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WILLIAM & MARY LAW SCHOOL

64th Annual Tax Conference

**November 7-9, 2018
Williamsburg, VA**

**MERGERS AND ACQUISITIONS OF CLOSELY-HELD
CORPORATIONS**

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*** Special thanks to C. Wells Hall, III of
Nelson Mullins Riley & Scarborough, LLP
Charlotte, North Carolina who co-authored this outline and slides.***

BIOGRAPHY

Jerry August is a nationally recognized tax lawyer who advises clients on income tax matters, including foreign taxation of U.S. businesses and U.S. taxation of foreign businesses and investors. In many instances he works with corporate and real estate counsel on selecting the proper entity in which to engage in domestic or foreign business or investment operations. He has been involved in structuring as well as negotiating merger and acquisitions, both taxable and non-taxable, joint ventures, financings, workouts and recapitalizations. He also represents clients in tax controversy and litigation in challenging the positions maintained by the Internal Revenue Service and other taxing authorities. He has also worked with the National Office of the Internal Revenue Service in filing private letter rulings or pursuing the competent authority provisions of a particular bilateral tax treaty involving the United States and a foreign country.

His work includes representation of public and private U.S. business entities, including private equity and hedge funds, as well as foreign public and private business entities, funds and individuals. Mr. August is frequently retained by law and accounting firms in advising their clients on tax and related matters as well as in working on tax disclosures required for SEC filings, IPOs and in evaluating issues related to contingent tax liabilities. He also represents high net worth individuals, including non-residents, on both U.S. and foreign income and wealth tax matters, including estate planning.

Mr. August is a frequent speaker and author on federal tax matters on topics ranging from international joint ventures and mergers and acquisitions to foreign tax credits, the use of defective entities in tax planning, and partnership formations, among others. August is a Life Sustaining Member of the prestigious American Law Institute (ALI) and regularly serves as program chair and speaker for ALI-CLE federal tax webcasts on various topics involving federal taxation. He also has for thirty years served on the Board of Advisors of the New York University Federal Institute of Taxation and is Chair of the Board of Advisors of the ALI's long-standing tax law journal, *The Practical Tax Lawyer*. August has been a guest lecturer at the University of Pennsylvania Law School and the University of Pittsburgh School of Law, and a visiting professor on corporate income taxation at the Graduate Tax Program of the University of Florida School of Law. Mr. August is also a member of American College of Tax Counsel, the American College of Trust and Estate Counsel, and the American Tax Policy Institute.

In addition to speaking at national federal tax law institutes and seminars, Jerry has authored well over one hundred articles published by national journals, including the *Florida Law Review*, on partnership, corporate and international taxation. He also is a noted legal authority on tax controversy matters, including the partnership audit rules and the attorney-client privilege and work product doctrine. Recently, Mr. August has spoken on various national and state bar association programs on recent business and international tax law changes, including the repatriation of accumulated foreign earnings and evaluating the potential benefits as well as problem areas resulting from the wide-sweeping domestic and international tax law enacted into law.

Mr. August has substantial experience in representing clients facing tax controversies before the Internal Revenue Service and other tax authorities, including trials before the United States Tax Court, the Court of Federal Claims, federal district courts, and the Eleventh Circuit Court of Appeals on a variety of tax matters. He also has been frequently involved in pre-indictment criminal tax investigations arising out of an audit or referral to the Criminal Investigation Division of the IRS. Mr. August has represented the Tax Section of the Florida Bar in writing and filing an amicus curiae brief with the Supreme Court in a landmark tax case, *Commissioner v. Estate of Hubert*, 520 U. S. 93 (1997).

Prior to joining Chamberlain Hrdlicka, Mr. August was a partner at Kostelanetz & Fink, New York, NY and spent 10 years as partner and co-chair of the Taxation and Wealth Planning Department of Fox Rothschild LLP and worked out of its Philadelphia and West Palm Beach Office. He also was the Chair of the Tax Opinions Committee. Prior to merging with Fox Rothschild LLP, Mr. August was the majority shareholder in the tax law firm of August, Kulunas, Dawson & Siegel, P.A., in West Palm Beach, Florida, which he started in 1988 after serving as Co-Chair of the Tax Department of the Miami-based firm of Steel Hector & Davis.

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INTRODUCTION

When a Closely-Held Business is an Acquisition Target

This outline is designed to highlight the legal and tax aspects of mergers and acquisitions problems when a closely-held business is a target in M&A transactions. Planning for the acquisition or disposition of stock or assets of a closely-held business, usually operated as an S corporation or a limited liability company (LLC), may involve nontaxable and taxable asset acquisitions involving S corporations and LLCs. When an S corporation is the target, this includes consideration of the election and termination of Subchapter S status, the eligibility rules governing shareholders, including the one class of stock limitation, the allocation of income and loss in the year of a disposition of stock or termination of S status, the application of the pass through rules, and adjustments to stock basis for pass through income, distributions, and losses, and basis step up or carryover basis for the purchaser under Subchapter S of the Internal Revenue Code of 1986 (the “Code”).¹ There is also the much wider world of Subchapter C and the rules governing tax-free and taxable acquisitions, redemptions, distributions, and carryover of tax attributes. When the target is an LLC classified as a partnership or disregarded entity for income tax purposes, the transaction may qualify for a stepped up basis whether structured as an entity purchase or asset purchase.

In certain types of acquisitive transactions, the overriding concern may be to preserve the S corporation’s election or pass through treatment as a limited liability company, in order to avoid double taxation currently or in the future under Subchapter C, or the built-in gains tax under Subchapter S. There are also inside (asset) basis and outside (stock) basis dichotomies in assessing the potential tax impacts. Associated with this issue are gain or loss characterization rules as well as timing issues, such as the availability or non-availability of the installment sale method for reporting gain. There are also change of control issues that may be implicated in a particular acquisition, particularly in structuring bonus compensation payments or cashing out or replacing stock options granted to key executives of the target. In direct or deemed asset acquisitions, the potential application of the anti-churning rules for purchased intangibles under Section 197(f) must also be considered although this rule, contained in Section 197(f), has limited applicability from a practical standpoint.

Tax Aspects of Corporate Mergers and Acquisitions

The tax considerations relating to the sale and purchase of assets by an S corporation or the sale or purchase of the stock of an S corporation are similar to the tax consequences of asset sales and purchases by C corporations and sales and purchases of C corporation stock, with a number of twists and turns thrown in that are unique to S corporations and their shareholders. Some of the issues unique to the sale of assets by S corporations include the potential application of the built-in gain tax, the timing of the liquidation of the S corporation following the sale of all or substantially all of the assets of the S corporation, the receipt (and subsequent distribution) of installment sales obligations received in consideration for the sale

¹ Unless otherwise specified, all “Section” and “§” references are to the Code and all “Regulation” and “Reg. §” references are to the Treasury regulations promulgated under the Code.

of assets and issues related to contingent earn-outs contained in asset purchase agreements. With respect to sales of S corporation stock, the provisions of Section 1(h) must be considered in determining the character of the gain recognized on the sale of the stock, and special attention must be paid to stock sales where a Section 338(h)(10) election or a Section 336(e) election is made to treat the stock sale as an asset sale for federal tax purposes.

In planning for the acquisition or disposition of stock or assets of a C corporation, consideration may be given to either a direct purchase of assets, or purchase of stock.² The latter strategy is favored by sellers in order to report any gain from the transaction as long-term capital gain.³ Of course, there are two other benefits with a straight stock sale, including one that is effectuated as a (taxable) reverse or forward triangular merger. The first benefit is the liabilities of the corporation that are assumed or taken subject to by the acquirer are not included in computing the “amount realized” for the sale of shares under Section 1001. The second benefit is that double taxation is visited upon the selling shareholders. Purchasers of all of a corporation’s stock may indeed discount the amount paid for the shares due to the continuation of the built-in gain inside the corporation and that liabilities assumed cannot be added to the cost basis in the shares. There also is the potential for a “disappearing basis” problem where the acquiring corporation, for example, liquidates the target corporation. In other words, the stock basis in purchasing the stock disappears and the liquidation yields a carryover basis in the target corporation’s asset to the acquiring parent corporation.⁴ A C corporation may also be acquired in a deemed asset purchase either from the sale of a parent corporation’s stock in wholly owned subsidiary or as a result of a deemed sale election.⁵

The acquisition of an S corporation may cover the entire spectrum of Subchapter S taxation. This includes consideration of the election and termination of Subchapter S status, the eligibility rules governing shareholders, including the one class of stock limitation, the built-in gain tax imposed under Section 1374, the allocation of income and loss in the year of a disposition of stock or termination of S status, the S corporation’s accumulated adjustments account (AAA) and its earnings and profits, if any, and the effect of these items on S corporation distributions, redemptions and taxation, the application of the pass-through rules, impact on stock basis, including the rules applicable to distributions, loss limitation rules, and the effect and advisability of making a Section 338(h)(10) election or a Section 336(e) election to treat the sale of stock as an asset sale.

The wider world of Subchapter C and the rules governing tax-free and taxable acquisitions, redemptions, distributions, carryover of tax attributes, etc. applies to mergers and acquisitions of both C and S corporations. In certain types of acquisitive transactions, the overriding concern will be to preserve the S corporation’s election in order to avoid double taxation currently or in the future under Subchapter C or the built-in gain tax under Subchapter S. There are also inside (asset) basis and outside (stock) basis dichotomies in assessing the potential tax impacts. Associated with this issue are gain or loss characterization rules as well as timing issues, such as the availability or non-availability of

² See also Section 336(g)(purchasing corporation’s election to make a deemed asset sale election).

³ See also Sections 354, 453, 1202, 1400Z.

⁴ Sections 337, 332.

