

THE F REORGANIZATION AS PART OF THE S CORPORATION ACQUISITION TRANSACTION STRUCTURE



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In many industry sectors, an economic recovery has followed the initial economic downturn of the COVID-19 pandemic. At the same time, many private company owners—particularly baby boomers—are thinking about selling their companies. Also at the same time, many private equity firms have money to invest and have accordingly increased their acquisition and consolidation of private companies. Tax counsel (and other transaction advisers) should be aware that one transaction tax structure that is particularly popular with regard to private equity firm acquisitions is an Internal Revenue Code (Code) section 368(a)(1)(F) reorganization of the private S corporation.

This article considers several of the reasons why owners may want to sell—and why private equity firms may want to buy—the S corporation target company. In particular, this article describes the benefits to the S corporation sellers of a section 368(a)(1)(F) reorganization as one step in the private company sale transaction as well as the benefits to the private equity buyers (and certain other types of S corporation buyers) of the F reorganization as a component of the transaction tax structure. This article summarizes the procedures for implementing the F reorganization and the tax planning considerations for the merger and acquisition (M&A) transaction participants—and for their tax counsel and other transaction advisers—with regard to the F reorganization as part of the private company acquisition structure.

Sale of the S corporation private company

Many baby boomer private company owners have reached (or passed) retirement age and may be considering a business sale exit strategy as part of their retirement plans. Some private companies have been extremely successful during the pandemic while others have become financially distressed during the same period. In either case, private equity firm buyers have money to invest—and an appetite for M&A transactions in many industries.

The typical strategy of a private equity firm is to consolidate—or roll up—several companies in the same general industry. This private equity firm acquisition strategy could be based simply on growth and size. In most industries, larger companies typically sell for higher valuation pricing multiples than do smaller companies, all other factors being equal. The acquisition strategy could also be based on geography or on industry segment (service line) specialties—either consolidation or diversification.

In any event, the typical goal of the private equity firm is to buy several companies in the same general industry. The private equity acquirer consolidates the target companies, eliminates duplicative functions and costs, improves operational efficiencies, and increases profitability. Then, the private equity firm sells the now-consolidated company. That sale could be made to a strategic acquirer industry

participant or it could be implemented through an initial public offering (IPO) of the consolidated company. The private equity firm expects to earn a profit based on the difference between the total of the prices it paid for the purchase of the target companies and the price it receives from the sale of the consolidated company.

As discussed below, one typical transaction tax structure in the private equity acquisition of a target S corporation involves a section 368(a)(1)(F) reorganization as part of the overall deal structure. Tax counsel should be aware that this F reorganization has benefits to the S corporation sellers who typically retain a small equity interest in the target company after the private equity acquisition. Tax counsel should be aware that this F reorganization has benefits to the private equity firm buyer that may be concerned about any issues related to the target company's S corporation tax status.

S corporation income tax status

Many privately owned companies are organized as S corporations for federal income tax purposes. S corporation status provides numerous benefits to the private company owners. S corporation income and gains are taxed only one time—at the shareholder level. In contrast, C corporation income and gains are taxed at the corporation level while distributions are taxed again at the shareholder level. However, there are limitations associated with the S corporation tax status. One limitation, particularly for a larger private company, is the limitation on the number of S corporation shareholders.

In 1958, when the US Congress first authorized S corporations, the maximum number of shareholders was limited to 10. That limitation on the number of S corporation shareholders has increased several times since 1958, most recently in 2004 to 100 shareholders. Since 1997, S corporations have become the most common type of corporate entity—according to Internal Revenue Service (IRS) income tax return statistics. Therefore, it should not be a surprise to tax counsel that many private company acquisition targets are S corporations.

S corporations are considered tax pass-through entities and typically are not liable for federal income tax. As a tax pass-through entity, the S corporation income is taxable in the individual income tax returns of its shareholders. Typically, private equity firm acquisitions are structured as equity (stock) acquisitions—and not as asset acquisitions. One reason for that structure is because the private equity firm wants the selling shareholders to retain some small amount of equity (as economic motivation) in the target company.

The private company sellers typically prefer an equity sale structure over an asset sale structure. Typically, the sellers receive capital gain treatment on any gain recognized in the stock sale, while the sellers receive ordinary income treatment on any gain recognized in an asset sale. Of course, most private company buyers prefer an asset acquisition over a stock acquisition. In a stock acquisition, the buyer takes a carry-over tax basis in the target company assets.

