Why F Reorganizations are a Staple in Deal Making

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The M & A market has enjoyed a surge in activity during the first quarter of 2021, as compared to 2020 when the COVID-19 pandemic put the brakes on transactions. While the number of deals is up only modestly, the total value of pending and completed deals is up significantly. A key factor appears to be lower price expectations on the part of sellers. Another factor is plentiful access to cheap debt, which is particularly attractive to private equity firms. One popular feature of many transactions involves F reorganizations of S corporations.

S corporations enjoy many tax benefits, such as corporate income and gains being taxed only once, at the shareholder level, and losses, deductions and credits being passed through to the shareholders. As a result, S corporations have become one of the most predominant forms of business organization. Businesses that private equity firms or other buyers wish to acquire are likely to be S corporations.

There are disadvantages to being classified as an S corporation. For example, the corporation may not have more than 100 shareholders at a time. In addition, only one class of stock is permitted, although there may be differences in voting rights. Lastly, all shareholders must be “eligible,” which generally means the following:

- Individuals who are U.S. citizens or resident aliens;
- Estates (but, estates held open for over two years without good reason can be reclassified as trusts); and
- Certain trusts (grantor trusts, testamentary trusts for up to two years, voting trusts, Qualified Subchapter S Trusts, Electing Small Business Trusts, and qualified retirement plan trusts).

Buyers like acquiring S corporations because they are eligible to make the election under Section 338(h)(10) to treat a stock purchase transaction as an asset purchase transaction for federal income tax purposes. Essentially, the buyer gets a valuable tax basis step-up without the legal complexities associated with an asset purchase. Thus, one of the concerns on the part of buyers is making, and then maintaining, a valid S corporation election for the target. Otherwise, if the target's S corporation election was inadvertently invalidated prior to closing, the buyer would be treated as having acquired the stock of a C corporation.   An F reorganization is a technique to minimize this potential risk.

Steps in an F Reorganization

Treas. Reg. §1.368-2(m)(4) contains examples of different types of F reorganizations. In practice, F reorganizations typically involve S corporations. However, while the pass-through tax treatment of an S corporations is attractive, the limits on who can be a shareholder, and the single class of stock requirement, can pose challenges to retaining pass-through tax treatment after an acquisition.

One common way of completing an F reorganization is through the following steps:

1. The shareholders owning the S corporation (the "Transferor Corporation") form a new corporation (the "Resulting Corporation"). The Resulting Corporation elects to be treated as an S corporation.
2. The shareholders of the Transferor Corporation contribute all of their shares to the Resulting Corporation in exchange for all of the issued and outstanding shares of the Resulting Corporation. This makes the Transferor Corporation a wholly owned subsidiary of the Resulting Corporation which itself ends up being owned by the original shareholders of the Transferor Corporation.
3. The Transferor Corporation then becomes a disregarded entity for federal income tax purposes either by making an election to be treated as a qualified subchapter S subsidiary or by the becoming an LLC under a state law conversion.

F Reorganization Requirements

Under Section 368(a)(1)(F), an F reorganization is defined as "a mere change in identity, form, or place of organization of one corporation, however effected." Rev. Rul. 2008-18 outlines the steps and timing an S corporation must adhere to in order to achieve an F reorganization while maintaining its S corporation election. The IRS issued final regulations in 2015 identifying six requirements that must be satisfied to qualify as an F reorganization. These regulations may be found at Treas. Reg. § 1.368-2(m). The purpose of the regulations is largely to make sure that there is only one continuing corporation involved in the reorganization, and that the transaction is not acquisitive or divisive in nature.

Generally speaking, the six requirements are as follows:

1. Immediately after the F reorganization, all of the issued and outstanding stock of the Resulting Corporation must be distributed to the shareholders of the Transferor Corporation. The IRS will disregard a *de minimis* amount of the stock in the Resulting Corporation being owned by someone other than the shareholders of the Transferor Corporation if necessary to facilitate the F reorganization. "*De minimis*" is not defined, but Treas. Reg. § 1.368-2(m)(4), Example 3, suggests that 1% would be acceptable.
2. The same persons must own all of the stock of the Transferor Corporation immediately before the transaction, and all of the stock of the Resulting Corporation immediately after the transaction in identical proportions. However, there is a *de minimis* exception. The rule is also not violated if some stockholders receive shares with different governance rights as long as all of the shares are of equivalent value, or if the shareholders receive a distribution of money or other property.
3. The Resulting Corporation may not have any tax attributes, e.g., income or losses, or any assets prior to the F reorganization. However, there is an exception that allows (i) a *de minimis* amount of assets to facilitate the F reorganization, (ii) tax attributes related to holding those assets, and (iii) holding the proceeds of borrowings in connection with the F reorganization. In order to ensure that there are no unwanted assets or tax attributes, most F reorganizations involve the creation of a new entity.
4. The Transferor Corporation must completely liquidate for federal income tax purposes. However, this does not mean that the business is required to dissolve under state law. It may maintain its legal existence as a separate entity, which is one of the attractive features of an F reorganization, because assets, licenses, etc. can continue to be held by the Transferor Corporation without needing to be transferred to the Resulting Corporation. This result commonly occurs when the Transferor Corporation ends up as a wholly owned subsidiary of the Resulting Corporation, and then becomes a disregarded entity by filing a qualified subchapter S subsidiary election or by becoming an LLC through a state law conversion.
5. Immediately after the F reorganization, only the Resulting Corporation may hold title to the property of the Transferor Corporation if the Resulting

Corporation acquires the tax attributes of the Transferor Corporation under the rules of Section 381 of the Internal Revenue Code.

6. Likewise, immediately after the F reorganization, the Resulting Corporation may not hold any property acquired from any corporation other than the Transferor Corporation if the Resulting Corporation acquires the tax attributes of the Transferor Corporation under rules of Section 381. These last two requirements are intended to ensure that only the Resulting Corporation holds the tax attributes of the Transferor Corporation (no other corporation) after the F reorganization has been completed.

F Reorganization Planning Opportunities

An F reorganization can solve a number of problems in connection with an acquisition. The buyer can receive a step-up in basis either by making a Section 338(h)(10) election or by acquiring a single member LLC interest in the case where the Transferor Corporation has become a limited liability company ("LLC") through a state law conversion. Acquiring an interest in the single member LLC can be particularly attractive, since the buyer does not need to worry about the limitations associated with owning S corporation stock. Purchasing the entire equity interest of the Transferor Corporation outright may also eliminate the need for certain third-party consents in connection with transferring assets, licenses, etc. Converting the S corporation to a single member LLC under state law also creates the opportunity for new equity investments from investors who would otherwise not qualify as S corporation shareholders, such as foreign persons.

The idea of shareholders in an S corporation forming a new corporation into which they contribute their shares, and then make an election to treat as a qualified subchapter S subsidiary, thereby effectuating a deemed tax-free liquidation of the subsidiary into its parent, is similar to the transactions outlined in Rev. Rul. 2008-18. While the revenue ruling may not specifically conclude that those steps qualify as an F reorganization, the IRS has issued a number of private federal rulings reaching that result (e.g., PLRs 200725012, 200701017 and 200542013).

In the M&A context, combining an F reorganization with an acquisition may give rise to concerns that the F reorganization will be viewed as merely a transitory part of a larger transaction or series of transactions, and that it might not be respected as a result. However, Treas. Reg. §1.368-2(m)(3)(ii) provides that transactions preceding or following an F reorganization generally will not cause a qualification failure. Even prior to the final regulations there were many revenue rulings holding that the application of the step-transaction doctrine should not result in the failure of an F reorganization to qualify simply because it is part of a larger transaction or series of transactions (e.g., Rev. Ruls. 96-29, 79-250, 69-516, 64-250, and 60-156).

There are also other benefits to using an F reorganization in an acquisition. For example, rollover transactions are a popular method for keeping the selling shareholders invested in the future success of a business following an acquisition. An F reorganization allows some of the S corporation shareholders to retain shares of the S corporation as a means of accomplishing a rollover of their equity on a tax-free basis. This is more tax efficient than having the shareholders sell their shares in the target corporation, recognize gain on the sale, and then afterward reinvest a portion of the proceeds in the stock of the acquiring corporation.