⁵ See Sections 338(h)(10), 336(e).

the installment method. There are also change of control issues that may trigger certain tax consequences in a particular acquisition, particularly in structuring bonus compensation payments to key executives of the target (so called “golden parachutes”).⁶ In direct or deemed asset acquisitions, the potential application of the anti-churning rules for purchased intangibles under Section 197(f) must also be considered. Given the limitless amount of material and complexity present in the law, this outline is limited to highlighting the general considerations and special problems faced by S corporations and their shareholders engaging in mergers and acquisitions.

⁶ See Sections 280G, 83(a), 421-423, 162(m), 409A, 457, 4999. Prior to the TCJA, an employer could generally deduct reasonable compensation for personal services as an ordinary and necessary business expense. Section 162(m) provides limited the deductibility of compensation expenses in the case of publicly traded corporate employers. The otherwise allowable deduction for compensation with respect to a “covered employee”, as defined, of a publicly held corporation is limited to no more than \$1M per year. A covered employee includes the (1) the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year and (2) any employee whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934 (“Exchange Act”) by reason of being among the corporation’s four most highly compensated officers for the taxable year (other than the chief executive officer). The regulations under Section 162(m) provide that whether an employee is the chief executive officer or among the four most highly compensated officers should be determined pursuant to the executive compensation disclosure rules promulgated under the Exchange Act. Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds \$1 million. The following types of compensation are not taken into account under §162(m): (i) remuneration payable on a commission basis; (ii) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met (“performance-based compensation”); (iii) payments to a tax-favored retirement plan (including salary reduction contributions); (iv) amounts that are excludable from the executive’s gross income (such as employer-provided health benefits and miscellaneous fringe benefits); and (v) any remuneration payable under a written binding contract in effect on February 17, 1993. Also excluded from “compensation” for this purpose for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of compensation is deferred until after termination of employment. Compensation qualifies for the exception for performance-based compensation where: (i) it is paid solely on account of the attainment of one or more performance goals; (ii) such goals are set out in writing by a compensation committee consisting solely of two or more outside directors; (iii) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate majority-approved vote prior to payment, and (iv) prior to payment, the compensation committee certifies that the performance goals were satisfied. The TCJA revises the definition of a “covered employee” to include both the CEO and CFO. The provision also includes the three (rather than four) most highly compensated officers for the taxable year who are required to be reported on the company’s proxy statement. This includes such officers not required to file a proxy statement but the corporation otherwise meets the revised definition of a publicly traded corporation. The provision extends the applicability of Section 162(m) to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs. The definition may include certain additional corporations that are not publicly traded, such as large private C or S corporations. The exception for “performance-based compensation and commissions” is eliminated. Therefore, excess compensation is taken into account with respect to a covered employee for a taxable year that exceeds \$1M and therefore is not deductible under §162. This provision is effective for taxable years beginning in 2018. A grandfather rule is also provided.

Role of Private Equity in the Financing and M&A Transactions Involving Middle Market Companies

Mergers and acquisitions (M&A) of closely-held businesses proliferated in the years before the global economic crisis of 2008, and have re-emerged in significance as middle market M&A activity has returned to normalcy. Current middle market M&A activity has resulted from both strategic and financial buyers, as well as the infusion of private equity into the marketplace.

Private equity, as referred to in this outline, includes venture capital investments in entrepreneurial start-ups, investments in and the financing of growth businesses, leveraged buyouts, management buyouts, and recapitalizations of existing businesses and companies in financial trouble.

Private equity investors and private equity funds actively acquire portfolio investments through the buyout of operating companies from the founder shareholders, as well as from purchases of businesses from diversified companies operating many businesses and subsidiaries and divisions, wishing to divest a non-core business or a business that it is unable to make profitable. Many of these middle market businesses have been operated as S corporations. Of course PE firms acquiring business entities may continue to operate the business in its long-standing format, whether as a C corporation (or consolidated group of C corporations), S corporation or multiple owner entity taxable as a partnership.⁷

The private equity investor hopes that additional capital for expansion, synergy through additional acquisitions, properly incentivized management, and close supervision by sophisticated management, or a combination of these circumstances, will cause the enterprise value of the portfolio company's business and operations to increase geometrically.

Private equity investors are generally willing to expose capital to risk in order to achieve higher rates of return. There are cheaper sources of capital than private equity capital, such as traditional bank loans and private placements of senior debt securities. However, such sources may not be available to an early stage entrepreneur with no proven business plan or collateral or an operating company producing cash flow deficits. Even if traditional financing is available for a portion of the capital required, private equity financing may be necessary to provide the equity base for a business plan to succeed.

Federal law has encouraged private equity investments through various tax and other incentives for over 50 years. The Small Business Investment Act of 1958 permitted banks and bank holding companies to invest in Small Business Investment Corporations (SBICs) subject to certain restrictions.⁸ The involvement of banks in private equity investments

⁷ But see Rev. Rul. 99-6, 1999-1 C.B. 432.

⁸ An SBIC may invest in a business or “portfolio company” if it meets one of two “size standards” (i) the portfolio company has tangible book net worth (exclusive of intangible assets such as “goodwill”) that does not exceed \$18 million and the prior two fiscal years’ average net income does not exceed \$6 million, or (ii) the portfolio company meets certain employee or revenue standards published by the SBA for the industry in which it is principally engaged. While an SBIC may continue to invest in a portfolio company after it exceeds the size standards, it must divest itself of control after 7 years (subject to extension with the SBA’s

through the 1960s and 1970s provided the basis for the development of a professional private equity industry in the United States.

Today, participants in private equity transactions include high net worth individuals, merchant banking subsidiaries or divisions of bank holding companies, insurance companies, investment banks, and other large corporations, publicly held and privately held funds formed for the purpose of making private equity investments, and employee pension plans, university endowment funds, and other investors looking for a greater than normal investment return which generally require a high level of risk. Special private equity funds have been formed to permit private investors to diversify their risk among a portfolio of investments, while achieving professional management and oversight of the investments.

Tax Cuts and Jobs Act: Changes Affecting Structure of Merger or Acquisition of a Privately Owned Corporation

Corporate Income Tax Rate Changes.

Before the Tax Cuts and Jobs Act (the “TCJA”), corporations were subject to graduated rates of income tax that resulted in a 35% corporate rate for taxable income over \$10M, with a phase out of the lower rate for taxable income over \$100,000. Certain personal service corporations were subject to a maximum rate of tax at 35%. The maximum rate of a corporation’s net capital gain is also 35%. The new law reduces the corporate income tax to 21% and repeals the maximum corporate tax rate on net capital gain as obsolete.

Dividends Received Deduction.

Under Section 243(a) a corporation is allowed a deduction for dividends received from other taxable domestic corporations. In general, the deduction is 70% of the dividend received. This produces a maximum rate of 10.5%. For a domestic corporation’s holding 20% or more of the stock of another C corporation, the amount of the deduction is 80% of the dividend received. Such dividends are taxed at a maximum rate of 7%. For dividends received from a member of the same affiliated group, the DRD is generally 100% of the dividend.⁹ The TCJA reduces the 70% DRD to 50% and the 80% DRD to 65%. This will yield the same tax rate as under prior law as the reduction is based on the reduced corporate income tax rate of a flat 21%.

Corporate Alternative Minimum Tax (C-AMT).

Prior to the TCJA corporations were subject to the C-AMT to the extent that the tentative minimum tax exceeds its regulator tax. The tentative minimum tax is computed at the rate of 20% on the AMTI in excess of \$40,000, i.e., the exemption amount, that phases

approval to complete divestiture of control or to ensure the company’s financial stability).

⁹ Sections 243(a)(3), 243(b)(1). See also Section 1504(a).

out by an amount equal to 25% of the amount that the corporation’s AMTI exceeds \$150,000. AMTI is the taxpayer’s taxable income increased by certain preference items. A corporation with average gross receipts of less than \$7.5M for the prior three taxable years is exempt from the corporate minimum tax. The \$7.5M million threshold is reduced to \$5M for the corporation’s first three-taxable year period. A major item included in the corporation’s AMT base is the “adjusted current earning (“ACE”) adjustment. The ACE adjustment is equal to 75% of the amount by which adjusted current earnings of a corporation exceed AMTI. The NOL carryover of a corporation cannot reduce the AMT base by more than 90% of the NOL. Nonrefundable business credits allowed for regular tax purposes are not allowable for C-AMT. Where a corporation is subject to the C-AMT, the amount of C-AMT is a credit for use in any subsequent tax year where the taxpayer’s regular tax liability exceeds its tentative minimum tax in such later year. The corporate AMT is repealed by the TCJA. Existing C-AMT credits are refundable for any tax year beginning after 2017 and prior to 2022 in an amount equal to 50% (100% for tax years beginning in 2021) of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability.

Replacement of Corporate Alternative Minimum Tax With Base Erosion Tax Under New Section 59A.

In replacing the corporate alternative minimum tax, and in response to earnings stripping enforcement efforts by members of the G-20, the U.S. independently enacted a base erosion minimum tax to prevent companies from stripping earnings out of the U.S. through payments to foreign affiliates that are deductible for U.S. tax purposes. The tax is structured as an alternative minimum tax that applies when a multinational company reduces its regular U.S. tax liability to less than a specified percentage of its taxable income, after adding back deductible base eroding payments and a percentage of tax losses claimed that were carried from another year. The “base erosion minimum tax” is 10% (5% for years beginning in 2018) of the “modified taxable income” of a subject taxpayer over an amount equal the regular tax liability reduced by applicable credits of the corporation. The rate climbs to 12.5% for taxable years beginning after 2025. The BEATs tax only applies to large C corporations. The tax applies to deductible payments to foreign affiliates from domestic corporations, as well as on foreign corporations engaged in a U.S. trade or business in computing the tax on their effectively connected income (ECI). The BEAT tax is applicable to: (i) a corporation other than a regulated investment company (RIC); (ii) real estate investment trust (REIT) or an S corporation. It must have average annual gross receipts for the immediately preceding 3 year period of at least \$500M and its “base erosion percentage” for the taxable year is 3% (and possibly in some instances 2%) or higher.¹⁰

Net Operating Losses of Corporations.