In an asset acquisition, in contrast, the buyer steps up the tax basis in the target company's assets—based on the purchase price paid for the business. That is, the buyer gets to depreciate or amortize any purchase price premium paid (over the assets' tax basis) for federal income tax purposes. In addition, as a non-tax consideration, the buyer does not have to assume all of the target company's unknown or contingent liabilities in an asset purchase transaction.

For an S corporation acquisition, the buyer and the seller will often make an election under section 338(h)(10) or section 336(c). Such an election allows the buyer to treat the purchase of the target company stock as if it were the purchase of the target company assets, for federal income tax purposes. Therefore, the buyer generally enjoys the income tax benefits associated with an asset acquisition transaction structure. However, tax counsel should be aware that such tax elections have both requirements and limitations.

First, the buyer and the sellers have to agree to—and coordinate—such a deemed asset purchase tax election. Second, the sellers cannot achieve a tax

deferral on any rollover portion of the target company purchase transaction. Private equity firm buyers typically require the sellers to continue to own, say, 10 percent to 20 percent of the target company. The private equity buyers sometimes refer to this rollover equity as the sellers' "skin in the game." This rollover equity is intended to economically motivate the sellers to stay active in the target company and to help make the multiple acquisition roll-up strategy successful.

In addition, the sellers may want to retain some small amount of ownership in the target company. This retained ownership interest allows the sellers to enjoy additional gains when the roll-up or consolidated entity is ultimately sold—either to a corporate acquirer or in an IPO.

Concerns over the target company S corporation status

Tax counsel understand that one concern of any S corporation acquirer—particularly a buyer considering a section 338(h)(10) election—is that the target company has a valid S income tax status. Both section 338(h)(10) and section 336(e) transactions are stock purchase transactions for legal purposes and are considered asset purchase transactions for federal income tax purposes. If the target company's S income tax status is not valid, then the buyer acquired the stock of a C corporation. Tax counsel should appreciate that the economics of the section 338(h)(10) election or the section 336(e) election are always unfavorable when applied to a C corporation acquisition.

Therefore, S corporation buyers—including private equity buyers—will be concerned about the risk of an invalid (including an accidentally invalid) target company S status. To mitigate this risk, the application of the section 368(a)(1)(F) reorganization has become a step in private equity firm acquisitions of an S corporation target. In addition, the F reorganization may also be appropriate in any sale of the S corporation where the sellers retain some equity ownership interest. One such example may be the sale of the private company to its key employees in a leveraged buyout (LBO) transaction. In such a transaction,

the employee buyers may want the sellers to retain some ownership in the target company—in order to assist with a smooth ownership transaction. Also, the company sellers may want to retain an equity interest for some period—to ensure that the key employee owners can successfully pay down the acquisition debt (including any seller notes).

The F reorganization transaction objectives

In the S corporation acquisition, implementing an F reorganization prior to the purchase transaction is intended to achieve the following transaction objectives:

- The F reorganization provides the buyer with a step-up in the depreciable tax basis of the target company assets for the purchase portion of the transaction (even if that portion of the transaction is under 80 percent);
- The F reorganization provides the sellers with the same tax treatment as is available under the section 338(h)(10) election—but without the requirement for an at least 80 percent sale of the company stock and with the seller's ability to achieve a tax deferral on the rollover equity portion of the transaction;
- The F reorganization avoids the cumbersome legal considerations that are typical in an asset purchase transaction structure; and
- The F reorganization allows the target company to continue to use the same employer identification number (EIN) for payroll tax purposes; this continuation may be an important consideration for the target company buyer.

An acquisition that is preceded by an F reorganization does not experience the limitations that typically come with a section 338(h)(10) election. Tax counsel should be aware that some of these section 338(h)(10) election limitations include the following:

- The requirement that the transaction involves 80 percent or more of the target company stock;
- The taxation of 100 percent of the total transaction price—even if the sellers roll over (i.e.,

retain ownership of) some portion of the target company stock; and

- The requirement that the transaction involves a qualified stock purchase.

The F reorganization structure provides an effective transaction tax structure when a tax-deferred equity rollover investment is part of the S corporation purchase/sale. And, the F reorganization structure is a particularly efficient transaction tax structure if the buyer wants to benefit from the step-up in the tax basis of the target company assets.

