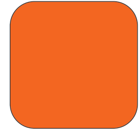


F REORGANIZATIONS IN CONSTRUCTION COMPANY ACQUISITIONS

An F reorganization implemented just prior to an S corporation acquisition may provide significant income tax benefits both to the S corporation selling shareholders and the corporate acquirer.

ROBERT F. REILLY

Many privately owned construction companies are organized as S corporations for federal income tax purposes. In many industry sectors, an economic recovery is following the economic downturn of the COVID-19 pandemic. At the same time, many private construction company owners — particularly owners of the baby boomer generation — are thinking of selling their companies. Recently, private equity firms have become active with regard to acquiring and consolidating private construction companies in many industry sectors. One transaction tax structurefina that is particularly popular in private equity firm acquisitions is an IRC Section 368(a)(1)(F) reorganization of the private S corporation.

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

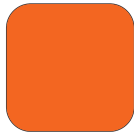
Sale of the S corporation private construction company

Many baby boomer construction company owners have reached (or passed) retirement age. These private company owners may be considering a business sale exit strategy

ROBERT F. REILLY, CPA, *is a managing director of Willamette Management Associates, a valuation consulting, forensic analysis, and financial advisory services firm. He is a resident in the firm's Chicago office and is a certified public accountant accredited in business valuation and certified in financial forensics. He is also a certified management accountant, chartered financial analyst, and certified business appraiser.*

as part of their retirement plans. Some private construction companies have been extremely successful during the pandemic, while others have become financially distressed. In either case, private equity firm buyers have become particularly interested in construction industry M&A transactions.

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



THE TYPICAL GOAL OF THE PRIVATE EQUITY FIRM IS TO BUY SEVERAL COMPANIES IN THE SAME GENERAL INDUSTRY.

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. Regardless of the method of sale, the private equity firm expects to earn a profit based on the difference between the total of the prices it paid to purchase the target companies and the price it receives from the sale of the consolidated company.

As will be explained as follows, a typical transaction tax structure in the private equity acquisition of an S corporation target company involves a Section 368(a)(1)(F) reorganization as part of the overall deal structure. 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. The F reorganization also 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. As was mentioned already, many privately owned construction 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, and C corporation distributions are taxed again at the shareholder level. However, there are limitations associated with the S corporation tax status. One such limitation, particularly for larger private companies, is placed on the number of S corporation shareholders.

In 1958, when the U.S. 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. Since 2004, the maximum number of S corporation shareholders has been limited to 100. That shareholder limitation did not limit the popularity of S corporation income tax status. Since 1997, S corporations have been the most common type of corporate entity, according to IRS income tax return statistics.[1] It is not surprising, then, that many private construction company acquisition targets are S corporations.

S corporations typically are not liable for federal income tax. They are considered tax pass-through entities. 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 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. In contrast, sellers typically receive ordinary income treatment on any gain recognized on 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 carryover tax basis in the target company assets.

In an asset acquisition, 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 nontaxation issue, 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, such tax elections have both requirements and limitations.

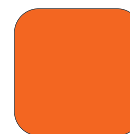
First, the buyer and the sellers have to agree to and coordinate such a deemed asset purchase tax election. Second, the sellers cannot achieve a tax deferral on any rollover portion of the target company purchase transaction. Private equity firm buyers typically require the sellers to continue to own, say, 10 percent to 20 percent of the target company. The private equity buyers often refer to this rollover equity as "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 often want to retain some small amount of ownership in the target company. This 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

One concern any acquirer of an S corporation may have is whether the target company has a valid S income tax status. The valid S corporation tax status is particularly important for any buyer considering a Section 338(h)(10) election. 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 — that is, if the target company's S tax status became invalid at any time in the past — then the buyer acquired the stock of a C corporation. 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 — are often concerned about the risk of an invalid (including an accidentally invalid) target company S status. To mitigate this invalid S tax status risk, the use of the Section 368(a)(1)(F) reorganization as a step in the acquisition transaction has become typical in private equity firm acquisitions of an S corporation target. In addition, the F reorganization may also be appropriate in any sale of an S corporation in which the sellers retain some equity ownership interest. One such example may be the sale of the private construction company to its key employees in a leveraged buyout (LBO) transaction. In such a key employee LBO, the employee buyers may want the sellers to retain some ownership in the construction company 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 off the acquisition debt (including any seller notes).



