

AN ALERT FROM THE BDO FEDERAL TAX PRACTICE

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SUBJECT

"F" REORGANIZATION UNDER REV. RUL. 2008-18: TIMING OF QSUB ELECTION IS KEY

SUMMARY

Pre-transaction restructuring for S Corporations using the "F" Reorganization has become a very commonly used technique, especially for Private Equity (PE) firms that wish to acquire a closely-held corporation (the transferee corporation or "Target") in transactions that require tax-free rollover equity.

The "F" Reorganization structure involves the formation of a new S Corporation (the resultant corporation or "NewCo"), followed by a contribution of the stock of the Target into NewCo in exchange for NewCo stock. Following the contribution, a Qualified Subchapter S Subsidiary (QSub) election is made to treat the Target as a disregarded entity for income tax purposes. This strategy follows the model established by Revenue Ruling (Rev. Rul.) 2008-18,¹ and is often the strategy of choice where the parties wish to avoid potential tax or structural inefficiencies.

For example, if rollover equity is desired in a tax-free manner by the seller(s), and if the PE firm wishes to obtain a cost basis in the assets acquired, this strategy often precedes the conversion of the QSub to a single-member limited liability company (SMLLC), which is also a disregarded entity for tax purposes. The conversion of one disregarded entity into another disregarded entity has no federal income tax consequences.

A partnership is then created by either distributing a nominal, *e.g.*, 1% interest in the LLC to one of the shareholders of the S Corporation, or by compensating a key employee with a nominal interest in the LLC. After a period of time has passed, an election under Internal Revenue Code Section (Sec.) 754 is made by the partnership, and the PE firm purchases an interest in the partnership. The S Corporation will recognize gain equal to the percentage of the underlying LLC that is sold, and the PE firm receives a tax basis step-up for the underlying assets that it purchased.²

¹ 2008-1 CB 674 (March 7, 2008).

² In situations where the tax basis step-up relates to Sec. 197 amortizable intangible assets, it is often necessary to consider the anti-churning rules under Sec. 197(f). Where the PE firm acquires a partnership interest and obtains a Sec. 743(b) basis adjustment, the anti-churning rules may be inapplicable. For example, see Regs. Sec. 1.197-2(h)(12)(v) and Regs. Sec. 1.197-2(k), Example 19.

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Following these steps as outlined in Rev. Rul. 2008-18 will satisfy the objectives of the Target shareholders and the PE firm. However, the timing of the QSub election can be a “trap for the unwary,” as highlighted in a recent Private Letter Ruling, PLR 201724013.³

DETAILS

“F” Reorganization

The Internal Revenue Code provides that corporations and shareholders do not recognize gain with respect to certain qualifying reorganizations.⁴ To satisfy the requirements for this nonrecognition benefit, a transaction must meet one of the statutory definitions of a “reorganization” set forth in Sec. 368(a)(1). Sec. 368(a)(1)(F) provides that a reorganization includes a mere change in identity, form, or place of organization of one corporation, however effected, i.e., an “F” Reorganization.

Treasury Regulations elaborate that a mere change occurs if, as a result of a transaction or series of transactions: (1) All the stock of the resulting corporation, including stock issued before the transfer, is issued in respect of the transferring corporation's stock; (2) There is no change in the corporation's ownership in the transaction, except a change that has no effect other than that of a redemption of less than all of the corporation's shares; (3) The resulting corporation does not hold any property or have any tax attributes immediately before the transfer; (4) The transferring corporation completely liquidates in the transaction; (5) The resulting corporation is the only acquiring corporation; and (6) The transferor corporation is the only acquired corporation.⁵ To meet the fourth requirement, the transferring corporation is not required to legally dissolve.⁶

An “F” Reorganization is, by its statutory definition, limited to a transaction involving a single entity which is treated as a corporation for federal tax purposes.⁷ Two corporations can be involved in a type “F” Reorganization if only one corporation has an active trade or business, and that active trade or business is

treated as contained within the newly-formed corporation created to enter into the reorganization. Moreover, a series of related transactions can together constitute an “F” Reorganization; the “F” Reorganization will generally continue to qualify as such even if it is preceded or followed by other related transactions.⁸ The acquiring company succeeds to the tax attributes of the transferor company and is treated as the transferor would have been treated had there been no reorganization.⁹

The interplay of the “F” Reorganization with S Corporations and QSubs provides valuable planning opportunities, but also introduces complexities.