Definition of the F reorganization

Section 368(a)(1)(F) defines an F reorganization as a mere change in identity, form, or place of organization of one corporation, however affected. This statutory definition of an F reorganization seems short and simple. Nonetheless, this statutory definition does allow for ambiguities as to its specific requirements. There may be other entity changes that occur within the steps of implementing an F reorganization. These other entity changes become important: (i) if the S corporation sellers are to avoid potential gain recognition; and (ii) if the target company buyer is to retain the tax-free nature of the F reorganization.

In 2015, the IRS issued Regulation section 1.368-2(m) which provides six requirements that must be satisfied in order for a transaction that involves an actual or deemed transfer of property by a transferor corporation to a resulting corporation to be “a mere change” that qualifies as an F reorganization. The objectives of this regulation are to ensure that only one continuing corporation is involved in the reorganization and that the transaction is not acquisitive or divisive in nature.

Four of the six section 1.368-2(m) requirements were known prior to 2015. These requirements were included in proposed regulations dating back to 2004. The fifth and sixth requirements were new. These two new requirements were added in the 2015 final regulation in order to ensure that the transferee corporation would be equivalent to the transferor corporation:

- Requirement 1: The resulting corporation stock must be distributed in exchange for transferor corporation stock. The goal of this requirement is to ensure that the transferor corporation and the transferee corporation have essentially the same stockholders. A de minimis amount of stock issued by the resulting corporation is allowed—if that stock is issued other than in respect to the stock of the transferor corporation to facilitate the organization of the resulting corporation or to maintain its legal existence.
- Requirement 2: The identity of the stock ownership must remain the same. The same persons must own all of the transferor corporation and the resulting corporation before and after the F reorganization. The important requirement is that these same persons must own the stock in identical proportions. The regulations do provide some leniency with regard to the identical proportions requirement. That is, stockholders are permitted to exchange their shares in the transferor corporation for a different class of stock in the resulting corporation. Such an exchange is allowed as long as: (i) the shares of stock are of equivalent value; and (ii) the existing shareholders can receive a distribution of money or other property either from the transferor corporation or from the resulting corporation. The shareholders can receive that distribution whether or not it is in exchange for the stock of the transferor corporation or of the resulting corporation.
- Requirement 3: There must be no prior assets or attributes of the resulting corporation. The resulting corporation may not own any property or have any tax attributes immediately before the F reorganization. This requirement would not be violated if the resulting corporation holds (or held) a de minimis amount of assets. That statement is true if the assets are intended to facilitate the resulting corporation’s organization to maintain its legal existence. And, this requirement would not be violated if the resulting corporation holds tax attributes related to the de minimis assets or holds the proceeds of borrowings undertaken in connection with the F reorganization.

- Requirement 4: There must be a complete liquidation of the transferor corporation. In the F reorganization, the transferor corporation must completely liquidate for federal income tax purposes. However, the transferor corporation is not required to dissolve under applicable state law. And, the transferor corporation may retain a de minimis amount of assets for the sole purpose of preserving its legal existence.
- Requirement 5: The resulting corporation must be the only acquiring corporation. No other corporation may hold property that was owned by the transferor corporation immediately before the F reorganization—other than the resulting corporation. That is, as a result of the F reorganization, no other corporation may succeed to or take into account the transferor corporation's income tax attributes under section 381.
- Requirement 6: The transferor corporation must be the only acquired corporation. The resulting corporation may not hold property transferred from another corporation—other than from the transferor corporation. That is, as a result of the F reorganization, the resulting corporation may not succeed to or take into account that other corporation's income tax attributes under section 381.

Of the six requirements, the third and fourth requirements ensure that everything the resulting corporation owns after the F reorganization (with limited exceptions) came from the transferor corporation. The third and fourth requirements also ensure that the transferor corporation will not retain any assets and will terminate—for income tax purposes.

Of the six requirements, the fifth and sixth requirements relate to a transaction that includes multiple acquisitions from multiple transferor corporations of property and of tax attributes. These requirements ensure that the resulting corporation settles with the tax attributes of the transferor corporation.

Step transaction concerns

Tax counsel (and other transaction advisers) may be concerned that the IRS will raise allegations of a step transaction. That is, tax counsel (and other

transaction advisers) may be concerned that the IRS's application of the step transaction doctrine may cause a failure in the proposed F reorganization. In other words, the IRS may allege that the F reorganization is transitory or part of a series of transactions and should not be considered on its own merits.

