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What buyers won't tell you about deal structure - and why it matters to your after-tax proceeds.

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Most sellers I work with are smart, experienced operators. They've built real businesses — $1M, $5M, $10M in EBITDA — and when they start thinking about a sale, they naturally focus on the headline number: *What's my business worth?* That's the right question to start with. But it's not the question that determines how much money you actually keep.

The real economics of a deal are shaped by structural decisions that most sellers don't encounter until they're deep into a negotiation — elections, allocations, escrow terms, insurance. These aren't footnotes. In a $10M–$50M transaction, the gap between a well-structured deal and a poorly structured one can easily be $1M–$3M in after-tax proceeds. And most of these decisions get locked in at the LOI stage, before your leverage is at its peak.

Below are five issues that come up in nearly every deal I advise on. Understanding them before you sit down with a buyer puts you in a much stronger position — and keeps you from leaving money on the table you didn't know was there.

1. The 338(h)(10) Election: When the Buyer Wants You to Pay More Tax

Benefits to the Seller

A 338(h)(10) election lets you sell your stock — preserving the legal form of a stock sale — while giving the buyer the tax benefits of an asset purchase. That means you avoid the headache of retitling every asset, contract, and license. And because the election is a concession from you, it's a legitimate negotiating chip: you agree to the election in exchange for a higher purchase price or a tax gross-up provision that compensates you for the extra tax hit.

Watch Out For

Even though you're legally selling stock, the IRS treats you as if you sold assets. That triggers depreciation recapture — §1245 property (equipment, vehicles, software) gets taxed at ordinary income rates up to 37%, not capital gains rates. State taxes may not conform to the federal election, creating an additional layer of complexity. And here's the real danger: the **purchase price allocation** determines the magnitude of the hit. Buyers will try to allocate as much value as possible to depreciable assets (maximizing their deductions) at your expense.

BOTTOM LINE

Never agree to a 338(h)(10) election in the LOI without seeing the buyer's proposed allocation model and a full tax gross-up analysis. The election is a concession you're making — not a default. Treat it accordingly.

2. IRC §1202 / QSBS: The Tax Exclusion That Could Save You Millions

Benefits to the Seller

Section 1202 provides up to a **100% exclusion of federal capital gains** on the sale of qualified small business stock (QSBS) held for five or more years. For many founders, this is the single most valuable tax provision in the code. The *One Big Beautiful Bill Act*, signed into law in mid-2025, significantly expanded eligibility: for stock issued after July 4, 2025, the gross asset threshold was raised from $50M

to $75M, the per-taxpayer gain exclusion cap increased to $15M, and a new tiered exclusion structure was introduced — 50% at 3 years, 75% at 4 years, and 100% at 5 years of holding.

Watch Out For

QSBS only applies to original-issue C corporation stock — not S corps, LLCs, or partnerships. A 338(h)(10) election or asset sale structure **destroys the exclusion entirely**, because the transaction is treated as an asset sale for tax purposes. The corporation's aggregate gross assets must have been under $50M (or $75M for post-7/4/25 issuances) at or immediately after the stock was issued. Stock redemptions near the time of issuance can disqualify otherwise eligible shares.

The F Reorganization: Bridging the Buyer-Seller Tax Gap

I mentioned the F reorganization above as a way to preserve QSBS while giving the buyer asset-sale economics. This comes up often enough in the $20M–$50M range that it's worth understanding what it actually is — and what it costs you.

An F reorganization under IRC §368(a)(1)(F) is technically a "mere change in identity, form, or place of organization" of a corporation. In plain English, you restructure your company's legal entity before the sale without changing ownership, operations, or economics. The IRS treats the new entity as a continuation of the old one — same taxpayer, same tax history, same EIN.