ONE CONCERN ANY ACQUIRER OF AN S CORPORATION MAY HAVE IS WHETHER THE TARGET COMPANY HAS A VALID S INCOME TAX STATUS.

The F reorganization transaction objectives

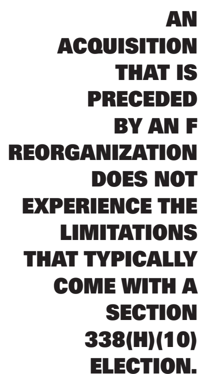
In the S corporation acquisition, implementing an F reorganization prior to the purchase transaction is intended to achieve the following transaction objectives:

- It 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).

- It provides the sellers with the same tax treatment as available under the Section 338(h)(10) election, but (1) without the requirement for an at least 80 percent sale of the company stock and (2) with the seller's ability to achieve a tax deferral on the rollover equity portion of the transaction.
- It avoids the cumbersome legal considerations that are typical in an asset purchase transaction structure.
- It 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. 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.



AN ACQUISITION THAT IS PRECEDED BY AN F REORGANIZATION DOES NOT EXPERIENCE THE LIMITATIONS THAT TYPICALLY COME WITH A SECTION 338(H)(10) ELECTION.

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. It 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, it does allow for ambiguities as to its specific requirements. There may be other considerations that occur within the steps of implementing an F reorganization. These other considerations become important if (1) the S corporation sellers are to avoid potential gain recognition and (2) the target company buyer is to retain the tax-free nature of the F reorganization.

Regulation Section 1.368-2(m) was issued by the IRS in 2015. Regulation 1.368-2(m) provides six requirements that must be satisfied 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 the regulation are to ensure that (1) only one continuing corporation is involved in the reorganization and (2) the transaction is not acquisitive or divisive in nature.

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

The six Regulation 1.368-2(m) requirements are presented in the following. The two new requirements are indicated as requirements 5 and 6.

Requirement 1: Resulting corporation stock 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 other than in respect to the stock of the transferor corporation (1) to facilitate the organization of the resulting corporation or (2) to maintain its legal existence.

Requirement 2: Identity of the stock ownership. 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 the 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 (1) the shares of stock are of equivalent value and (2) the existing shareholders can receive a distribution of money or other property from

either the transferor corporation or the resulting corporation. The shareholders can receive that distribution whether or not it is in exchange for the stock of the transferor corporation or the resulting corporation.

Requirement 3: 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 corporation's organization to maintain its legal existence. This requirement would not be violated if the resulting corporation (1) holds tax attributes related to the *de minimis* assets or (2) holds the proceeds of any borrowings undertaken in connection with the F reorganization.

Requirement 4: Liquidation of the transferor corporation. In the F reorganization, the transferor corporation must completely liquidate for federal income tax purposes. The transferor corporation is not required to dissolve under applicable state law, and it may retain a *de minimis* amount of assets for the sole purpose of preserving its legal existence.

Requirement 5: The resulting corporation is 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 is 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 corporation (with limited exceptions) came from the transferor corporation. The third and fourth requirements also ensure, for income tax purposes, that the transferor corporation will not retain any assets and will terminate.

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

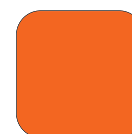
Step transaction concerns

The transaction participants (and their advisers) may be concerned that the IRS may raise allegations of a step transaction, which could cause a failure in the proposed F reorganization. That is, the IRS may allege that the F reorganization is transitory. This IRS position may be that the F reorganization is part of a series of transactions and should not be considered on its own merits.

The regulations provide guidance to alleviate such 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.[2] The previously mentioned regulation (and the historical revenue rulings) provide guidance to transaction participants regarding how to implement a pretransaction 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 previously, the implementation of an F reorganization may be particularly attractive in the construction company M&A transaction involving a private equity acquirer. The typical private equity acquisition structure (particularly of an S corporation) often involves multiple transaction steps at multiple times. Therefore, the S corporation sellers may have to engage in intentional pretransaction



THE IMPLEMENTATION OF AN F REORGANIZATION MAY BE PARTICULARLY ATTRACTIVE IN THE CONSTRUCTION COMPANY M&A TRANSACTION INVOLVING A PRIVATE EQUITY ACQUIRER.

