

S Corporations and F Reorganizations

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F Reorganizations can be very simple, including a mere change in identity, form or place of organization, however affected. As but one example, if you have a California corporation and you want a Delaware corporation instead, an F reorganization can be as simple as forming a new Delaware corporation, and merging the California corporation into it. In that way, a single organization disincorporates in California and reincorporates in Delaware.

Internal Revenue Code Section (“Code Sec.”) 381 provides that in the case of an F reorganization, the acquiring company is treated just as the transferor corporation would have been treated had there been no reorganization. [Reg. § 1.381(b)-1(a)(2).] Where an S corporation is involved, there can be wrinkles. Given the value of an S election these days (indeed, any time since the repeal of the *General Utilities* Doctrine in 1986), it pays to pay attention to these wrinkles.

Fortunately, the IRS long ago concluded that where an S corporation merges into a newly formed corporation in an F reorganization, with the newly formed, surviving corporation *also* meeting the requirements of an S corporation, the reorganization does not terminate the S election. [See Rev. Rul. 64-250, 1964-2 CB 333.]

QSubs

It is axiomatic that an S corporation cannot have a corporate shareholder. [See Code Sec. 1361(b)(1)(B).] Generally speaking, that means a subsidiary cannot be an S corporation. However, an S corporation is allowed to have an S corporation subsidiary if it owns 100 percent of the subsidiary’s stock.

Not only must there be 100-percent ownership, but the subsidiary must not otherwise be ineligible for S status, and the S corporation parent must make an election to treat the subsidiary as a qualified Subchapter

S subsidiary (QSub). [See Code Sec. 1361(b)(3)(B).] This QSub election is made by the parent on Form 8869.

By doing this, the QSub will not be treated as a separate corporation for federal income tax purposes. Instead, much like a check-the-box election to be treated as a disregarded entity, the assets, liabilities and items of income, deductions and credits of the QSub will be treated as those of the parent. [Code Sec. 1361(b)(3)(A).]

S and F

How does all of this fit into the practice of otherwise simple F reorganizations involving S corporations? Read on. The IRS ruled decades ago that an acquiring corporation in an F reorganization should use the EIN of the transferor corporation. [See Rev. Rul. 73-526, 1973-2 CB 404.] Of course, QSubs came into existence after that.

Moreover, Code Sec. 1361 now provides that QSubs are generally *not* disregarded for purposes of information returns and for certain other purposes. The regulations detail the fact that a QSub is treated as a separate corporation for employment tax and related reporting requirements. This rule is effective for wages paid on or after January 1, 2009. [See Reg. §1.1361-4(a)(7).]

Furthermore, the regulations state that a QSub is treated as a separate corporation for purposes of certain excise taxes. This rule is effective for periods commencing January 1, 2008, and thereafter. [See Reg. §1361-4(a)(8).]

Does Your S Election Terminate?

The almost imponderably bad thing you want to avoid with an F reorganization, of course, is any break in continuity. I'm using the term "continuity" here in a colloquial sense, not a continuity of interest or continuity of ownership sense. Put simply, you don't want your S election to terminate.

A recent revenue ruling looks at the high stakes question whether an S election terminates, and what impact which EIN you use will have. Rev. Rul. 2008-18, IRB 2008-13, Mar. 31, 2008, examines two circumstances.

In Situation 1, B is an individual who owns all of the stock of an S corporation. The Individual

forms NewCo, contributing all of the Y stock to NewCo. We're told that NewCo meets the requirements to qualify as an S corporation, and timely elects to treat Y as a QSub. In year 2, NewCo sells a one-percent interest in Y to a third party.

Relying on Rev. Rul. 64-250, the IRS says that Y's original S election does not terminate. It simply continues on for NewCo. NewCo must obtain a new EIN. Y, now a subsidiary, must keep the old EIN. We're told that Y, as a QSub, must use this historic EIN any time it needs to keep track of its separate entity status for federal tax purposes (and we are reminded that would include employment and excise taxes).

Furthermore, when NewCo later sells a one-percent interest in Y to a third party, that, of course, terminates Y's QSub election. Thereafter, Y must use the historic EIN following that QSub election termination.

In the second situation, we are presented with C, an individual who owns all of the stock of an S corporation called Z. Z's EIN is 33-3333333. Z forms NewCo, which in turn forms MergeCo. MergeCo then merges with and into Z, with Z surviving. C receives solely NewCo stock in exchange for his Z stock. NewCo qualifies as an S corporation, and timely elects to treat Z as a QSub.

Here, again relying on Rev. Rul. 64-250, we're told that Z's original S election does not terminate, but instead continues on for NewCo. However, NewCo must obtain a new EIN. Z, on the other hand, must retain its historic EIN, even though a QSub election is made for Z. As a QSub, Z will need its original EIN only when being treated as a separate entity for federal tax purposes (including employment and certain taxes).

Effective Dates

Rev. Rul. 2008-18 applies to F reorganizations occurring on or after January 1, 2009, though in some cases, taxpayers may invoke it for certain 2008 transactions.

Careful

As anyone who has ever ended up with several EINs, or the wrong EIN in the wrong entity knows, such seeming banalities can have momentous tax consequences.