A net operating loss (NOL) is allowed corporations and individuals in computing taxable income in an amount equal to the aggregate of the NOL carryovers and NOL

¹⁰ See Section 59A(e)(1).

carrybacks for that year. Under the law prior to the TCJA, the NOL deduction was not subject to the a limitation based on taxable income.¹¹

Individual Tax Rates Modified and Reduced.

The new tax rates start at 10% and increase to 37%. The net investment income tax (Obama Medicare Tax of 3.8% under Section 1411) still applies. The individual alternative minimum tax is still in effect. As per Section 172(b)(2), where an NOL is not used in the first year to which it is carried, the loss can be carried to a second year (with certain modifications). Prior to TCJA, generally net operating losses could be carried back two years and forward 20 years. The TCJA limits the NOL deduction for taxable years beginning in 2018 to 80% of taxable income.

Deduction for Qualified Business Income.

New Section 199A allows a 20% deduction from taxable income for a taxpayer other than a corporation. An S corporation is an individual. The deduction applies at the individual S shareholder level as it does for partners in a partnership. Section 199A treats each shareholder or partner as receiving his allocable share of the items needed for computing the Section 199A deduction. The deduction equals the sum of lesser of (a) the “combined qualified business income amount” and (b) 20% percent of the excess of (i) taxable income (computed without regard to Section 199A) over (ii) the sum of any “net capital gain” plus any “qualified cooperative dividends.” The second amount is the lesser of (a) 20% of the qualified cooperative dividends or (b) taxable income reduced by net capital gains. The amount determined under the formula may not exceed the taxable income reduced by the net capital gain. The combined qualified business income amount includes certain amounts with respect to each qualified trade or business. In addition, the combined qualified business income amount includes 20% of qualified REIT dividends and qualified publicly traded partnership income. The amount determined for any QBI is subject to a limitation. The limitation is the lesser of: (a) 20% of ABI or (b) the greater of (i) 50% of W-2 wages with respect to the qualified trade or business or (ii) the sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis after the acquisition of “qualified property”. The unadjusted basis is the cost of the property immediately after the acquisition of the property involved and is not reduced by depreciation taken on the asset after its acquisition. The W-2 wages and qualified property apply separate as to each trade or business. For individuals whose income does not exceed a threshold amount, the 20% deduction is allowed even if the trade or business is not a QBI but is a specified service trade or business. The threshold amount is \$157,500 (\$315,000 for a joint return) (with inflation adjustments). This rule phases out if the taxpayer’s taxable income is up to \$50,000 more than the threshold amount (\$100,000 or more for a joint return). Proposed regulations were recently issued under Section 199A.

Limitation on Deduction for Interest.

Frequently an acquisition is a “leveraged acquisition” in which case the buyer obtains financial from institutional or private investors, including foreign institutions or investors, in

¹¹ See also Sections 381, 382, 384.

acquiring a domestic corporation. One of the benefits of the financing is the ability for the acquiring corporation to deduct interest subject to whether such interest is required to be capitalized under Section 263A(f) or Section 461(g) or the so-called INDOPCO regulations.¹² Interest is generally deducted by a taxpayer as it is paid or accrued, depending on the taxpayer’s method of accounting. Where an obligation is issued with original issue discount (“OID”), a deduction for interest is allowable over the life of the obligation on a yield to maturity basis.

Investment Interest: Section 163(d).

For a taxpayer other than a corporation, the interest deduction allocable to property held for investment is limited to the taxpayer’s net investment income. Disallowed interest is carried forward.

Earnings Stripping: Former Section 163(j).

Section 163(j) disallows the deduction for disqualified interest paid or accrued by where two threshold tests are met: (i) the obligor’s debt-to-equity ratio exceeds 1.5 to 1.0 (“safe harbor” rule); and (ii) obligor’s net interest expense exceeds 50% of its adjusted taxable income, as computed. Disqualified interest includes interest paid or accrued to: (i) related parties when no Federal income tax is imposed with respect to such interest; (ii) unrelated parties in certain instances in which a related party guarantees the debt; or (iii) to a real estate investment trust (“REIT”) by a taxable REIT subsidiary of that trust.¹³ Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation can be carried forward three years.¹⁴ Under TCJA, for tax years beginning after 2017, Section 163(j) limits the deduction for net business interest expense to 30% of the adjusted taxable income of the business. Disallowed business interest may be carried forward indefinitely, subject to certain restrictions applicable to partnerships. Taxpayers whose average annual gross receipts for the three-tax year period ending with the earlier tax year do not exceed \$25M are exempt from this restriction. The business interest limitation doesn’t apply to certain regulated public utilities and electric cooperatives. Real property trades or businesses can elect out of the provision if they use the alternative depreciation system (ADS) to depreciate applicable real property used in a trade or business. Farming businesses may also elect out if they use ADS to depreciate any property used in the farming business with a recovery period of ten years or more. An exception from the limitation is also provided for interest on floor plan financing, defined as financing for the acquisition of motor vehicles, boats, or farm machinery for sale or lease and secured by that inventory. Where a tax treaty reduces the rate of tax on interest, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed by the treaty, bears to the rate of tax imposed without regard to the treaty.¹⁵ It is important to note that the Section 163(j) limitation is applied at the partnership or S corporation level.¹⁶ Unlike Section

¹² See also Sections 163(e)(5), 163(f), 267.

¹³ Section 685(j)(3).

¹⁴ Section 163(j)(2)(B)(ii).

¹⁵ Section 163(j)(5)(B).

¹⁶ See Section 163(j)(4).

199A deductions, excess interest of a pass through entity still reduces the outside basis of each partner or shareholder in an S corporation.

Enhanced Expensing of Tangible Personal Property.

Under the law prior to the TCJA, Section 168(k) provided that a taxpayer that owned “qualified property” was allowed, subject to the phase-down rules discussed below, additional depreciation at a 50% rate (bonus depreciation) in the year that the property was placed in service (with corresponding reductions in basis and, therefore, reductions of the regular depreciation deductions otherwise allowed in the placed-in-service year and in later years. The TCJA increases the bonus depreciation rate to 100% for all qualified property and cancels certain “phase-down” rules. The enhanced expensing rules may further motivate acquirers of target corporations to engage in direct asset purchases or deemed asset purchase under Section 338(h)(10) or Section 336(e).¹⁷

Excess Business Loss Disallowance Rule.

Under the TCJA, new Section 461(a) provides that for a tax year of a non-corporation beginning after 2017 and prior to 2026, a taxpayer’s excess business loss (EBL) is disallowed.¹⁸ Such losses are carried forward and treated as part of the taxpayer’s NOL carryforward for subsequent taxable years. An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. The threshold amount for a taxable year is \$250,000 (or twice the otherwise applicable threshold amount in the case of a joint return). The threshold amount is indexed for inflation. In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner’s distributive share and each S corporation shareholder’s pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation are taken into account in applying the limitation under the provision for the taxable year of the partner or S corporation shareholder. This limitation applies after application of Sections 1366(d)(basis limitation), 704(d)(basis limitation), 465 (at-risk limitation) and 468 (passive activity loss rule).

GENERAL ACQUISITION AND SALE PATTERNS IN ACQUIRING A C CORPORATION

This part of the outline discusses the methods for acquiring the ownership of the assets and/or stock of a target C corporation. Such methods are further discussed further below in connection with the acquisition of an S corporation since there is substantial overlap between the two.

Purchase and Sale of Assets

Direct Asset Purchase.

¹⁷ See also Section 179.

¹⁸ See Section 461(l)(1)(B).

The bulk sale of the target corporation’s assets, including assuming or taking subject to the liabilities of the target, constitutes a taxable sale of assets for federal income tax purposes. Under the TCJA, all of the taxable income of the corporation in the year of sale is reported as taxable income, subject to federal income tax at a 21% rate (plus state income tax). The sale transaction, in general, is effectuated by bill of sale and assignment of intangibles or through a state law merger in a taxable merger (i.e., forward merger or forward triangular merger).¹⁹

Where the sales proceeds are distributed to the shareholders, there are two levels of taxation.²⁰ Under the TCJA, the two levels of tax, excluding the 3.8% net investment income tax on dividend income, approximate 36.8% plus applicable corporate and shareholder level income taxes. The dividend does not allow for recovery of basis in many instances due to the presence of earnings and profits as may be substantially increased by the earnings and profits generated on the sale. The purchaser obtains a cost basis in the acquired assets. In most cases the dividend will constitute a qualified dividend and subject to capital gains rates (and not the ordinary income rate of 37%). Where a shareholder owns 20% or more of the target corporation’s stock, then a DRD of up to 80% (or in some instances 100%) can be realized.

Direct Asset Purchase Followed by a Complete Liquidation.

The sale of the assets followed by a complete liquidation of the corporation has the same corporate level tax impacts, unless the transaction is a Type C reorganization. In general, a liquidating trust is used for holdbacks and indemnification provisions as well as any target liabilities not assumed by the purchaser. The complete liquidation allows the shareholders to obtain a non-taxable basis recovery with respect to shareholders’ stock basis.²¹ Where a shareholder is a corporation, the same recovery of basis is permitted but gain on liquidation is taxed at the 21%. Where the corporation owns 80% or more of the target corporation’s stock, the liquidation distribution to the corporate shareholder is not subject to tax.

Section 336(e) Election.

Under regulations, where a corporation owns 80% or more of the stock of a target corporation under Section 1504(a)(2), and sells or distributes all of its stock in the target corporation, then an election under Section 336(e) can be made to treat the sale of stock as the disposition of all of the assets of the target corporation and no gain or loss will be

¹⁹ See, e.g., Del. Gen. Corp. Law, §259. A reverse merger (or reverse triangular merger) can yield the same outcome but with different state law impacts. On the other hand, a merger, including a forward or reverse merger, may qualify as a non-taxable reorganization, with income tax resulting to the target corporation and its shareholders to the extent of “boot”. See Sections 368(a)(1)(A), 368(a)(1)(C), 368(a)(2)(D), 368(a)(2)(E).