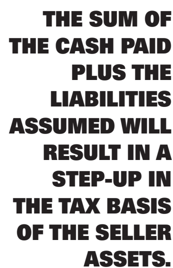
structuring. Some of the typical transaction structuring procedures include the following:

- The S corporation (Seller) shareholders 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 these procedures are nontaxable events. These procedures are all considered to be part of the F reorganization and are similar to the procedures described as Situation 1 in Revenue Ruling 2008-18.

Revenue Ruling 2008-18 does not specifically state that the illustrative transaction qualifies as an F reorganization, but it 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.[3]

One additional procedure that is typically implemented 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 legal 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). The conversion of the QSub disregarded entity into an LLC disregarded entity has no federal income tax consequences. After the conversion, Seller LLC will be a single member LLC (SMLLC).



THE SUM OF THE CASH PAID PLUS THE LIABILITIES ASSUMED WILL RESULT IN A STEP-UP IN THE TAX BASIS OF THE SELLER ASSETS.

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 organizer's asset tax basis step-up if Seller inadvertently fails to qualify for S corporation status any time in the past. It further protects the acquirer's tax basis step-up 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 (1) forming Seller Holdco and (2) 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 would 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 (and particularly private equity buyers) often want the selling stockholders to retain a small equity ownership interest in the 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 (1) a partial rollover and (2) 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 Seller assets. To the extent 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 the appreciated tangible assets.

The remaining (unsold) seller equity may be rolled over in exchange for the buyer equity. The buyer equity would remain held

by Seller Holdco. The Seller stockholders would expect that 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 founded by distributing an ownership interest in Seller to one or more key employees.

The result of this transaction structure is that Seller becomes a multimember (not a single member) LLC, and that LLC 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 853 as a result of the Section 754 election.

F reorganization cost–benefit analysis

S corporation shareholders involved in an M&A transaction should consider the costs and benefits of an F reorganization transaction structure. Such F reorganization costs and benefits may be considered from the perspectives of both the S corporation sellers and the buyer (the corporate acquirer).

To the S corporation sellers, some of the F reorganization deal structure benefits include the ability of the shareholders to:

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

These benefits are particularly relevant to the typical M&A transaction involving a private equity acquirer. These benefits are also relevant to an LBO transaction in which the key person sellers retain an equity ownership interest during a transition period or a debt paydown period.

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

- obtain a step-up in the tax basis of the S corporation's assets for the purchase portion of the transaction;
- avoid the risk of an invalid S corporation tax status when making the Section 338(h)(10) election; and
- avoid the hassle of transferring ownership of each individual S corporation asset category in an asset purchase transaction structure.

Also, since the F reorganization involves a stock purchase transaction, 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.

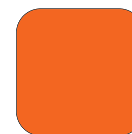
Transaction participants should note that the F reorganization transaction structure does not eliminate all tax (or legal) concerns. Tax due diligence is still required on the part of the corporate acquirers, and the buyer still assumes some tax liabilities related to the S corporation target company.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

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

Summary and conclusion

Many privately owned construction companies are structured as S corporations for federal income tax purposes. Post-COVID-19, many construction companies are positioned either as corporate acquirers or as acquisition targets.

Private equity buyers have been active in the construction industry. These private equity buyers either roll up geographic competitors, assemble companies with complementary specializations, or acquire (and improve) companies with less-than-stellar



MANY PRIVATELY OWNED CONSTRUCTION COMPANIES ARE STRUCTURED AS S CORPORATIONS FOR FEDERAL INCOME TAX PURPOSES.

operating results. In addition, many private construction 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 percentage in the construction company. This so-called rollover capital motivates the sellers to ensure a smooth transition and to 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 the corporate acquirer.

This discussion considered some of the typical strategies of the construction company private equity buyer and summarized the income tax considerations — for both the S corporation sellers and the buyer — of the F reorganization structure. This discussion also described the steps and procedures involved in implementing the pre-transaction F reorganization deal structure. Finally, this discussion considered both the costs and the benefits of the F reorganization structure to both the S corporation selling shareholders and to the corporate acquirer. ■

NOTES

1. "SOI tax stats – S corporation statistics 1995 to 2013," IRS (2021). Available at: https://www.irs.gov/statistics/soi-tax-stats-s-corporation-statistics-1995-to-2013.
2. See Revenue Rulings 61-156, 64-250, 69-516, 79-250, and 96-29.
3. See Letter Rulings 200542013, 200701017, and 200725012.