The Treasury regulations provide guidance to alleviate such tax counsel (and transaction participant) concerns. Regulation 1.368-2(m)(3)(ii) provides that transactions either preceding or following an F reorganization typically will not cause a failure of the reorganization to qualify under section 368(a)(1)(F). Even before the issuance of this regulation, the IRS had issued some older revenue rulings that indicated the step transaction doctrine should not cause the failure of an F reorganization that was implemented as part of a larger transaction.¹ Regulation 1.368-2(m)(3)(ii) (and the older revenue rulings) provide guidance regarding how to implement a pre-transaction F reorganization as part of an M&A deal structure. That implementation guidance is discussed next.

Implementation guidance for an F reorganization prior to the acquisition

For all of the reasons mentioned above, the implementation of an F reorganization may be particularly attractive in the private company M&A transaction involving a private equity acquirer. The typical private equity acquisition structure (particularly with respect to an S corporation) often involves multiple transaction steps at multiple times. Therefore, tax counsel may have to engage in intentional pre-transaction structuring including:

- The S corporation (Seller) shareholders will form a new corporation (Seller Holdco) by contributing shares of Seller to Seller Holdco in exchange for all of the shares of Seller Holdco.
- Seller elects to become a subchapter S subsidiary (QSub) of Seller Holdco. That election effectuates a deemed tax-free liquidation of Seller into Seller Holdco. This procedure also extends S corporation status to Seller Holdco—according to Revenue Rulings 64-250 and 2008-18.

All of the above-listed procedures are nontaxable events. These procedures are all considered to be part of the F reorganization. The above-described transaction procedures are similar to the procedures described as Situation 1 in Revenue Ruling 2008-18.

Tax counsel should note that Revenue Ruling 2008-18 does not specifically state that the illustrative transaction qualifies as an F reorganization. But, the revenue ruling does represent that the illustrative transaction procedures may qualify as an F reorganization. In addition, the IRS has issued a number of letter rulings that indicate that a contribution followed by a QSub election qualifies as a section 368(a)(1)(F) reorganization.²

One additional procedure that counsel typically implement after the F reorganization is to convert the Seller S corporation to a Seller limited liability company (Seller LLC). This conversion is typically implemented by counsel under the appropriate state statutes. Seller LLC remains a disregarded entity for federal income tax purposes (just as the S corporation Seller was a disregarded entity). Tax counsel should be aware that the conversion of the QSub disregarded entity into an LLC disregarded entity has no federal income tax consequences. Post-conversion, Seller LLC will be a single member LLC (or a SMLLC).

This conversion to LLC income tax status is often implemented when the acquirer is a tax pass-through entity. In such an instance, it is not efficient to have Seller as a C corporation after the acquisition closing. The conversion to LLC income tax status also protects the acquirer's asset tax basis step-up if Seller inadvertently fails to qualify for S corporation status any time in the past or if the Seller QSub election was not properly implemented.

For example, let's assume that Seller inadvertently failed its S corporation status two years prior to a current acquisition. The procedures of forming Seller Holdco and converting Seller to an SMLLC will still ensure a successful F reorganization. This is because the purported QSub election for Seller will be disregarded as a result of Seller's failure to maintain its

S corporation tax status. And, the acquirer's step-up in the tax basis of the Seller assets will still be protected.

Options to implement the acquisition

Management/employee buyers and, particularly, private equity buyers have several transaction structure options available to them after the S corporation sellers have implemented the F reorganization. Both types of buyers (especially private equity buyers) often want the selling stockholders to retain a small equity ownership interest in the acquired company. Therefore, Seller Holdco can contribute some of the Seller equity into the buyer's acquisition structure while the remaining Seller equity is acquired directly by the buyer. This typical structure is treated as a partial rollover and a partial taxable sale of an undivided interest in each of the Seller's assets. For income tax purposes, the amount of the consideration is calculated as the cash paid plus the assumptions of an associated percentage of the Seller liabilities. This transaction structure is wholly consistent with the hypothetical Situation 1 presented in Revenue Ruling 99-5.

Assuming that the Seller assets have appreciated over time, the sum of the cash paid plus the liabilities assumed will result in a step-up in the tax basis of the assets. To the extent that the total consideration is allocated to goodwill and other intangible assets, the Seller stockholders should find this transaction structure acceptable. For instance, these selling stockholders will not have to pay ordinary income tax (related to the depreciation recapture) on any appreciated tangible assets.