²⁰ See Sections 301(c)(1), 301(c)(3).

²¹ Brod, *Section 337 Liquidating Trusts Revisited — The IRS Revises Rev. Proc. 79-1*, 59 TAXES 286 (1981); Del Negro, *Liquidating Trusts — Their Nature and Uses*, 38 N.Y.U. Ann. Inst. on Fed. Tax. ch. 23 (1980). A liquidating trust must be treated as a trust for tax purposes and not be viewed as an association taxable as a corporation. See Reg. §301.7701-4(d).

recognized by the parent corporation on the sale of such stock. From a technical standpoint, the target subsidiary is treated as selling its assets, repurchasing those assets, and liquidating into its parent.²² The Section 336(e) election may be made by domestic C corporations, members of a consolidated group, or S corporation shareholders for a “qualified stock disposition” of at least 80% of the stock of its domestic subsidiary;²³ the election is made pursuant to a written, binding agreement entered into by seller and target or all S corporation shareholders on or before the due date of the federal income tax return for the taxable year that includes the disposition date.²⁴ A “qualified stock disposition” (QSD) is defined as a taxable sale or distribution of the target’s stock to an unrelated purchaser.²⁵ Section 336(e) does not apply where the seller or the target is an S corporation or a foreign corporation or to transactions between “related persons”. The election is a joint election. Unlike Section 338(h)(10) or Section 336(g), the Section 336(e) election can be made whether the purchaser is not a corporation. The regulations generally adhere to the provisions in the Section 338 regulations in determining aggregate grossed-up basis (AGUB) and aggregate deemed asset disposition price (ADADP).²⁶

Stock Purchases Treated As Asset Acquisitions

Straight Stock Purchase by Purchasing Corporation Without Section 338 Election.

Where a purchasing corporation acquires 80% or all of the stock of a target C corporation, the acquired subsidiary retains its tax history and the tax basis in its assets. Application to S corporation target corporations is discussed below in detail. Therefore, where a Section 338 election is not made and the target corporation is subsequently liquidated into its parent corporation under Section 332, the tax basis in the target’s assets and tax attributes, including carryovers and earnings and profits, will carry over to the successor corporation under Section 381. The liquidation is described further in Sections 337 and 332. An acquisition of more than 50%, directly or indirectly, of a target corporation’s stock over a test period of two years, results in a ownership change under Section 382 and with it a reduction in the loss and credit carryforwards of the target C corporation. With the net operating loss carryover rules now limited to 80% of the available NOLs, a Section 382 change of ownership results in an additional reduction in value of the NOLs. The change in the NOL rules may further result in the making of Section 338 elections of target corporations in order to fully utilize available net operating losses. However, where the carryover limitation under the TCJA is in effect, gain will still result since the NOLs cannot reduce gain on a dollar-for-dollar basis, only 80%. Based on a corporate tax rate of 21%, equal amounts of gain from a deemed sale and a NOL carryforward still results in a corporate income tax of 4.8%. Unless subsequent regulations or other guidance provides rules to the contrary, the

²² In instances where the QSD is one described in §355(d) or §355(e), the target subsidiary is not treated as liquidating into its parent; is treated as continuing its corporate existence and retains its tax attributes. Reg. §1.336-2(b)(2).

²³ Reg. §1.336-1(b)(6).

²⁴ Reg. §1.336-2(h).

²⁵ As for the 80% subsidiary stock ownership requirement for a QSD, all sales and distributions of target stock to unrelated parties during the 12-month disposition period may be aggregated. In addition, members of a consolidated group that dispose of target stock are treated as a single seller.

²⁶ Reg. §1.336-4.

selling corporation in a Section 338(h)(10) or Section 336(e) transaction, or purchaser in a Section 338(g) election context, need to factor into the equation the lack of full absorption of NOLs even if Section 382 is avoided.

Qualified Stock Purchase (QSP).

A QSP involves the purchase of 80% control of the acquired corporation, within the twelve-month acquisition period, by another corporation. The acquisition may be in either a single transaction or a series of transactions. For this purpose, “purchase” is defined to include any acquisition of stock except: (i) where stock basis to the purchaser is determined by reference (in whole or in part) to the adjusted asset basis of the transferor; (ii) an Section 351 acquisition type transaction; or (iii) an acquisition from a person, the ownership of whose stock would be attributed to the purchaser Section 318 exception under the option attribution rule in Section 318(a)(4). Note the availability of Section 338 to an indirect stock acquisition such as a reverse subsidiary cash merger.²⁷ The existence of the newly organized subsidiary that is merged into the target corporation is disregarded. Where the target corporation is liquidated, the step transaction doctrine is turned off and the transaction is treated as an asset purchase. Therefore, whether such a transaction is treated as an asset purchase is dependent on whether a Section 338 election is made or deemed made.

Section 338(g): A “Plain Vanilla Section 338 Acquisition”.

Under Section 338, a purchasing corporation can elect to treat the target corporation: (i) as having sold all of its assets in a single transaction on the date of the qualified stock purchase (i.e., the purchase of at least 80% of the target corporation’s stock in one or more transactions within a twelve-month acquisition period) for the fair market value of the assets; and (ii) as if the target corporation were a new corporation purchasing the assets for a similar amount on the following day.²⁸ The effect of this deemed sale ordinarily is that the target’s assets acquire a new, stepped-up basis equal to their fair market value. Assuming a qualified purchase of all of the target’s stock, this value would normally be identical to the amount paid by the purchasing corporation for the stock plus the target corporation’s liabilities. As discussed below, an S corporation can be a “purchasing corporation” for purposes of Section 338(g).

Time of Election.

Purchasing corporation must make the Section 338(g) election within 15th day of 9th month (8 and ½ months) beginning after the month in which the “acquisition date” occurs. For this purpose the acquisition date is the first date within the 12 month (or less)

²⁷ See Rev. Rul. 90-95, 1990-2 C.B. 67 (reverse cash merger treated as QSP under Section 338 by application of the step transaction doctrine).

²⁸ A QSP requires the purchase (cost basis transaction(s)) of 80% of the voting stock and value of all shares of issued stock of the target corporation. Stock excluded from this determination include: (i) nonvoting stock; (ii) stock limited and preferred as to dividends and does not participate in growth to any significant extent; (iii) does not have redemption and liquidation rights that exceed the issue price of the stock (except for a reasonable liquidation or redemption premium); and (iv) nonconvertible stock. See Section 1504(a)(4).

acquisition period during which the required 80% QSP occurs. The election, once made, is irrevocable.²⁹

Interim Sale of Acquired Target Stock.

The purchasing corporation can decide to sell the target stock during the period until a Section 338(g) election is made.

Target Corporation’s Ownership of One or More Subsidiary Corporations

Where the target owns 80% or more of a subsidiary and provided a Section 338 election is made for the target, the purchasing corporation is deemed to have acquired the subsidiary’s stock by purchase on the acquisition date of the target’s stock, the analytical framework that the subsidiary’s stock was, along with the target corporation’s other assets, sold and repurchased in the hypothetical sale and repurchase of the target corporation’s other assets. The election for the target’s ownership in each subsidiary corporation results in ignoring the deemed stock sale gain.³⁰

Deemed Asset Sales of Target Affiliates.

As mentioned, gain or loss, in general, is not recognized on a target’s deemed sale of stock to another corporation where: (i) the target subsidiary owns 80% or more (by voting and by value) of the target affiliate; (ii) a Section 338 election is also made for the target affiliate; and (iii) the deemed asset sales of target and target affiliate are reported on a consolidated return. Gain or loss is usually not recognized on a target’s deemed sale of stock of another corporation (a target affiliate) if (1) the target directly owns at least 80 percent (by vote and by value) of the target affiliate’s stock, (2) a Section 338 election is also made for the target affiliate, and (3) the deemed asset sales of target and target affiliate are reported on a consolidated return.³¹ When Section 338 elections are made for all corporations in a chain of corporations, of which the target is the common parent, each corporation recognizes gain or loss only on deemed sales of assets other than stock of other members of the group. For example, if P purchases all of the stock of T, which owns all of the stock of T1, and makes Section 338 elections for both T and T1, T recognizes no gain or loss on its deemed sale of

²⁹ See Reg. §1.338-1(e)(3)(where old target is an S corporation, it must file its deemed sale final return as a C corporation in a separate C taxable year). The corporate level tax may, in general, be avoided where the target corporation is an S corporation through the target’s shareholders and the purchasing corporation making a joint §338(h)(10) election. Reg. §1.338-10(a)(3)).

³⁰ If a §338 election is made for a target subsidiary, the same is true of its subsidiary. See S. Rep. No. 494, 97th Cong., 2nd Sess. 194 (1982); §§338(h)(3)(B), 338(h)(15); Reg. §1.338-3(b)(4) (acquisition date for tiered targets however makes clear that consistency rules no longer require an election for both). Pre-acquisition redemptions during the 12 month acquisition period generally is not taken into account unless the shareholder whose shares are redeemed is the purchasing corporation or a person related to the purchasing corporation.

³¹ Reg. §1.338-4(h)(2). A target, domestic or foreign, recognizes gain, but not loss, on a deemed sale of stock of a DISC or former DISC, but the recognized gain may not exceed the accumulated DISC income attributable to the stock. Reg. §1.338-4(h)(6). A domestic target recognizes gain (but not loss) on a deemed sale of a target affiliate that is a foreign insurance company electing under Section 953(d) to be treated as a domestic corporation, but only to the extent of pre-1988 earnings and profits. Reg. §1.338-4(h)(5).

T1 stock, but T1 recognizes gain or loss in a deemed sale of its assets. In contrast, if P makes a Section 338 election for T but not T1, T recognizes gain or loss on its deemed sale of T1 stock, but there is no deemed sale of T1’s assets.