QSubs

While an S Corporation generally cannot have a corporate shareholder,¹⁰ the tax law permits an S Corporation to have a disregarded corporate subsidiary if it owns 100% of the subsidiary's stock,¹¹ the subsidiary is not an ineligible corporation,¹² and the S Corporation parent elects to treat the subsidiary as a QSub by filing Form 8869, Qualified Subchapter S Subsidiary Election.

An entity thus meets the QSub eligibility requirements - outlined in Sec. 1361(b)(3)(B) - if it is a corporation otherwise eligible to be an S Corporation, but its stock is owned entirely by a single electing S Corporation.¹³

When a parent S Corporation makes a QSub election for its wholly owned subsidiary, the subsidiary is generally deemed to have engaged in a tax-free liquidation for tax purposes. As a result, the QSub is treated as a division of the S Corporation parent for federal income tax purposes.¹⁴

³ March 8, 2017; released June 16, 2017.

⁴ Secs. 354-368.

⁵ Treasury Regulations Section (Regs. Sec.) 1.368-2(m)(1).

⁶ Regs. Sec. 1.368-2(m)(1)(iv).

⁷ H.R. Rep. No. 97-760, at 541 (1982); Rev. Rul. 96-29, 1996-1 CB 50; PLR 201014048 (Dec. 30, 2009); PLR 200825031 (Mar. 19, 2008); PLR 200803012 (Oct. 17, 2007); PLR 200803005 (Oct. 19, 2007).

⁸ Regs. Sec. 1.368-2(m)(3)(i), (ii).

⁹ Sec. 381; Regs. Sec. 1.381(b)-1(a)(2).

¹⁰ Sec. 1361(b)(1)(B); Regs. Sec. 1.1361-1(f).

¹¹ Sec. 1361(b)(3)(B); Regs. Sec. 1.1361-2 and 1.1361-3.

¹² A domestic corporation is eligible to elect S Corporation status if (i) it has no more than 100 shareholders, (ii) all of its shareholders are individuals (with certain exceptions for estates, trusts, and tax-exempt organizations), (iii) none of its shareholders are nonresident aliens, and (iv) it has only one class of stock. Ineligible entities are insurance companies taxed under subchapter L of the Code, bank or thrift institutions using the reserve method of accounting for bad debts under Sec. 585, possessions corporations under Sec. 936, and domestic international sales corporations (“DISCs”) or former DISCs.

¹³ Sec. 1361(b)(3)(B).

¹⁴ Regs. Sec. 1.1361-4(a). However, QSubs are treated as separate entities for purposes of employment taxes and certain excise taxes (Regs. Sec. 1.1361-4(a)(7) and (8)); QSubs are also treated as separate entities for legal purposes.

The deemed liquidation of a QSub into its parent is subject to the rules generally applicable to liquidating distributions of a corporation, including the "step transaction doctrine,"¹⁵ whereby the deemed liquidation could be treated as part of a larger transaction.¹⁶

The parent S Corporation can make the QSub election at any time during the tax year.¹⁷ However, the requested effective date of the QSub election generally cannot be more than:

1. Twelve months after the date the election is filed, or
2. Two months and 15 days before the date the election is filed.

The QSub eligibility requirements must be met at the time the election is made and for all periods during which the election is to apply.¹⁸

Using a QSub can be a valuable tax planning opportunity where there is a business reason to maintain certain S Corporation operations in a separate subsidiary. Moreover, since a QSub is treated as a division of its parent S Corporation, the sale of an interest in a QSub is treated as a sale of an undivided interest in its assets for federal income tax purposes (corresponding to the amount of stock sold),¹⁹ which provides the buyer with a "step-up" in the basis of the acquired assets for depreciation and amortization purposes. The corporation that is formed as a result of a sale of a QSub interest would be a C Corporation. Since the owners would prefer to hold a pass-through entity to afford a single level of tax on a subsequent asset sale at capital gains tax rates, the QSub is typically converted to a SMLLC immediately prior to the sale. A sale of a partial interest in a SMLLC would still result in a partial asset sale for income tax purposes, but it would create a partnership for income tax purposes.²⁰

Rev. Rul. 64-250: S Election Continuity

In Rev. Rul. 64-250,²¹ the IRS held that when an S Corporation merges into a newly-formed corporation in a transaction that qualifies as an "F" Reorganization, and the newly-formed surviving corporation also qualifies as an S Corporation, the reorganization will not terminate the S election, and the S election remains in effect for the new corporation.

