

Before you buy that S-Corp...

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As consolidation add-on acquisitions continue to increase, properly executed F-reorganizations (F-Reorgs) can provide significant tax and transactional benefits. We consider the tax implications of these transactions for buyers and sellers, reviewing the key technical requirements, timing requirements, and filings.

F-reorganizations and other considerations

In recent years, private equity and other similar investors have sought out acquisition targets as “add-ons” for existing portfolios. These acquisitions are typically pursued after an initial buyout where an investor sets up a platform and then seeks to create and increase the value of the portfolio company by acquiring complimentary targets.

There is no lack of variety in the potential add-on acquisition space with deals including the acquisition of car washes, health and beauty spas, roofing companies, storage units, and other similar businesses that can benefit from these kinds of roll-ups. Despite the diversity of industry, what most of these businesses (targets) have in common is that they are typically small operations prior to the acquisition that are organized either as limited liability companies (LLCs) or S-corporations (S-Corps).

This article will focus on S-Corps as they presents unique tax challenges. The S-corporation is considered by many soon-to-be-sellers as the ideal entity classification for small business owners, as it provides limited liability protections, pass-through tax treatment (i.e., profits, losses, deductions, and credits flow through to the owners, and this provides only one layer of taxation), and ease of conversion—if the owners of an S-Corp wish to convert to a C-corporation (C-Corp), they can file a statement with the IRS stating that they are revoking their election under Section 1362(a) of the US Internal Revenue Code (the Code)¹.

Define the relationship: the PE investment lifecycle

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Speakers: Erica Goldman, Ellie Kang, Meghan McKeever, and Tristan Hood

Alas, no benefit ever came free, and S-Corps are no exception. The Code has very strict rules for S-Corps, which include, among other things, a shareholder limit (no more than 100)², a shareholder eligibility restriction (corporations and certain others cannot be shareholders of an S-Corp)³, and a limitation on stock classes (one only)⁴. The penalty for failing to qualify as an S-Corp would open the owners up to two layers of taxation, increased scrutiny from the IRS (e.g., potential audit depending on the circumstances behind the loss of S-Corp status), and potential penalties for wrongful filing.

Because of the potential downsides of failing to be a “good” S-Corp, prior to closing an acquisition it has become popular practice to reorganize the target in a pre-closing reorganization to protect the buyer from any mistakes the target’s owners may have made from a tax perspective⁵.

These acquisitions are likely familiar to the skilled dealmaker, as these transactions are growing in popularity. Just as familiar, if not more, is that when a deal like this comes across the desk and the tax folks have been looped in, the first question is usually something along the lines of, “Have the parties considered a pre-closing F-reorganization?” Which immediately begs the question: “What is an F-reorganization, and why are the tax folks always asking about this?”

Below, we provide a high-level overview of (i) the reasons why parties may choose to undertake an F-reorganization, (ii) what the function of an F-Reorg is, (iii) how an F-Reorg works, and finally, (iv) key regulatory and timing requirements involved in such reorganizations.

Why do an F-Reorg in the first place?

In a perfect world, buyers and sellers would be aligned from the start and acquisitions would be far less complex, but life isn’t perfect, and that’s where lawyers come in. One of the first and most significant business issues that typically needs to be resolved is whether the transaction will take the form of a stock sale or an asset sale. Each side has distinct reasons for preferring one structure over the other.

Buyers often prefer an asset sale because, unlike in a stock sale, they can obtain a fair market value tax basis in the acquired assets, which allows for depreciation and amortization deductions. Sellers, on the other hand, generally prefer a stock sale. In a C-Corp context, selling stock allows the seller to avoid the double taxation associated with selling assets inside the corporation and then distributing the proceeds. In the case of an S-Corp, where corporate level tax is typically avoided due to the unique “pass-through” nature of the S-Corp regime, sellers still tend to favor a stock sale because it allows them to transfer the business—including its liabilities—by selling their shares and recognizing capital gain on the sale of the stock.

One strategy for achieving the desired outcome of selling shares from a commercial perspective while allowing buyers to obtain a fair market value basis in the acquired assets is for the parties to make a joint Section 338(h)(10) election. In simple terms, a 338(h)(10) election treats the sale of an S-Corp’s stock as a deemed asset sale for federal income tax purposes. Sounds ideal—but why not always choose this approach?

There are three primary limitations.