Domestic Corporation’s Ownership of Foreign Target Corporation.

Despite the Section 338 election, a domestic target must recognize gain or loss on a deemed sale of a foreign target affiliate. The non-recognition rule applies to gain or loss of a foreign target or target affiliate on a deemed sale of stock of a lower-tier target affiliate, except to the extent the gain or loss is ECI (per Section 864(c)) or is otherwise treated as ECI.

Example Involving Section 338 and Foreign Target Corporation.

X (US) and Y(US) own 60% and 40 percent of a foreign corporation, FC. X sells its FC stock to B, a US corporation on 12/31/2015, the last day FC’s tax year, and Y sells its FC stock to B on 6/30/2016. X and Y are U.S. shareholders under Section 951(b) of FC on the last day of 2015 and must include their ratable shares of FC’s subpart F income for 2015. If B makes a Section 338 election for FC, FC’s tax year ends on 6/30/2016, when its shareholders are Y and B, and must report their pro rata share of FC’s subpart F income for that short period and including subpart F income generated (and recognized) from the income recognized on the Section 338 sale. Under Section 1248, gains recognized by X and Y on selling shares of FC are dividends to the extent of the earnings and profits attributable to the stock sold. Were X and Y non-U.S. persons, and therefore not described under Section 951(b), FC becomes a CFC only upon B’s purchase of 60% of FC on 12/31/2015. B is also taxed on FC’s subpart income on 6/30/2016 including subpart F income resulting from the Section 338 sale. Under the TCJA, the gain may not be treated as subpart F income to the extent that the income is described as GILTI income under new Section 951A.³²

Acquisition Period Requirement.

The QSP requires that the 80% required ownership must be acquired, by purchase, within a 12 month period. This means that if a corporation purchases 21% of the target’s stock in a single transaction and does not purchase the balance of the stock to meet the QSP threshold within 12 months, then as to the 21% stock purchase, Section 338 is unavailable. In such instance, the purchasing corporation must in fact cause the target corporation to issue more shares so that it may meet the QSP requirement with respect to a subsequent purchase or purchases of target corporation stock or cause the redemption of stock

³² Under the TCJA, each person who is a US shareholder per Section 951(b)(as revised) of a CFC is required to include in gross income such shareholder’s global intangible low-taxed income (GILTI) for such taxable year. GILTI, as to each US shareholder, is the excess (if any) of—(i) such shareholder’s net CFC tested income for such taxable year, over (ii) such shareholder’s net deemed tangible income return for such taxable year. The GILTI tax is mitigated, in the case of a U.S. corporate shareholder of a CFC, by the 50% deduction against Section 951A in Section 250 plus the ability to claim the deemed-paid foreign tax credit under Section 960, which is modified by the Act to equal 80% of foreign taxes paid or accrued by the foreign corporation with respect to the income subject to tax under Section 951A.

from a 21% of the target’s existing shareholders.³³ Under Reg. §1.338-8(j)(5), the 12 month acquisition period is extended where, pursuant to an “arrangement”, a purchasing corporation purchase 80% by vote and value of the stock of a target corporation over a period that exceeds 12 months.

Purchasing Corporation.

Only corporations, domestic and foreign, are eligible to make a Section 338 election.³⁴ For this purpose, stock acquisitions by members of an affiliated group are treated as made by a single corporation. General federal income tax principles apply in determining whether the purchaser is a “corporation”. Therefore, an LLC which elects under the check-the-box regulations, to be taxed as an “association” taxable as a corporation, should qualify as a purchasing corporation. Similarly, a purchasing corporation which forms a single member LLC to serve as the acquisition entity, the defective entity result should leave the purchasing corporation eligible to make a Section 338 election. Furthermore, where a corporation forms a new acquisition subsidiary, NewCo, to acquire the target corporation under a reverse subsidiary cash merger, the parent is treated as the true purchaser of target’s stock and NewCo is disregarded. On the other hand, a pre-existing corporation should be treated as a purchasing corporation where it engages in a downstream merger into the target corporation after the QSP.³⁵

Section 338 Election Impacts.

The “old target” corporation is treated as having sold all of its assets at the close of the “acquisition date” at FMV in a single transaction to a “new” and separate “new target” corporation that purchase all of the assets as of the day after the acquisition date. Old target, under a straight Section 338(g) election is treated as owned by the “purchasing corporation on the day of the deemed sale and therefore will economically be responsible for payment of tax on the net gain after reduction by available NOLs.³⁶ The “new target” obtains a new deemed cost basis in its assets on as of the day after the “acquisition date”. The tax attributes and history of the “old target” corporation are eliminated as of the day after the acquisition date. The purchasing corporation’s basis in the target stock is still the same as the purchase price. Note, however, the disappearing basis problem caused by an actual or deemed liquidation. The taxable year of “old target” closes at the end of the acquisition date. Where the purchasing corporation is a part of a consolidated group, including the parent corporation, “old target” will be part of the consolidated return of the purchasing corporation. Therefore, the old target becomes disaffiliated from any group in which it was a member

³³ See *DeWitt v. US*, 503 F.2d 406 (Ct. Cl. 1974).

³⁴ Section 338(d)(3); Regs. §1.338-3(b)(1), -2(e)(as to “foreign purchasing corporations”). See also Section 1371(a)(1).

³⁵ Reg. §1.338-3(c)(2). See *Helving v. Bashford*, 302 US 454 (1938)(narrow interpretation of continuity of interest doctrine); *Idol v. Comm’r*, 38 TC 444 (1962), aff’d 319 F2d 647 (8th Cir. 1963); *US v. General Geophysical Co.*, 296 F.2d 86 (5th Cir. 1961). *FSA 200122007*. See *Rev. Rul. 70-223*, 1970-1 CB 79 (purchaser merged into the target within two years after QSP treated as type A reorganization). See also *Esmark, Inc. v. Comm’r*, 90 TC 171 (1988).

³⁶ See Section 338(h)(9). The purchasing corporation’s NOLs may not be used to reduce the resulting Section 338 gain. See also Regs. §§1.1502-76(b)(1), 1.338-10(a)(2).

immediately before the deemed sale.³⁷ From a state law standpoint “old target” is acquired unchanged so that any existing liabilities, contract rights, claims made by or against, etc. carry over despite the deemed asset sale.

Target Corporation’s Deemed Sale Price of Target’s Assets.

Under ADSP rules in Reg. §1.338-4(b) apply, which is a method that is different than the AGUB (adjusted gross-up basis) to the purchasing corporation per Reg. §1.338-5(b).

ADSP.

ADSP is the sum of: (i) the grossed-up amount realized on the sale to the purchasing corporation of the QSP shares plus (ii) old target liabilities assumed or taken subject to.³⁸ ASDP is initially determined on the day after the acquisition date, and redetermined in such amount as an increase of the purchase price is required under general principles of tax law, for example, subsequent adjustments to the purchase price.³⁹ The gross up amount realized is reduced by selling costs incurred by the selling shareholders. Target liabilities for this purpose includes liability for tax on gain recognized on the deemed sale.⁴⁰ In the new 21% corporate income tax world under the TCJA, the increase to ADSP is reduced by 40% of the tax amount that may have been computed prior to the TCJA.

AGUB.

AGUB is the sum of the following: (i) the “gross-up basis” of the purchaser(s) for “recently disposed of stock”; (ii) the purchasers’ bases for nonrecently disposed of stock; and (iii) the new target’s liabilities.⁴¹

Section 338(h)(10).

In General.

A Section 338(h)(10) election may be made for a domestic “target” corporation that is: (i) a member (not the parent) of an affiliated group of corporations filing a consolidated return; (ii) a member (but not the parent) corporation of an affiliated group which is not currently filing a consolidated return; or (iii) an S corporation. Where the Section 338(h)(10) election is properly consented to and timely filed, the “old” target corporation is deemed to have sold all of its assets to “new” target corporation and then immediately distributes the sales proceeds to the shareholders of the “old” target corporation which corporation then ceases to exist in a deemed Section 332 liquidation of “old” target into “new” target. This election promotes the avoidance of one level of tax. The Section

³⁷ In general, “new target” continues to use the same employer identification number. Reg. §1.338-1(b)(3)(iii).

³⁸ Regs. §§1.338-4(b)(1), -4(d)(1).

³⁹ Reg. §1.338-4(b)(2).

⁴⁰ Reg. §1.338-4(e).

⁴¹ Reg. §1.338-5(c).

338(h)(10) election must be made jointly by the shareholders of “old” target and the purchasing corporation and must be made not later than the 15th day of the 9th month beginning after the month which includes the acquisition date. Once made, the Section 338(h)(10) election is irrevocable. A qualified Section 338(h)(10) election for a target corporation results in a deemed Section 338 election having also been made for the target. Where the (h)(10) election is invalid, the deemed Section 338 election for the target is also not valid per Reg. §1.338(h)(10)-1(c)(5) thereby avoiding a draconian tax impact under Section 338(g) that was not intended.

By Domestic Corporation.

Unlike a Section 338(g) election, the deemed asset sale under Section 338(h)(10) puts the deemed asset sale to the seller’s consolidated return, as if the target corporation had actually sold its assets and liquidated upstream to the corporate parent under Section 332. The Section 338(h)(10) election for S corporation sellers was added by regulations.⁴² The election must be made jointly by both the purchasing corporation and the seller corporation as the seller is liable for the resulting tax liability.⁴³ The regulations provide that where a Section 338(h)(10) election is made for the target corporation the election is deemed made for the target corporation. On the other hand, if a Section 338(h)(10) election for the target corporation is not valid, the regulations provide that the Section 338 election for the target corporation is also not valid.

Use by Affiliated Groups.