This principle of continuity of the election has been amplified by Rev. Rul. 2008-18, which addresses certain "F" Reorganizations involving QSubs.

Rev. Rul. 2008-18: "F" Reorganizations Involving QSubs

In Rev. Rul. 2008-18, the IRS held that where the shareholders of an existing S Corporation (Target) cause it to become the wholly-owned subsidiary of a new S Corporation holding company (NewCo) owned by the same shareholders, and NewCo timely elects to treat Target as a QSub effective immediately following the transaction, these steps are treated as an "F" Reorganization under Sec. 368(a)(1)(F).²²

The requirements for an "F" Reorganization are met, with NewCo continuing the tax attributes of Target, because Target is treated as a QSub and disregarded for income tax purposes, and all of its activity is treated as occurring within the newly-formed entity.

Rev. Rul. 2008-18 cited Rev. Rul. 64-250 in concluding that an election of S Corporation status on Form 2553, *Election by a Small Business Corporation*, should not be required for NewCo, as Target's S election remains in effect for NewCo. However, a new employer identification number (EIN) is generally required for NewCo, while Target (now a QSub) retains its existing EIN.

In the wake of Rev. Rul. 2008-18, the IRS redesigned Form 8869, *Qualified Subchapter S Subsidiary Election*, allowing taxpayers to check a box in Part II, Item 14, to indicate that the election is made in combination with an "F" Reorganization described in Rev. Rul. 2008-18. Checking this box puts the IRS on notice that no new S Corporation election is required and that the S Corporation status has transferred from Target to NewCo.

An "F" Reorganization pursuant to Rev. Rul. 2008-18 typically entails the following sequence of steps:

Step 1: The shareholders of Target contribute all of their shares to NewCo, in exchange for all of the shares of NewCo, thus causing Target to become a wholly-owned subsidiary of NewCo.

Step 2: Effective on the same date as the contribution in Step 1, NewCo files Form 8869 to treat Target as a QSub.

¹⁵ The step transaction doctrine is a judicially developed concept that forms a subset of the more general "substance over form" doctrine that originated in the Supreme Court's decision *Gregory v. Helvering*, 293 U.S. 465 (1935). Under the step transaction doctrine, the IRS and courts generally treat a series of formally separate "steps" as a single transaction if the steps are "in substance integrated, interdependent, and focused toward a particular end result" (*Penrod v. Comr.*, 88 T.C. 1415, 1428 (1987); *Christian Est. v. Comr.*, T.C. Memo 1989-413). On the other hand, separate steps are not disregarded, even if the steps are taken pursuant to an overall plan, if each step is meaningful and has independent economic significance.

¹⁶ See Regs. Sec. 1.1361-4(a)(2)(i).

¹⁷ Regs. Sec. 1.1361-3(a)(3).

¹⁸ Regs. Sec. 1.1361-3(a)(1).

¹⁹ Sec. 1361(b)(3)(C)(ii)(I).

²⁰ Rev. Rul. 99-5, 1999-1 CB 434 (January 15, 1999).

²¹ 1964-2 CB 333.

²² Rev. Rul. 2008-18, *Situation 1*.

As discussed above, in order to achieve the objectives of both the buyer and the seller(s), the reorganization is often followed by the conversion of Target (the QSub) to a limited liability company (LLC) via a state law merger or a state law formless conversion,²³ in preparation for a subsequent transaction.

PLR 201724013

In PLR 201724013, the IRS granted relief under Sec. 1362(f) for an inadvertently invalid QSub election where the defect related to the timing of the election.²⁴ The facts involved an "F" Reorganization intended to follow the basic sequence of steps outlined in Rev. Rul. 2008-18.

The PLR describes the following fact pattern: Effective on Date 1, "X" was organized and elected to be an S Corporation effective that date. "Sub" was organized on Date 2 and made an S election effective on Date 3. On Date 4, as part of a transaction intended to qualify as an "F" Reorganization, Sub's shareholders contributed all of their stock in Sub to X, thereby causing Sub to become a wholly-owned subsidiary of X. Sub then converted to an LLC under state law on Date 5, and by default was treated as a disregarded entity for federal tax purposes. Afterwards, X made an election to treat Sub as a QSub effective on Date 4.

X's election to treat Sub as a QSub was considered ineffective, because Sub did not meet the QSub eligibility requirements of Sec. 1361(b)(3)(B) – specifically, classification as a corporation – at the time the election was filed, which was after it had converted from a corporation to a disregarded entity for federal income tax purposes. However, the generally requested timelines for a QSub election appear to have been met, *i.e.*, a requested effective date not more than two months and 15 days before the date the election is filed.

