

TYPES NOT MAPPED YET April 02, 2024 | TTR not mapped yet | Nicholas J. Engel

Using Pass-Through Entity Tax Benefits in M&A transactions

Individual taxpayers who itemize deductions on their federal income tax returns generally can offset federal taxable income for taxes paid to state and local governments. However, the Tax Cuts and Jobs Act of 2017 created a \$10,000 limitation on an individual taxpayer's ability to deduct those taxes. This limitation commonly referred to as the "SALT cap" can be costly, particularly to sellers in M&A transactions.

In response to the SALT cap, many states enacted pass-through entity tax ("**PTET**") regimes for partnerships or S corporations. In a PTET regime, taxpayers may elect to have flow-through entities pay income tax at the entity level. The entity-level income tax is not subject to the SALT cap that applies only to individuals. This results in income allocated to the pass-through entity's owners that reflects "deductions" for the full amount of state and local taxes the entity paid. Additionally, owners typically receive a credit against their individual state income taxes equal to their share of the PTET the entity paid.

In most scenarios, the largest tax bill an individual will have occurs in the year they sell a business. If an individual sells equity of their company that results in \$25 million worth of taxable gain, their federal and state tax bill will be in the millions of dollars. A state with income tax of 5% would trigger \$1.25 million of state taxes alone for the seller, and without a PTET election, the owner may lose out on over \$1 million of tax deductions.

There are 36 states that have passed PTET tax laws, but this discussion is less impactful in states that do not impose an individual income tax (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming).

Buyer and Seller Objectives in M&A

M&A transactions are often structured as acquisitions of equity rather than direct asset sales since a number of commercial factors make transferring assets, contracts, and employees burdensome. Additionally, for entities treated as corporations for income tax purposes, there can be incremental tax costs associated with selling assets. However, buyers have a strong preference for asset acquisitions that result in a greater step-up in tax basis on the assets of the target, which can be depreciated or amortized over time.

Traditional "F reorganization" structure for S corporations

The most common structure for deals involving S corporations is a traditional "F" reorganization completed by the seller (pursuant to Internal Revenue Code Section 368(a)(1)(F)), followed by an acquisition of LLC interests that is treated as an asset acquisition for federal income tax purposes.

In an F reorganization, the S corporation ("**Old S**") forms a new S corporation ("**New S**") and contributes all of the equity of Old S to New S in exchange for a proportionate share of New S. New S then files an election with the IRS to treat Old S as a qualified subchapter S subsidiary. Under Revenue Ruling 2008-18, New S is treated as a continuation of Old S, and Old S is eligible to convert to an LLC under state law, making Old S a disregarded entity for tax purposes. Once classified as a disregarded entity, any acquisition of Old S will be treated as an acquisition of assets. This structure also isolates any historical liabilities or concerns with the seller's S corporation status and conveniently accommodates tax-deferred rollovers of equity for sellers. These features make this structure appealing to both buyers and sellers.

However, a deemed asset acquisition of Old S can result in incremental taxes on ordinary income items such as accounts receivable, inventory, or depreciation recapture. Sellers will often seek gross-up payments for such taxes.

Impact of PTET election

A PTET election may bridge the gap between a purchaser's preference for an asset sale to achieve a step-up in basis and the seller's desire for an equity sale or to be grossed-up for the incremental tax cost of an asset sale.

With a PTET election in place, sellers in an M&A transaction treated as an asset sale for tax purposes may not lose the value of state and local income tax deductions that they would otherwise lose under the SALT cap. Accordingly, their need for gross-up payments can be significantly reduced or eliminated. In certain instances, an F reorganization that is followed by a PTET election at New S may actually result in tax savings for the seller compared with a sale of Old S stock.

Other PTET Considerations

PTET regimes are governed by state law, and each state has different rules regarding how an election is made, when the election is due, and how taxpayers can use deductions from the PTET payments. Additionally, entities are subject to state income taxes (and potentially other local taxes) in all states where income is derived or sourced. This means an entity may need to make PTET elections in multiple states to avail itself of different state tax benefits.

Additionally, based on the type of assets involved in the business, a modeling exercise should be completed to fully calculate and understand the tax impact of an asset sale versus stock sale, as well as the amount of any gross-up payments a seller may seek.

Due to the complexities among these laws, buyers and sellers should discuss the impact of a PTET election and the ability of a selling entity to make such an election as early in the transaction process as possible.

Future of the SALT cap

The \$10,000 SALT cap is scheduled to sunset December 31, 2025. Changes to the cap were the subject of debate in the House of Representatives earlier in 2024 and will likely remain a topic for Congressional debate and discussion. So long as the SALT cap is not eliminated, benefits of PTET elections will remain an important element in structuring M&A transactions and calculating the tax implications of the transaction.

authorsTest

nicholas

Nicholas J. Engel