Where the selling corporation has a substantial gain with respect to its subsidiary’s stock and the subsidiary has a substantial “inside” gain on the FMV of the subsidiary over its adjusted tax basis, the Section 338(h)(10) election will be advantageous to the extent the “inside” gain exceeds the “outside” (FMV less basis in target stock) basis. The Section 338(h)(10) election preserves the target corporation’s tax attributes to the selling parent corporation (and consolidated group) which receives the attributes in the deemed Section 332 liquidation of the target-subsiary. Compare this outcome with a direct sale of the target’s stock which also preserves the target’s tax attributes, which the target retains if it is kept alive or, if the target is liquidated, which are inherited by the purchaser if the purchaser does not make an election under Section 338(a).

Target Corporation As Parent/Subsidiary of Consolidated Group.

Where the target is the parent of a consolidated group, the Form 8883 is filed with the group’s final consolidated return ending on the acquisition date. Where the old target is a subsidiary of the selling group the Form 8883 must be attached to the group’s consolidate return that includes the sale transaction. The same form must also be filed by new target and if new target becomes a member of a consolidated group the form must be attached to the consolidated return that includes the day after the acquisition. When the selling shareholder or shareholders are members of an affiliated group the deemed Section 332 liquidation under

⁴² Regs. §§1.338(h)(10)-1(d)(1)(iii), 1.338(h)(10)-1(e)(2)(ii), 1.338(h)(10)-1(e)(2)(iv).

⁴³ Reg. §1.338(h)(10)-1(c)(4).

the Section 338(h)(10) construct will provide nonrecognition treatment on the deemed liquidation only the target subsidiary will recognize gain or loss on the deemed asset sale.

Availability of Section 338(h)(10) Election in Certain Multi-Step Transactions.

The regulations provide that regardless of the rule set forth in Reg. §1.338-1(c)(1)(i), a Section 338(h)(10) election may be made where the purchase of target stock, viewed independently, constitutes a QSP and, after the stock acquisition, T the target merges or liquidates into the purchasing corporation (or another member of the affiliated group that includes the purchasing corporation), regardless the application of the step transaction doctrine or regardless of whether the acquisition of the target corporation stock and subsequent merger or liquidation of the target corporation qualifies as a reorganization under Section 368(a). If a Section 338(h)(10) election is made in a case where the acquisition of the purchasing corporation’s stock followed by a merger or liquidation of the target corporation into a purchasing corporation is a reorganization under Section 368(a), it is still treated as a QSP.

Consequences of Section 338(h)(10) Election.

As provided in Reg. §1.338(h)(10)-1(d): (i) the purchasing corporation is deemed (automatically) to have made a gain recognition election for its nonrecently purchased target corporation stock, if any, and includes a taxable deemed sale by the purchasing corporation on the acquisition date of any nonrecently purchased target stock;⁴⁴ (ii) the AGUB of “New Target” for its assets is determined under Reg. §1.338-5 and allocated among the acquisition date assets as per the regulations;⁴⁵ and (iii) the target corporation remains liable for the tax liabilities of the members of any consolidated group that are attributable to tax year in which those corporation and “old target” corporation joined in the same consolidated return.⁴⁶ As to the “old target” corporation, it is treated as transferring all of its assets to an unrelated person in exchange for consideration including the discharge of its liabilities in a single transaction at the close of the acquisition date (but prior to the deemed liquidation). Such gain or loss is included in the consolidated return which includes the acquisition date. Consolidated NOLs and other tax attributes of the selling corporation group (including the target corporation’s NOLs) can be used to offset gain on the deemed asset sale.⁴⁷ The deemed Section 332 liquidation implicates the deferred intercompany transaction rules of Reg. 1.1502-13. Where the target corporation is the “selling member” the selling consolidated groups takes over the deferred gain or loss with respect to intercompany transactions.⁴⁸

⁴⁴ Reg. §1.338-5(d).

⁴⁵ Regs. §§1.338-6, 1.338-7.

⁴⁶ Reg. §1.1502-6.

⁴⁷ See 1503(e) overruling *Woods v. Investment Co. v. Comm’r*, 85 TC 274 (1985), acq., 1986-2 C.B. 1. See also Reg. 1.1502-31.

⁴⁸ Regs. §§1.1502-13(f)(5)(i), 1.1502-13(f)(5)(ii)(B), 1.1502-13(j)(2)(i)(A), 1.1502-13(j)(9). Also see Reg. §1.1502-32.

Target S Corporation.

The shareholders of an S corporation may elect to elect, along with the consent of the purchasing corporation, to treat the sale of 80% or more of the S corporation (target) under Section 338(h)(10) as the sale of assets of the target corporation and deemed liquidation of the S corporation.⁴⁹ The target S corporation’s S election ends (unless the purchasing corporation is an S corporation) as is the case with a straight or regular Section 338(g) transaction.⁵⁰ Under the regulations to Section 338(h)(10) the shareholders report the gain or loss on an asset by asset basis and make corresponding adjustments to their outside stock basis. The built-in gains tax can apply if the deemed asset sale occurs with the 5 year recognition period. The deemed liquidation is then tested for its tax effect after the basis adjustments for income or loss are made by the shareholders. The liquidation gain or loss is determined in accordance with Section 331. The “new” target corporation is treated as a new corporation with a AGUB asset base. Where there are shareholders who retain their shares of S stock, they are also treated as purchasing stock of the “new” corporation for FMV on that date.⁵¹ The deemed asset sale overrides the reporting of gain or loss on the sale of stock. The installment sales rules can apply at both the corporate and shareholder levels.⁵²

Single Purchase Transaction.

The QSP of the S corporation’s stock must take place in one transaction or simultaneous transactions. This is because if the QSP was staggered, the first stock purchase to the acquiring corporation may end the target corporation’s S election making the S corporation provision in the regulations to Section 338(h)(10) inapplicable.

Characterization Changes Possible.

The gain or loss from an S shareholder’s sale of stock is capital gain or loss. This is not the gain with a deemed asset sale under Section 338(h)(10). There can be a fair amount of transmutation of the character of the shareholder’s gain or loss which is passed through depending on the level or amount of value in the ADSP allocable to ordinary income or recapture assets, including depreciation recapture.

Minority Shareholder Problems.

Since the Section 338(h)(10) deemed asset sale of a target S corporation requires that K-1s reporting the full amount of the gain or loss to all shareholders is required,

⁴⁹ Reg. §1.338(h)(10)-1(c). For the definition of “S corporation target,” see Reg. §1.338(h)(10)-1(b)(4).

As to the term “S corporation shareholders,” see Reg. §1.338(h)(10)-1(b)(5).

⁵⁰ §1361(b)(1)(B).

⁵¹ Reg. §1.338(h)(10)-1(d)(5)(ii). See Reg. §1.338(h)(10)-1(e), Exs. 6, 10.

⁵² See Reg. §1.338(h)(10)-1(d)(8). See Sections 453(h), 453B(h). See also Reg. §1.338(h)(10)-1(e), Ex. 10. PLR 201530001 (4/22/2015) (permitting late election out of installment reporting Section 453(d)). Where an S corporation target holds assets, such as inventory or marketable securities, for which installment reporting is unavailable, the deemed sale of the assets apparently triggers immediate recognition of gain, which passes through to the shareholders.

the minority shareholders holding onto their shares are still subject to federal income tax on the deemed sale income pass through under Section 1366. In some cases the minority shareholder or group forming the less than 20% of the shareholders of the S corporation target may demand that a premium be paid to sell their shares. Does this constitute a second class of stock if the majority shareholder group (the 80% control group) agrees to make such concession?

Section 336(e).

Under the Tax Reform Act of 1986, which of course is well known for its repeal of the General Utilities doctrine, Section enacted Section 336(e) which authorized the Treasury to issue regulations under which an election may be made to treat the sale, exchange, or distribution of at 180% or more of the voting and value of the stock of a target corporation as constituting the sale of all its underlying assets. Proposed Regulations under Section 338(e) were issued in 2008 but were not finalized until 2013.⁵³ Section 336(e) was intended to mimic the results under Section 338(h)(1) in an effort to eliminate one level of tax and without requiring the purchaser to be a “corporation”.

Qualified Stock Disposition (“QSD”).

A Section 336(e) election may be made with respect to a QSD of domestic target stock by a domestic corporate seller or by the shareholders of an S corporation. Foreign target corporations and foreign selling corporations are excluded from access to Section 336(e). In contrast with the QSP rules under Section 338, a QSD does not require a single purchasing corporation or affiliated purchasing corporations. The QSD does not require a “purchase” but applies only to sales, exchanges or dispositions of target corporation stock and allows the aggregation of all stock of a target that is sold, exchanged, and distributed by a seller (or S corporation shareholders) to different acquirers.

Greater Access to Deemed Sale Treatment of Subsidiary Assets.

Section 336(e) widens the set of transactions whereby a domestic parent corporation can avoid two (if not three) levels of taxation with respect to the sale of stock of a target corporation. Accordingly, under Section 336(e), deemed sale treatment can include: (i) a sale or disposition of a target to a partnership (or LLC taxed as a partnership), such as a private equity fund; (ii) a sale to an individual or individuals; (iii) an otherwise tax-free spin-off of the stock of a target that is described in Sections 355(d)(2) or Section 355(e)(2); or (iv) a taxable distribution of the stock of a target corporation (in a non-liquidating Section 311 distribution or a liquidating distribution under Section 331).

Limited to Domestic Corporation Targets.

Like Section 338(h)(10), target corporations eligible for a Section 336(e) election include S corporations and domestic corporations that are members of a consolidated group or that are 80% owned by another domestic corporation. A QSD follows

⁵³ T.D. 9619, 73 Fed. Reg. 28,467 (5/15/2013). The final Section 336(e) regulations apply for any QSP for which the first disposition date is on or after May 15, 2013.

the QSP with regard to the purchase of 80% or more of the voting and value of the target corporation’s stock.

Impact and Consequences of Section 336(e).