The IRS found that the ineffective QSub election was inadvertent and thus granted relief under Sec. 1362(f), concluding that Sub will be treated as a QSub effective on Date 4.

This PLR highlights that "F" Reorganizations described in Rev. Rul. 2008-18 can bring about a potential "compliance trap": a QSub election filed "timely, but too late," with potentially adverse tax consequences where inadvertent termination relief is not pursued or not granted.

TIMING DETERMINES TAX IMPLICATIONS

"F" Reorganization Outside Rev. Rul. 2008-18

PLR 201724013 does not disclose the time period that elapsed between the transfer of Sub's (*i.e.*, Target's) stock to X (*i.e.*, NewCo) and the conversion of Sub to an LLC.

If no significant time period elapsed since the stock transfer, then the LLC conversion could be viewed as part of an overall plan of reorganization for the transfer of assets from Target to NewCo and the liquidation of Target for federal income tax purposes. Under the step transaction doctrine, the completion of these steps within a short period of time should result in an "F" Reorganization outside of Rev. Rul. 2008-18, without the need for a valid QSub election for the period of time during which Target was organized as a corporation.

Therefore, the QSub election could be skipped altogether if the LLC conversion takes place immediately after the stock contribution and the plan of reorganization is clearly documented, so as to leave no doubt regarding "F" Reorganization treatment. Pursuant to Rev. Rul. 64-250 (discussed above), no new S election would be required in this scenario.

If, however, the LLC conversion occurs long after the contribution of Target stock to NewCo, the transaction does not qualify as an "F" Reorganization and a valid QSub election is essential to avoid potential risks associated with momentary C Corporation status of Target.

Consequently, the time interval between the steps is the principal factor that determines the level of risk to be weighed when considering whether or not inadvertent invalid election relief under Sec. 1362(f) should be sought.

Potential Risks of Ineffective QSub Election

Momentary C Corporation status of Target could result in "built-in gains" (BIG) tax exposure upon the liquidation of Target into NewCo for tax purposes.

When a C Corporation converts to S status, BIG tax is assessed at the highest corporate income tax rate (currently 35%) when the corporation disposes of assets with unrealized BIG in a taxable sale or exchange during a 5-year recognition period.²⁵

²³ Statutes in the majority of states provide for "formless conversions," which allow an entity to retain its existence yet change its legal status, merely requiring the filing of a form with the Secretary of State's office declaring the status of the entity going forward.

²⁴ Sec. 1362(f), *Inadvertent invalid elections or terminations*, provides in pertinent part that if a QSub election was not effective for a taxable year for which it was made by reason of a failure to meet the requirements of Sec. 1361(b), and the Secretary determines that the circumstances resulting in ineffectiveness were inadvertent, then such corporation shall be treated as a QSub during the period specified by the Secretary. To obtain such relief, a Private Letter Ruling is necessary.

²⁵ Sec. 1374.

In addition to BIG tax, tax is due at the shareholder level, *i.e.*, 65% of gain remaining after payment of the BIG tax flows to the shareholder via the S Corporation and is subject to tax at the shareholder's individual income tax rate.

Moreover, if the transaction does not qualify as an "F" Reorganization outside of Rev. Rul. 2008-18, a new S election would be required for NewCo. Where the taxpayer unwittingly relies on Rev. Rul. 64-250 and does not make an S election, any subsequent gain on the sale of assets could be subject to two levels of tax under the C Corporation rules, and the subsequent liquidation could generally be subject to the 3.8% net investment income tax.²⁶

Practical Merit of Following Rev. Rul. 2008-18

Even though "F" Reorganization treatment could be achieved outside of Rev. Rul. 2008-18 where a QSub election is considered ineffective, taxpayers should keep in mind that there is practical merit to adhering to the sequence of steps outlined in Rev. Rul. 2008-18, followed by a conversion of Target to an LLC via a state law formless conversion.

As noted above, the IRS redesigned Form 8869 in that a box may be checked to indicate that the QSub election is made in combination with an "F" Reorganization described in Rev. Rul. 2008-18. Upon receiving Form 8869 with this box checked, the IRS would not expect a separate Form 2553 for NewCo. In this manner, a taxpayer can establish a clear paper trail for filing Form 1120S for NewCo as a continuation of Target.

²⁶ Sec. 1411.