First, a 338(h)(10) election requires both buyer and seller to agree; it cannot be made unilaterally by either party. Second, because of this required cooperation, sellers often demand a gross-up to be made financially whole. This is because the deemed asset sale created by a 338(h)(10) election can result in additional tax leakage to the seller, particularly where the shares of the S-Corp were inherited with a stepped-up basis that does not apply to the assets, or where there are significant assets being sold that would not produce capital gain on sale (e.g., receivables and certain other similar assets) or would trigger depreciation recapture that would not apply to a transaction treated as a stock sale for tax purposes.

Finally, an election under 338(h)(10) is ineffective if the target’s S-Corp status has been terminated, whether knowingly or unknowingly. And if the entity is no longer a valid S-Corp at the time of sale, the buyer will not receive a fair market value basis in the target’s assets. That’s a level of risk many buyers may be unwilling to accept.

Fortunately, you can mend a fence from either side if you've got the will to do it, and that is where the pre-closing F-Reorg comes in. A pre-closing F-Reorg allows buyers to effectively achieve the same result as a 338(h)(10) election while also reducing the risk to the buyer that the target's S-Corp status was inadvertently terminated or never effective in the first place.

What is a pre-closing F-Reorg?

An F-Reorg is defined in Code Section 368(a)(1)(f) as a “mere change in identity, form, or place of organization of one corporation, however effected”⁶. The purpose of an F-Reorg is to allow a corporation to reincorporate, change its name, or move its place of organization without triggering gain or loss recognition. In the end, the resulting corporation is considered the same as the original corporation, which allows it to maintain the tax attributes of the old corporation and possibly carry back NOLs or net capital losses⁷.

To be a *pre-closing* F-Reorg, the target completes the steps of an F-Reorg prior to closing.

How a pre-closing F-Reorg works

The pre-closing F-Reorg is accomplished in roughly five steps.

1. The selling shareholders of old S-Corp (Oldco and Target) form a new holding company (Newco).
2. The selling shareholders immediately transfer all of their shares in Oldco to Newco in exchange for all of the stock of Newco.
3. The shareholders immediately elect to treat Oldco as a Qualified Subchapter S-Corp Subsidiary (a QSub) by filing an IRS Form 8869, as provided for in Revenue Ruling 2008-18⁸.

Pausing here, the first three steps, if done properly, is a transaction that qualifies as a Section 368(a)(1)(F) reorganization with Newco now treated as the continuing S-Corp for US tax purposes and Oldco treated as a disregarded subsidiary of Newco.

4. Oldco may now convert to an LLC (Situation 1) or, alternatively, merge into a newly formed LLC formed by Newco (Situation 2). In both cases, the transaction is a non-event for federal income tax purposes because the Target is an entity disregarded as separate from its owners⁹.
5. Following the completion of Steps 1-4, including the applicable filing requirements, Newco may dispose of its ownership interests in the LLC. The buyer is deemed to be acquiring the assets of Newco (which as noted, is treated as the continuing S-Corp) for federal income tax purposes. As such, the buyer will receive a step up in basis equal to the fair market value of the assets acquired regardless of whether Newco's original S-Corp election was ever valid or was ever inadvertently terminated.

As a practical matter, the Seller does not need to convert the QSub into an LLC for purposes of completing a pre-closing F-Reorg. However, if the acquirer is a C-Corp purchasing a QSub, the QSub election will automatically terminate at the end of the day on which the sale occurs, rendering the target ineligible for QSub status going forward¹⁰. Converting the QSub into an LLC also protects against the scenario where Oldco was never a valid S-Corp, or where Newco otherwise fails to be treated as an S-Corp, in which case Oldco cannot be treated as a QSub.

Regulatory requirements

The steps detailed above may seem simple enough, but there are several regulatory requirements that must be met for the transaction to qualify as an F-Reorg. The US Treasury Regulations (the Regulations) under Section 368 of the

Code provide that:

Stock of Newco can initially be issued only to existing owners of Oldco stock.

Example: Papageno and Figaro are the only two shareholders in an S-Corp (Oldco/Target), with each holding 50% of the shares of Oldco. They form a new corporation taxed as an S-Corp (Newco). They then contribute their respective 50% of shares of Oldco to Newco in exchange for all Newco's stock.

Identity of stock ownership must remain the same.

Example: Only Papageno and Figaro can own the stock of Oldco immediately before the exchange. Thereafter, and in identical proportions (i.e., 50/50 in this example), only they can own the stock of Newco. If Leporello joins in and receives stock in Newco alongside Papageno and Figaro as part of the pre-closing reorganization, the transaction will fail to qualify as an F-Reorg.