A company might also undergo an F reorganization, convert from an S corporation to a single member LLC, and then contribute the single member LLC interest to a new C corporation. The stock in the C corporation might be eligible for treatment as qualified small business stock under Section 1202 of the Internal Revenue Code. This provides investors with the opportunity to exclude some or all of the gains realized from the sale of the qualified small business stock provided that the other requirements of Section 1202 are satisfied.

Compliance Matters

The Resulting Corporation must obtain its own employer tax identification number (EIN) by filing Form SS-4. The Transferor Corporation retains its own EIN even after a qualified subchapter S subsidiary election has been filed. Although it will be treated as a disregarded entity after the election has been filed, there may be other non-income tax and business reasons why the Transferor Corporation would still need to use its own EIN, such as for banking purposes, making employment tax filings, and other state law matters.

The qualified subchapter S subsidiary election is made by filing Form 8869. In PLR 201724013, the IRS ruled that a qualified subchapter S subsidiary election was ineffective when the election was made after the subsidiary had converted into an LLC under state law. Fortunately, the taxpayer was eventually granted relief under Section 1362(f) of the Internal Revenue Code. Example 5 in the Treasury regulations suggests that perhaps a qualified subchapter S subsidiary election is not even needed if there is a plan to convert the Transferor Corporation into an LLC immediately after the shares are contributed to the Resulting Corporation. Nevertheless, in order to avoid any potential issues, Form 8869 should be filed before converting the Transferor Corporation into an LLC under state law.

Beginning in the year of the F reorganization, all future income tax filings must be made by the Resulting Corporation using its new EIN. Essentially, the Resulting Corporation will be treated just as the Transferor Corporation would have been treated had there been no F reorganization, including succeeding to the S corporation election previously made by the Transferor Corporation.

The taxable year of the Transferor Corporation does not end on the date of the F reorganization. Likewise, the Transferor Corporation does not need to file its own separate income tax return in the year of the F reorganization. However, to notify the IRS that an F reorganization has occurred, the Resulting Corporation must file a statement pursuant to Treas. Reg. §1.368-3 with its federal income tax return. Among other items, the statement must include the names and EINs of the parties involved in the F reorganization, the date of the reorganization, and the value and basis of the assets of the Transferor Corporation.

State and Local Tax Matters

There are a variety of state and local tax matters that may arise in connection with an F reorganization. One such matter concerns how to notify the state and local tax authorities that the Resulting Corporation has stepped into the shoes of the Transferor Corporation with the result that the Transferor Corporation is no longer required to file state and local tax returns. The Resulting Corporation may also need to register with the state or local tax authorities. The Transferor Corporation, on its part, may have overpayments or credit carry forwards requiring an application for a refund.

While many states generally conform to the federal rules regarding F reorganizations, some states may require a separate state S corporation election and/or qualified subchapter S subsidiary election. If the state elections are not timely made, then the Transferor Corporation and the Resulting Corporation will be taxed as C corporations by the state taxing authorities. A few states do not follow the federal income tax treatment of qualified subchapter S subsidiaries at all. As a result, a Transferor Corporation making a qualified subchapter S subsidiary election may be required to file its own tax returns in addition to those being filed by the Resulting Corporation.

Another issue is the recognition of gain on a sale of the qualified subchapter S subsidiary in an M&A transaction following the F reorganization. Because the qualified subchapter S subsidiary is treated as a division of its S corporation parent for federal income tax purposes, a sale of the stock of a qualified subchapter S subsidiary is actually treated as an asset sale for federal income tax purposes. States often classify the sale of business assets as apportionable business income. Thus, some states may attempt to apportion the proceeds on the sale of a qualified subchapter S subsidiary, and may even subject the gain to an additional layer of entity-level tax. In other words, the proceeds would be reported and taxed at the S corporation parent level and also at the top individual owner level, resulting in double taxation for state purposes. To make matters worse, historical liabilities for non-income taxes, such as sales and use taxes, may end up being inherited by the buyer.

Conclusion

F reorganizations allow buyers in M & A transactions to obtain a step-up in the tax basis of the target's assets without being reliant on the target maintaining its S corporation status, as required for Section 338(h)(10) election purposes. They also simplify transferring titles, licenses, etc. as compared to an asset sale, and may provide a more efficient process for rollover transactions. Likewise, they permit selling shareholders to defer gain recognition with respect to their rollover equity.

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