

# Structuring Acquisitions and Sales when the Target is an S Corp

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## S Corp Eligibility Requirements

- An S Corp cannot have more than 100 shareholders.
- Shareholders must be individuals with certain exceptions (certain trusts, estates, and tax-exempt entities); no C corps or partnerships.
- Shareholders cannot be foreign.
- An S Corp must have a single class of stock.
- An S Corp cannot be an ineligible corporation (certain financial institutions, insurance companies or DISCs).

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## Advantages of S Corps

- Tax Accounting Simplicity-
  - One Class of Stock leads to straight-forward tax return preparation compared to LLCs taxed as partnerships.
- Employees vs Partners-
  - Owners of S Corps can be W-2 employees whereas owners of partnerships cannot.
- Manage Employment Tax Liability-
  - Opportunity to reduce employment tax liability in some instances.

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## Disadvantages of S Corps

- Limited flexibility eligible shareholders (Acquiror eligibility issues).
- S Corps can only have a single class of stock (capital structure limits).
  - Income allocations and cash distributions pro rata only.
  - Cannot split capital and profits interests like partnerships.
- Former C Corps turned S Corps have build-in gains tax issues and passive income tax issues.
- Buyers generally prefer to buy LLCs over S Corps to get tax basis step-up in acquired assets.

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# Taxation of S Corporations

- S Corps pass through items of income and loss to their shareholders and generally are not subject to tax.
  - No corporate level tax except when earnings & profits from C Corp history (Built-in Gains Tax).
  - S Corp stock basis adjustment and “AAA account” ensures no double tax.
  - Distributions in excess of shareholder’s basis in S Corp stock taxable as capital gains (corporate debt does not increase basis in stock like in partnerships).
- S Corps can have a corporate subsidiary but not a corporate shareholder.
  - Wholly-owned corporate subsidiary can elect to be Qualified Subchapter S Subsidiary (QSub) that is treated as a disregarded entity for tax purposes.

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# S Corp Sales and Distributions

- Sale of S Corp stock results in capital gains tax to the owners and no tax to the corporation itself.
- Gains from the sale of S Corp assets generally results in gains passed through to the shareholders and taxed at the shareholder level; no gain is taxed to the corporation (unless “Built-In Gains” tax applies).
- Distribution of appreciated property by the corporation to its shareholders triggers gain on any excess of the fair market value of the asset over its tax basis, which is passed through to the shareholders and taxed at the shareholder level; no corporate level tax unless “Built-In Gains.”

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