Manage Your Business

How the ABCs of an F Reorganization Can Help Sell Your Business

The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

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The merger and acquisition (M&A) market was trending up in 2019 when the COVID-19 pandemic caused a temporary suspension in the number of closed M&A deals. The market recovered in 2020 and in 2021 the number of completed deals reached historic levels. The final 2022 results probably will not outpace the number of closed deals in 2021. However, this heightened level of M&A activity has prompted some owners who had not planned on selling to pause and consider if now is the right time or if their businesses are transaction-ready.

To decide if any pre-transaction work might be beneficial, here are a few questions to ask:

- Do I want to sell all or part of my business?
- Will I want to roll over some of my business interests into the new operating company post-transaction?
- Is there anything I can do before taking my business to market that might make it easier for a potential buyer to purchase it?

The list of pre-M&A transaction planning activities is long and varied, but tax planning is a popular topic because a little foresight can make a big difference in making an otherwise untenable deal a viable possibility.

A major part of planning and executing a successful business transaction is structuring it so the proceeds flow the way you want, and the tax implications are as favorable as possible. This begins by having your company organized under the optimal structure and ideally should be a consideration several years before the transaction even takes place.

In previous newsletters, we discussed two different tax elections – Sec 338(h)(10) and 336(e) – used by owners selling their closely held private business and by potential buyers. Now we are going to examine a popular strategy called an F reorganization, which is typically a tax-free structure that involves a target company taxed as an S corporation.

F reorganizations are frequently used as part of a presale strategy or for changing certain undesirable attributes of an operating company. Examples of such changes include a name change, a reincorporation in the same or a different state, or a change in the form of a business organization.

When Would an F Reorganization Be Helpful?

Here are a few examples of where an F reorganization would help the sale of a closely held business align with a business owner's goals and objectives.

- **Selling some but not all of the assets of a business:** This deal structure allows a seller to sell some rather than all the assets of a business. Assets being dropped down into the subsidiary could range from specific assets or a separate business division. For example, if you wanted to sell the retail division and retain the wholesale division, the OldCo would receive the retail division assets and the NewCo would hold the wholesale division assets. NewCo would then sell OldCo to the buyer.

- **An S corporation creates a subsidiary single-member limited liability company (LLC):** This deal structure allows a seller to create and sell a subsidiary single-member LLC to hold assets ultimately purchased by the buyer instead of the S corporation stock. A buyer might find this more enviable for two reasons. First, the buyer would not need to worry about the limitations involved with owning S corporation stock, which limits S corporation to fewer than 100 shareholders and to certain kinds of trusts. It also prohibits foreigners from owning S corporation stock. Secondly, a buyer might find it more enviable to purchase 100% of the LLC equity interests to avoid the need to obtain third-party consent for transferring assets.
- **Facilitating an equity rollover:** Business owners selling to a third-party buyer often want the opportunity to invest in the combined business or operating company after an M&A transaction. An F reorganization completed before the business sale gives the selling shareholders the chance to retain a stake in the business being sold as a means of rolling over their equity interest on a tax-free basis.

The Benefits of an F Reorganization to a Seller

An F reorganization structure can take different forms depending on the issue or problem, but its purpose is to put sellers in a position where they can have the flexibility to do the following:

- Structure the sale of the LLC interests thus avoiding the rigidity of an IRC Section 338(h)(10) election or an IRC Section 336(e) election, including the requirements on greater than or equal to 80% sale, taxing the entire gain and meeting the qualified stock purchase requirements.
- Defer gain recognition with respect to rollover equity.

The Disadvantages to a Seller

- Increased legal and other costs to effectuate the pre-closing F reorganization.
- Increased complexity of the underlying transaction.
- Risk of the F reorganization and its validity is typically borne by the seller (even if the structure is requested by the buyer).

The Benefits of an F Reorganization to a Buyer

The F reorganization structure places buyers in a position where they have the flexibility to do the following:

- Achieve a step-up in the basis of the assets of the business being sold equal to the portion paid for the seller's LLC interest.
- Retain the Federal Employer Identification number of the business being sold.
- Remove the risk associated with the validity of the seller's S corporation election that could otherwise potentially taint a step-up in the basis of the assets under an IRC Section 338(h)(10) election or an IRC Section 336(e) election.

The Disadvantages to the Buyer

- It will take the IRS months after the closing to approve or accept the tax filings involved in the transaction, creating some unknown risks.
- Transaction liability risks of an equity sale, even when structured this way, are still usually higher than an asset sale transaction.

The basics of an F reorganization dictate that a legal entity (corporation or LLC) is merely changing its identity, form, or place of organization. This allows a business to avoid potential gain recognition just by making certain changes to the corporate structure.

Although the definition seems short and simple, the devil is in the details and requires advice and counsel from competent tax and legal professionals.

There are numerous ways to complete an F reorganization. Because of space constraints, this overview was only intended to expand your knowledge about the benefits of pre-transaction planning and specifically those gained by pre-tax planning. For more information, please talk with your tax and legal advisors.

For more information about strategies and ways to plan ahead, contact your relationship manager, or contact our Business Advisory Services team through key.com/businessadvisory.

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