an otherwise attractive M&A transaction. ■