Basically follows the principles of Section 338(h)(10). The target corporation is deemed to sell all of its assets to a new corporation at the close of the date on which the QSD occurs and the new corporation acquires a cost basis (AGUB) with respect to such assets. The seller corporation disregards the target stock sale, and the target is deemed to liquidate (unless the QSD arises out of a transaction to which Section 355(d)(2) or Section (e)(2) applies). The Section 336(e) election is made by the seller corporation or the S corporation’s shareholders and by target by a binding written agreement which must meet the requirements set forth under the regulations. The purchase of the target stock must exercise due diligence on whether the seller intends to make the Section 336(e) election as to the QSD.

Two Models Potentially Involved.

The “sale to self” model with respect to Section 355(d)(2) and Section 355(e)(2) transactions. There is also the basic or general Section 338(h)(10) model. The rules under this area are complex and are not set forth in detail in this outline.⁵⁴

APPLICATION OF SUBCHAPTER S TO SUBCHAPTER C

Section 1371(a)(1) provides that “(e)xccept as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.” As a corollary to the general principle, Section 1371(b) generally prohibits carryovers and carrybacks between S corporation and C corporation years, Section 1371(c)(2) requires proper adjustment to an S corporation’s accumulated earnings account in certain acquisitive or divisive transactions, which by necessary implication would involve Sections 381-384. After the Subchapter S Revision Act of 1982 (“SSRA”), Subchapter C applies to an S corporation except to the extent that application of a rule or principle under Subchapter C would be inconsistent with the pass through rules under Subchapter S. This rule acknowledges that an S corporation can generally participate in a tax-free reorganization under Section 368, acquire the assets or stock of another C or S corporation, including a consolidated group of corporation, engage in a tax-free split-up or split-off under Section 355, or engage in a complete liquidation under Part II of Subchapter C.

*Background of Section 1371(a)(1): Subchapter S Revision Act of 1982.*⁵⁵

Section 1371(a)(1), which was enacted with the SSRA,⁵⁶ provides that except as otherwise provided in the Code and except to the extent inconsistent with the treatment of an

⁵⁴ See Cummings, Jr., *Final Regulations on Qualified Stock Dispositions*, Tax Notes (Aug. 19, 2013) at 820; Elliott, *Deemed Asset Sale Construct Can Trigger Excess Loss Account*, 2013 TNT 113-1 (6/12/2013).

⁵⁵ P.L. 97-354.

⁵⁶ Prior to SSRA this topic was covered by regulation.

S corporation as a flow-through entity for federal income tax purposes, the provisions of Subchapter C will apply to an S corporation and its shareholders. Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge with an S corporation tax-free if all other statutory and non-statutory requirements are satisfied. Furthermore, the Service had recognized both prior and after SSRA that an S corporation may be part of a divisive or non-divisive corporate division under Section 368(a)(1)(D) or Section 355 despite the presence of a subsidiary relationship, at least a momentary one.⁵⁷ For example, a distribution of AAA under Section 1368(c)(1) effectively overrides Section 301(c)(1). A third and more controversial rule, which serves as a corollary to the “unless otherwise inconsistent” integration principle of Section 1371(a)(2), was contained in Section 1371(a)(2) prior to 1996. This subparagraph provides that where an S corporation owns stock in another corporation, then, with respect to its capacity as a shareholder of such corporation, it is treated as an “individual” for purposes of Subchapter C. The purpose of this rule was to prevent an S corporation from qualifying as a corporation for the dividends received deduction. Thus, for purposes of Section 301, an S corporation shareholder is an “individual.” The legislative history unfortunately was silent as to all other applications of Subchapter C where an S corporation is an actor in its shareholder capacity. In 1988, the Internal Revenue Service announced its position that Section 1371(a)(2) is to be applied literally as to liquidations. Thus, the Service took the position that a C corporation may not be liquidated under Sections 337/332 upstream into an S corporation.⁵⁸ For purposes of determining whether a corporation remained a small business corporation, transitory ownership of stock in a subsidiary (i.e., stock meeting the Section 1504(a) tests) could be disregarded. In Rev. Rul. 72-320,⁵⁹ the Service ruled that momentary ownership of all of the stock in another corporation acquired in connection with a divisive reorganization under Section 368(a)(1)(D) did not terminate the S election of the transferor corporation. The ruling specifically notes that the S corporation never contemplated more than “momentary” control of the newly formed spun-off corporation. In Rev. Rul. 73-496,⁶⁰ the Service disregarded a 30-day period during which an S corporation controlled a subsidiary prior to the liquidation of the subsidiary under former Section 334(b)(2). In Haley Bros. Construction Corp. v. Comm’r⁶¹, the Tax Court strongly stated in dictum that the Service’s 30-day rule was inconsistent with the statute. The Court expressly reserved its opinion on whether “momentary” ownership would terminate an S election. Despite Haley Bros., the Service, relying on both Rev. Rul. 72-320 and Rev. Rul. 73-496, continued to issue rulings that ignored transitory stock ownership.⁶² In 1992, the IRS reversed its position, stating that the prior ruling prohibiting the application of Sections 337 and 332 to the liquidation of a subsidiary of an S corporation, was incorrect.⁶³

⁵⁷ See former Reg. §1.1372-1(c).

⁵⁸ See PLR 8818049 (2/10/88).

⁵⁹ 1972-1 C.B. 270.

⁶⁰ 1973-2 C.B. 313.

⁶¹ 87 T.C. 498 (1986).

⁶² See, e.g., TAM 9245004; PLR 9414016; PLR 9321006; PLR 9320009; PLR 9319041; PLR 9319018; PLR 9319016; PLR 9319002; PLR 9318024; PLR 9312025; PLR 9312019; PLR 9311022; PLR 9306017; PLR 9303021.

⁶³ See August, Taxable Stock Acquisitions by S Corporations: Technical Advice Memorandum 9245004 Permits Use of Sections 332 and 338, 5 J.S. Corp. Tax’n 203 (1994); Integration of Subchapter C with Subchapter S After the Subchapter S Revision Act, 37 U. Fla. L. Rev. 3 (1985). PLR 9245004 (7/28/92).

*Small Business Jobs Protection Act of 1996.*⁶⁴

The Small Business Jobs Protection Act of 1996 (the “SBJPA”) repealed Section 1371(a)(2) which treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the provision clarifies that the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of Sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under Section 1374 upon a subsequent disposition. An S corporation also will be eligible to make a Section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation’s gains and losses. The repeal of former Section 1371(a)(2) does not disturb the general rule under Section 1363(b), that an S corporation computes its taxable income as an “individual.” For example, it does not allow an S corporation, or its shareholders, to claim a dividends received deduction under Section 246 with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers. Section 1059 requires a corporate shareholder to reduce basis in its stock of another corporation to the extent of any nontaxed portion of an “extraordinary dividend,” i.e., a dividend equaling or exceeding a prescribed “threshold percentage” (5% for preferred stock and 10% for other stock) of the underlying stock basis, unless the stock was held for more than 2 years before the “dividend announcement date” or satisfies certain other conditions.⁶⁵ Since an S corporation receiving a dividend distribution from a C corporation is not entitled to a dividends received deduction, it generally will fall outside of the scope of Section 1059.

PRE-CLOSING ELIGIBILITY REQUIREMENTS FOR THE TARGET S CORPORATION

In General.

Since its enactment in 1958, the electing small business corporation has been limited by entity and owner limitations that have gradually been liberalized over time. Under current law, Section 1361(b)(1) provides that an S corporation is: (i) a domestic corporation; (ii) which does not have more than 100 shareholders; (iii) does not have a shareholder who is not an individual (other than an estate, certain trusts or charitable or tax-exempt organizations); (iv) does not have a nonresident alien as a shareholder;⁶⁶ (v) does not have more than one class of stock which is issued and outstanding; and (vi) is not otherwise an ineligible corporation. Accordingly, an entity taxable as a partnership cannot own stock in an S corporation. A regular or C corporation is not permitted to own stock in an S corporation. These limitations not only affect the organization of an S corporation but will greatly impact the structure of the acquisition of or by an S corporation.

⁶⁴ P.L. 104-188.

⁶⁵ See Sections 1059(c), 1059(e) (per se extraordinary list).

⁶⁶ Under TCJA, §13541(a), the TCJA permits a non-resident alien to be a potential current beneficiary of an electing small business trust under Section 1361(c)(2)(B)(v).

Perhaps the most scrutiny of the target’s S corporation history arises when the buyer expects to make a qualified “purchase” of 80% or more of the target stock and elect under Section 338(h)(10) to convert the stock purchase into an asset purchase for tax purposes. This election may only be made for a target that is a domestic corporation that before the sale of its stock, is a member of an affiliated group of corporations (whether or not the group files consolidated returns) *or is an S corporation*. If the target is owned by individual shareholders, Section 338(h)(10) is not available unless the target is an S corporation. Regulations further provide for deemed asset sale treatment for shareholders of an S corporation target provided all shareholders of the target consent.

Where a Section 338(h)(10) election is made, the target corporation recognizes gain or loss as though it sold its assets on the acquisition date, but target shareholders generally recognize no gain or loss on selling target stock to the purchasing corporation as a result of the basis adjustment arising from the pass through of the corporate level gain.⁶⁷ The deemed asset sale gives the buyer a cost basis in the assets of the target, subject to depreciation and amortization. In the event the S corporation has a C corporation history, the deemed sale of assets may trigger recognition of built-in gain and the imposition of the corporate level built-in gain tax imposed by Section 1374. Therefore, the history of the S election and the eligibility of the target for S status will need to be scrutinized carefully to ensure both the eligibility of the target for the Section 338(h)(10) election and avoidance of liability for any built-in gains tax.

S Corporation Shareholder Limitations.

Section 1361(b) provides that an otherwise eligible corporation may elect and maintain S status only if the corporation does not:

1. have more than 100 shareholders,
2. have a shareholder who is not an individual, an estate, an eligible trust described in Section 1361(c)(2), or certain exempt organizations,
3. have a nonresident alien as a shareholder, or
4. have more than one class of stock.