How It Works (Typical S Corp Sale)

The most common use case in lower-middle-market deals involves an S corporation target. Here's the sequence, simplified:

Step 1 — The existing shareholders form a new corporation ("Holdco") and contribute all of their stock in the S corp to Holdco in exchange for Holdco stock. Holdco files a protective S election.
Step 2 — Holdco files IRS Form 8869 to elect QSub (Qualified Subchapter S Subsidiary) treatment for the old S corp, indicating this is an F reorganization.
Step 3 — At least one day after the QSub election is filed and effective, the old S corp converts under state law to a single-member LLC, disregarded for tax purposes.
Step 4 — The buyer purchases the LLC membership interests (not stock) from Holdco.

The result: the buyer is purchasing LLC interests, which for tax purposes is treated as an asset acquisition — giving the buyer a full **step-up in tax basis** and future depreciation/amortization deductions. But for the seller, the sale of LLC interests flows through Holdco (the S corp) and is generally taxed at **capital gains rates**, similar to a stock sale. The F reorganization itself triggers no immediate tax.

Why Sellers Should Care

The F reorg solves the classic buyer-seller standoff. In a typical negotiation, the buyer wants an asset purchase (for the step-up) and the seller wants a stock sale (for capital gains treatment). A 338(h)(10) election bridges this gap but forces the seller to bear depreciation recapture and potentially lose QSBS eligibility. The F reorg offers three advantages over a 338(h)(10):

• **Rollover equity gets tax deferral.** If a PE buyer wants you to roll 20–30% of your equity, an F reorg lets you defer gain recognition on the rollover portion. A 338(h)(10) election generally taxes you on the full deemed asset sale — including the portion you didn't cash out.

• **No 80% ownership requirement.** A 338(h)(10) requires the buyer to acquire at least 80% of the target's stock. An F reorg has no such threshold, making it more flexible for partial acquisitions.

• **Eliminates S election risk.** If your S corp election has any defect in its history (missed filing, ineligible shareholder, inadvertent termination), a 338(h)(10) can fail entirely. The F reorg bypasses this risk because the buyer is purchasing LLC interests, not stock.

QSBS Preservation Through F Reorg

For C corporation founders holding QSBS, a variation of the F reorganization can facilitate the deal while preserving §1202 eligibility. The concept: restructure the target into a holding company / subsidiary structure, then contribute the business (via an LLC) to a new C corporation subsidiary. The holding company holds QSBS in the subsidiary, and qualifying gain on disposition flows through to the shareholders with the §1202 exclusion intact.

This is powerful but technically complex. One critical precedent: in *Leto v. United States* (D. Ariz. 2022), a federal court denied QSBS treatment where an S corp shareholder received C corp stock in a direct merger — because the stock was received in exchange for other stock, not in an original issuance for money or property as §1202(c)(1)(B) requires. The F reorg structure avoids this trap by ensuring the C corporation subsidiary issues stock in exchange for contributed property (the LLC interest), not in exchange for stock.

Watch Out For

The F reorganization is not risk-free. The IRS six-factor test under Treasury Reg. §1.368-2(m) must be satisfied precisely: identical ownership before and after, no prior assets in the new entity, complete liquidation of the old entity for tax purposes, and others. Execution requires careful sequencing of state

filings, QSub elections, and entity conversions — miss one step, and the entire structure can be recharacterized by the IRS.

There is also a **step transaction risk**: the IRS could argue that the QSub election and subsequent contribution of assets to a new C corporation should be collapsed into a single taxable transaction, ignoring the F reorganization. Courts have generally respected the separate existence of F reorganizations even when done as part of a larger deal, but the risk is worth acknowledging.

Additionally, for targets in existence before 1993 where the seller retains more than 20% equity post-close, the §197(f) anti-churning rules can prevent the buyer from amortizing stepped-up intangible value — which may reduce the buyer's willingness to pay a premium for the structure.

BOTTOM LINE

If you hold QSBS, protecting the §1202 exclusion should be the number-one structural priority in your deal. An F reorganization can preserve QSBS eligibility while giving the buyer asset-sale economics — but it must be modeled and structured by experienced tax counsel well before the LOI. The sequencing, elections, and state-law conversions are unforgiving. Get it right, and you've potentially saved millions in federal tax. Get it wrong, and you've added cost and complexity for nothing.

