Getting an "F" when Buying an S Corp. Makes the Grade

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When acquiring an S corporation, there are unique tax issues to be dealt with regarding the target's status as an S corporation. Fortunately, buyers are armed with a tax-free reorganization pursuant to Section 368(a)(1)(F) of the Internal Revenue Code (IRC), also known as the "F reorg." When an F reorg. is combined with a limited liability company (LLC) conversion, the issue of S corporation status becomes a nonfactor, allowing buyers and sellers to focus on other aspects of the acquisition.

To initially qualify and retain an entity's status as an S corporation, there are specific rules outlined within Section 1361 that must be continually met.[1] If an entity loses its status as an S corporation, it immediately converts to a C corporation and becomes subject to corporate income tax at the entity level rather than being taxed at the shareholder level. One can imagine the dismay when a seller learns that it inadvertently terminated its S corporation status and now has significant tax exposure on past earnings at the applicable corporate tax rate.[2]

Reviewing every year in which a target has been in existence (including any predecessor) to determine that it did not lose its S corporation status can be daunting, if not impossible. An S corporation or an authorized representative can contact the IRS for confirmation that a valid initial election was originally made, but that provides no comfort that it had not been subsequently inadvertently terminated. A buyer may request a management representation that the S corporation election is valid or include indemnifications in the purchase agreement, but they rarely provide adequate protection.

Confirming the S corporation election of a target will dictate whether the buyer is eligible for a stepped-up tax basis in the underlying assets via specific tax elections. Typically, a corporate buyer can get a step up in basis in the assets acquired through a deemed asset acquisition by making a Section 338(h)(10) election or a Section 336(e) election (i.e., if the acquirer is a noncorporate purchaser). Both elections, however, are unavailable if the target's S corporation election has been terminated.

The F reorg. and LLC conversion essentially take the question of the S election and availability of a step up in basis off the table for both buyer and seller. The steps of the F reorg. and LLC conversion are outlined below. Revenue Ruling 2008-18 confirms steps 1-3 to be a reorganization under Section 368(a)(1)(F); when combined with the LLC conversion (collectively, the "preclosing steps") the buyer can achieve the step up in tax basis.[3] This not only benefits the buyer but the preclosing steps also may provide the seller with more flexibility if the transaction involves rollover equity, which can be further complicated due to anti-churning rules of Section 197(f)(9). It is essential to follow the steps in the order provided and allow enough time between each.

- Shareholder(s) of the target create "S Corp. New Holdco" on Day 1.
- Shareholder(s) contribute target to S Corp. New Holdco on Day 2. Target's S corporation election continues for S Corp. New Holdco.
- S Corp. New Holdco makes a qualified Subchapter S subsidiary (QSub) election on Day 4 (two days after Step 2) for target by filing Form 8869 and checking the "Yes" box on question 14 among other requirements for timely and proper completion and filing of the form.[4]
- Target is converted to an LLC under state law on Day 5, if possible and if tax-efficient by a state law formless conversion; if not, by a merger into a new LLC with the LLC as the surviving entity.
- S Corp. New Holdco sells target on Day 6 or later.[5]

There may be specific state tax issues to consider, particularly if the state does not allow for conversion from a corporation to LLC. However, this can be remedied via a merger as indicated above.

The F reorg. combined with the LLC conversion remains a well-accepted tool that can benefit all parties involved.

[1] IRC Section 1361 defines an S corporation as an "eligible corporation" that has no more than 100 shareholders; no ineligible shareholders, including nonresident alien shareholders; and only one class of stock.

[2] Treas. Reg. Section 1.6037-1(c) provides a three-year statute of limitations if a corporation's status as an S corporation was inadvertently terminated and it annually filed Form 1120-S (as opposed to Form 1120 as a C corporation) and substantially all income is otherwise properly reported.

[3] Revenue Ruling 2008-18 amplifies the holding of S corporation continuity under Revenue Ruling 64-250, applicable to steps 2 and 3.

[4] There appears to be conflicting guidance whether the existing employer identification number (EIN) is retained by S Corp. New Holdco or is transferred to the target; however, one entity would need to obtain a new EIN. This is beyond the scope of this article.

[5] Careful consideration must be given by the S Corp. New Holdco following the sale and a distribution of proceeds to avoid a "complete liquidation," including a "de facto liquidation." Careful consideration should also be given to whether the plan constitutes a "partial liquidation."

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