Newco cannot hold any property or have any tax attributes before the potential F-Reorg.

Example: Newco cannot own investments prior to the reorganization. However, the Regulations allow for Newco to have a *de minimis* amount of assets to facilitate the reorganization.

Oldco must liquidate completely for tax purpose (but not for corporate purposes).

Example: The Regulations do not require Oldco to dissolve, merely to liquidate for tax purposes, which is accomplished by the QSub election or by becoming an LLC treated as a disregarded entity for tax purposes. The Regulations also allow for Oldco to retain a *de minimis* amount of assets for the sole purpose of preserving its legal existence. For example, after the exchange, Papageno and Figaro maintain a nominal bank account balance and some stationary for Oldco.

Newco must be the only acquiring corporation.

Example: If immediately after the exchange a corporation other than Newco acquires stock of Oldco and the result is that the ownership of Oldco is split between Newco and the other corporation, the transaction will fail to qualify as an F-Reorg.

Oldco must be the only acquired corporation.

Example: If immediately after the exchange Newco acquires property from a corporation other than Oldco, the transaction will fail to qualify as an F-Reorg.

Timing is key

Targets in these transactions are often not particularly sophisticated, and the rules contain numerous traps for the unwary. One of the most common mistakes is failing to comply with the strict timing requirements for an F-Reorg. It is in the acquirer's interest to ensure these steps are followed precisely, as failure to do so can create significant tax consequences and jeopardize the validity of the F-Reorg.

First, Newco must be formed before the acquisition—ideally at least two days prior. After Oldco transfers its equity to Newco, the QSub election for Newco should be filed no later than one day before the acquisition. If the parties also intend for the QSub to elect to be treated as an LLC, that election likewise must be completed one day prior to closing.

Generally, Newco does not need to file a new S-Corp election on IRS Form 2553 because Oldco's original S-election does not terminate in an F-Reorg; it carries over automatically to Newco¹¹.

Potential drawbacks and risks

While a pre-closing F-Reorg is an appealing tool, it is not always the right answer. Practitioners must remain mindful of (i) two short tax years (i.e., pre- and post-closing); (ii) state-level differences that may impose tax or require separate elections; and (iii) failure to meet the requirements discussed above, which could potentially cause unexpected gain or loss or other unanticipated tax consequences. Where non-cash consideration is being issued by buyer on a tax-deferred basis, a pre-closing F-Reorg also results in seller having to continue to keep their S-Corp in place to continue to own the non-tax consideration and avoid triggering the deferred gain.

Conclusion

Properly executed, a pre-closing F-Reorg provides both buyer and seller with significant tax and transactional benefits: cleansing historical compliance risks, preserving S-status for the seller, and facilitating a cleaner asset acquisition. Despite their reputation as a “mere change in form,” F-Reorgs require careful attention to technical requirements, sequencing, and filings. They represent one of the instances in tax where form truly does matter over substance. As private equity continues to consolidate businesses, pre-closing F-Reorgs will remain a routine and essential component of the acquisition landscape.

FOOTNOTES

- [1.](https://www.irs.gov/statistics/soi-tax-stats-s-corporation-statistics) Internal Revenue Service, SOI Tax Stats—S Corporation Statistics, <https://www.irs.gov/statistics/soi-tax-stats-s-corporation-statistics> (last visited Feb. 14, 2026); 26 U.S.C. §1362(d)(1)(A).
- [2.](#) 26 U.S.C. §1361(b)(1)(A).
- [3.](#) 26 U.S.C. §1361(b)(1)(B); this includes non-resident aliens as shareholders see 26 U.S.C. §1361(b)(1)(C).
- [4.](#) 26 U.S.C. §1361(b)(1)(D).
- [5.](#) Tax practitioners often joke, “show me an S-Corp and I will show you something that isn’t an S-Corp” or “every S-Corp is one mistaken signature away from being a C-Corp” and “S-corps are simple... until they aren’t”.
- [6.](#) 26 U.S.C. §368(a)(1)(f).
- [7.](#) Rev. Rul. 2008-18.
- [8.](#) *Ibid.*
- [9.](#) *Ibid.*
- [10.](#) Treas. Reg. §1.1361-5(a)(1)(iii).
- [11.](#) Rev. Rule 2008-18. This however assumes that Oldco’s original S-Corp election was validly filed.

To discuss these issues, please contact the author(s).

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