The remaining (that is, not sold) seller equity may be rolled over in exchange for the buyer equity. The buyer equity would remain, being held by Seller Holdco. The Seller stockholders would expect the rollover to be tax deferred. Seller Holdco would carry over its tax basis in the buyer's equity—equal to the tax basis that Seller Holdco had in the contributed property.

An alternative transaction structure involves the formation of a partnership. The partnership is formed by the distribution of an ownership interest in Seller (after Seller converted to an LLC) to one of the Seller

Holdco shareholders. Alternatively, the partnership could be formed by distributing an ownership interest in Seller to one or more of the target company key employees.

The result of this transaction structure is that Seller becomes a multimember (not a single member) LLC which is treated as a partnership for federal income tax purposes. After implementing this partnership formation, Seller makes a section 754 election and, then, the buyer acquires an ownership interest in Seller. Assuming the Seller assets have appreciated over time, the buyer receives a step-up in the tax basis of the Seller assets under section 753—as a result of the section 754 election.

F reorganization cost/benefit analysis

S corporation shareholders involved in an M&A transaction—and their tax counsel—should consider both the costs and the benefits of an F reorganization transaction structure. In fact, tax counsel may consider such F reorganization costs and benefits from the perspectives of both the S corporation sellers and the buyer (the corporate acquirer).

To the S corporation selling shareholders, some of the F reorganization deal structure benefits include the following:

- The shareholders may defer gain recognition on any rollover equity in the transaction;
- The shareholders may take income tax deductions related to the transactions costs; and
- The shareholders may defer any gain recognition related to any deferred payments in the transaction.

These above-listed benefits are particularly relevant to the typical M&A transaction involving a private equity acquirer. These benefits are also relevant to an employee/management LBO transaction where the sellers retain an equity ownership interest during a transition period or during a debt pay-down period.

To the S corporation corporate acquirer, some of the F reorganization deal structure benefits include the following:

- The acquirer obtains a step-up in the tax basis of the S corporation's assets—for the purchased portion of the transaction;
- The acquirer avoids the risk of an invalid S corporation tax status when making the section 338(h)(10) election; and
- The acquirer avoids all of the hassle of transferring the ownership of each individual S corporation asset category in an asset purchase transaction structure.

Also, the F reorganization involves a stock purchase transaction. Therefore, the acquirer can continue to use the S corporation's federal EIN and does not need to terminate and then rehire all of the S corporation employees into a new corporate organization.

Tax counsel (and other transaction advisers) should note that the F reorganization transaction structure does not eliminate all tax (or legal) concerns. Tax due diligence is still required on the part of tax counsel to the corporate acquirers. The buyer still assumes some tax liabilities related to the S corporation target company. After all, the buyer is acquiring the S corporation legal entity!

There may be a debate among tax counsel as to how much of the S corporation's historical income tax exposure the buyer (and particularly the S corporation Holdco) assumes after an F reorganization. Whatever that amount of historical tax liability exposure is, it is probably not zero. In addition to the tax liability issues, counsel should advise the buyer that it would certainly assume all of the S corporation's historical legal liabilities in this stock acquisition structure.

CONCLUSION

Many privately owned companies are structured as S corporations for federal income tax purposes. Post-COVID, many private companies are positioned either as corporate acquirers or as acquisition targets.

With money to invest, many private equity buyers have increased their M&A activity across many industries, rolling up geographic competitors, assembling companies with complementary specializations, or acquiring (and improving) companies with less-than-stellar operating results. In addition, many private companies are candidates for leveraged management buyouts or leveraged employee buyouts.

In all of these situations, the buyers often want some or all of the S corporation sellers to retain a noncontrolling ownership interest in the acquired company. This so-called rollover capital motivates the sellers to ensure a smooth transition and/or assist the private equity buyer with a roll-up strategy. In any event, a section 368(a)(1)(F) reorganization implemented just prior to the S corporation acquisition may provide significant income tax benefits both to the S corporation selling shareholders and to the corporate acquirer. 🍀

Notes

- 1 See Rev. Ruls. 61-156, 64-250, 69-516, 79-250, and 96-29.
- 2 See IRS Priv. Ltr. Ruls. 200542013, 200701017, and 200725012.