3. Depreciation Recapture: The Hidden Tax Bill in Asset Sales

Benefits to the Seller

If your business is goodwill-heavy — think software, IT services, or SaaS — your recapture exposure is likely modest. Most of the purchase price in these deals is allocated to goodwill, which is taxed at long-term capital gains rates (currently up to 20%, plus the 3.8% net investment income tax). That's a meaningful difference from ordinary income rates.

Watch Out For

§1245 recapture on tangible personal property — equipment, vehicles, capitalized software — is taxed at ordinary income rates up to **37%**. §1250 recapture on real property is taxed at up to 25%. In asset-heavy businesses like manufacturing and distribution, recapture can represent a significant portion of the seller's total tax bill. The purchase price allocation is what drives the hit, and the buyer has a direct financial incentive to allocate value in a way that hurts you.

BOTTOM LINE

Quantify your recapture exposure before the LOI. Negotiate a binding allocation schedule in the purchase agreement — don't let the buyer determine allocation post-closing. This is one of the most overlooked negotiation points in lower-middle-market deals.

4. Escrow and Holdbacks: How Much of Your Money Stays on the Table After Closing

Benefits to the Seller

In deals insured with representations and warranties insurance (RWI), the median escrow has dropped to just **0.3% of the purchase price** — a dramatic improvement from the 1% median in prior years. Twelve-month escrow periods are now standard, and 81% of claims resolve within that window. These are favorable terms that most sellers didn't have access to even five years ago.

Watch Out For

In non-insured deals, the picture is very different. The median escrow sits at roughly **9% of the purchase price** — up from 8% in prior periods. Survival periods have crept up to 18 months. Buyers may also propose "general holdbacks" outside of formal escrow — meaning the buyer holds your money directly, with no third-party escrow agent and limited release mechanisms. Escrow funds represent real money you can't invest, spend, or plan around until they're released.

BOTTOM LINE

Push for RWI early in the process — it dramatically reduces escrow. If RWI isn't available, require a third-party escrow agent (never let the buyer hold your money), interest accruing to the seller, and an express release schedule tied to specific milestones.

5. Reps & Warranties Insurance (RWI): Your Best Friend at the Closing Table

Benefits to the Seller

RWI transfers breach-of-representation risk from the seller to a third-party insurer. The practical impact is enormous: escrow drops from roughly 9% to **0.3%** of the purchase price, and you can often negotiate no-survival or limited-survival periods on general representations. Premiums typically run 2–3% of limits, retention sits at 0.5–1% of enterprise value, and minimum premiums have come down to as low as $50K on smaller deals.

Watch Out For

You may be asked to pay all or part of the RWI premium — this should be addressed in the LOI, not discovered at closing. Buyers sometimes use RWI as justification for **expanding the representation package** beyond what you'd give in a non-insured deal. Policy exclusions can leave gaps the seller doesn't realize exist until a claim arises. And on smaller deals ($20M–$30M), minimum premiums can be a meaningful percentage of the deal value.

BOTTOM LINE

Premium cost allocation should be spelled out in the LOI. Your indemnity cap should equal the RWI retention — not a separate, higher cap. And RWI should not be used as a reason to expand the rep package beyond what you'd give in a non-insured deal.

Bringing It Together

The headline purchase price is just the starting point. The deal structure — elections, allocations, escrow terms, insurance — determines what you actually keep. I've seen sellers leave seven figures on the table because they didn't understand how a 338(h)(10) election would change their tax bill, or because they agreed to an escrow structure that locked up 10% of their proceeds for 18 months. These aren't edge cases. They happen in almost every deal.

If you're thinking about a sale in the next one to three years, the best time to understand these issues is now — not when you're staring at an LOI with a 72-hour response window. A little preparation goes a long way toward making sure the number on the wire matches the number in your head.

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