Section 1361(c)(2) describes the type of trusts eligible to hold S corporation stock:

1. trusts treated as owned 100 percent by an individual who is a citizen or resident of the United States under Sections 673 and 678 (grantor and deemed owner trusts),
2. qualified subchapter S trusts (QSSTs) that meet the requirements of Section 1361(d),

⁶⁷ The S status of the target corporation remains in effect through the close of the acquisition date, including the time of the deemed asset sale and liquidation. Reg. §1.338(h)(10)-1(d)(3).

3. electing small business trusts (ESBTs) that meet the requirements of Section 1361(e),
4. grantor trusts for a two year period after the death of the grantor,
5. testamentary trusts for a two year period after stock is transferred to it under a will,
6. voting trusts, and
7. an IRA (or ROTH IRA) with respect to stock in a bank or depository holding company held on October 22, 2004 (the date of enactment of the 2004 Act as amended by the 2005 Act).

Family as One Shareholder Rule.

For multi-generational ownership, whether direct or indirect such as through an accumulation trust, e.g., electing small business trust, the 100 shareholder limitation could pose a problem. In 2004, Congress enacted a provision as part of the American Jobs Creation Act of 2004 (the “2004 Act”), Section 1361(c)(1)(D), which provides that for purposes of the counting rules, members of a family will be treated as 1 shareholder. The term “members of a family” means a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant. The so-called common ancestor must not be more than 6 generations removed from the youngest generation of shareholders who would (but for this subparagraph) be members of the family.⁶⁸

Single Class of Stock Requirement.

In General.

Where an acquisition or disposition involves an S corporation, the eligibility requirements of Section 1361(b) will be of primary importance since they can significantly restrict the structuring of the transaction. This will be particularly important where the acquiring corporation is an S corporation and wishes to continue to its S status after the acquisition. The Subchapter S rules prohibit the issuance of more than one class of stock, i.e., stock which has a preference on distributions during either the operational or liquidation phase.⁶⁹ A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in common stock voting rights are disregarded.⁷⁰ Shareholder covenants

⁶⁸ See Truskowski, “AJCA Changes to Subchapter S Broaden the Availability of the S Election,” 101 J. Tax’n 327 (December 2004). Under the Gulf Opportunity Zone Act of 2005 (the “2005 Act”), an election is no longer required for a family to be treated as one shareholder, as originally required under the 2004 Act.

⁶⁹ Section 1361(b)-(1)(D). Reg. §§1.1361-1(l)(2)(i) (differences in timing of distributions as a second class), 1.1361-1(l)(2)(ii) (effect of state income tax withholding regimes).

⁷⁰ Section 1361(c)(4).

contained in buy-sell agreements generally will not result in a second class of stock.⁷¹ This limitation has made it difficult for S corporations to raise funds and venture capital since many lenders seek hybrid forms of payment or “kickers” in addition to receipt of a pure interest stream of payments for the use of borrowed funds.

A detailed discussion of the single class of stock requirements for S corporations is set forth below.

Differences in Voting Rights.

Reg. §1.1361-1(1)(1) provides that differences in voting rights among shares of stock of the corporation will be disregarded in determining whether a corporation has more than one class of stock. Consequently, an S corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members to the board of directors, as long as such shares confer identical rights to distribution and liquidation proceeds.

Non-conforming Distributions.

The original proposed single class of stock regulations provided that even where all outstanding shares of stock conferred identical rights to distribution and liquidation proceeds, the corporation still would be treated as having more than one class of stock if the corporation made “non-conforming distributions.” Non-conforming distributions were defined as distributions which differed with respect to timing or amount as to each outstanding share of stock, with certain limited exceptions. Thus, under the original proposed regulations, excessive or inadequate compensation from an S corporation to a shareholder, shareholder loans, fringe benefits to shareholders, and other constructive distributions such as excessive rental payments between a shareholder and an S corporation could cause the inadvertent termination of an S corporation’s election under the non-conforming distribution rule. Under the final single class of stock regulations, non-conforming distributions will not cause a corporation to be treated as having more than one class of stock, but such distributions (including actual, constructive or deemed distributions) that differ in timing or amount will be given the appropriate tax effect in accordance with the facts and circumstances. Thus, the Service has the power to recharacterize such distributions.⁷²

Stock Taken into Account.

Under Reg. §1.1361-1(1)(3), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account, except for: (i) restricted stock within the meaning of Reg. §1.1361-1(b)(3) with respect to which no Section 83(b) election has been made; (ii) deferred compensation plans within the meaning of Reg. §1.1361-1(b)(4); and (iii) straight debt under Reg. §1.1361-1(b)(5) and -1(l)(5).

⁷¹ See Reg. §1.1361-1(l)(2)(iv); Rev. Rul. 85-161, 1985-2 C.B. 191.

⁷² Reg. §1.1361-1(1)(2)(i).

Governing Provisions.

Reg. §1.1361-1(1)(2) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is based upon the corporate charter, articles of incorporation, bylaws, applicable state law, and “binding agreements relating to distribution and liquidation proceeds” (the “governing provisions”). Thus, with respect to an S corporation’s outstanding shares of stock, only governing provisions can cause the corporation to be treated as having a second class of stock.

Routine Commercial Contractual Arrangements.

Reg. §1.1361-1(1)(2) provides that routine commercial contractual arrangements, such as leases, employment agreements and loan agreements, will not be considered binding agreements relating to distribution and liquidation proceeds, and consequently will not be considered governing provisions, unless such agreements are entered into to circumvent the one class of stock requirement.

State Law Requirements for Payment and Withholding of Income Tax.

Reg. §1.1361-1(1)(2)(ii) provides that state laws requiring a corporation to pay or withhold state income taxes on behalf of some or all of its shareholders will be disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds if, when the constructive distributions resulting from the payment of such taxes by the corporation are taken into account, the outstanding shares otherwise confer identical rights to distribution and liquidation proceeds. Consequently, a difference in timing between constructive distributions attributable to withholding and payment of taxes with respect to some of an S corporation’s shareholders and actual distributions to other shareholders will not cause the corporation to be treated as having more than one class of stock.

Distributions that Take Into Account Varying Interests.

Reg. §1.1361-1(1)(2)(iv) provides that an agreement will not be treated as affecting the shareholders’ rights to liquidation and distribution proceeds conferred by an S corporation’s stock if the agreement merely provides that, as a result of a change in stock ownership, distributions in one taxable year will be made on the basis of the shareholders’ varying interests in the S corporation’s income during the immediately preceding taxable year. If, however, such distributions are not made within a “reasonable time” after the close of the taxable year in which the varying interests occur, such distributions may be re-characterized depending upon the facts and circumstances, but still will not result in the corporation being treated as having a second class of stock.

Buy-Sell, Redemption and Other Stock Restriction Agreements.

Reg. §1.1361-1(1)(2)(iii) sets forth rules regarding when buy-sell, redemption and other stock restriction agreements will be disregarded in making the determination as to whether a corporation’s shares of stock confer identical rights to distribution and liquidation proceeds.

Agreements Triggered by Death, Divorce, Disability or Termination of Employment.

A bona fide agreement to redeem or purchase stock at the time of death, divorce, disability or termination of employment will be disregarded in determining whether a corporation’s shares of stock confer identical rights to distribution and liquidation proceeds.⁷³

Non-Vested Stock.

If stock that is substantially non-vested is treated as outstanding, the forfeiture provisions that cause the stock to be substantially non-vested will be disregarded.

Buy-Sell Agreements, Stock Restriction Agreements and Redemption Agreements.

Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements will be disregarded in determining whether a corporation’s outstanding shares of stock confer identical distribution and liquidation rights unless (i) a principal purpose of the agreement is to circumvent the one class of stock requirement, and (ii) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

Determination of Value.

Reg. §1.1361-1(1)(2)(iii) provides that a price established at book value or at a price between fair market value and book value will not be considered to establish a price significantly in excess of or below the fair market value of the stock.

A determination of book value will be respected if the book value is determined in accordance with GAAP; or the book value is used for any substantial non-tax purpose. Additionally, the regulations provide that a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of value was not performed with reasonable diligence.

Special Rule for Section 338(h)(10) Elections.

Reg. §1.1361-1(1)(2)(v) provides that if the shareholders of an S corporation sell their stock in a transaction for which an election under Section 338(h)(10) is made, the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm’s-length negotiations with the purchaser. This provision is important because the amount a shareholder is paid per share of stock (and the timing of the payment) often will vary among the shareholders (for example, due to control premiums and minority discounts); this could create a second class of stock concern if the shareholders were viewed as receiving

⁷³ Reg. §1.1361-1(1)(2)(iii)(B).

different amounts in the fictional liquidation of the S corporation resulting from the Section 338(h)(10) election.⁷⁴

Use of options and warrants.

Stock options or stock warrants are often important tools in structuring either a taxable or non-taxable acquisition.⁷⁵ Under the final regulations to Section 1361, a call option, warrant or similar instrument will constitute a prohibited second class of stock if the option is substantially certain to be exercised by the holder or a potential transferee, and the option has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder to a person who is not an eligible shareholder or materially modified.⁷⁶

“Not in the Money” Safe Harbor.

The regulations provide a safe harbor whereby a call option is not treated as a second class of stock if, on the date the call option is issued, transferred by a person who is an eligible shareholder to a person who is not an eligible shareholder, or materially modified, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. The failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock.

Option Issued to Commercial Lender.

An additional exception is provided for options that are issued to a person that is actively and regularly engaged in the business of lending and issued in connection with a commercially reasonable loan to the corporation as described by the regulations.

Option Issued for Services.

The regulations provide that a call option that is issued to an individual who is either an employee or an independent contractor in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) is not treated as a second class of stock under Subchapter S if the call option is not transferable under Reg. §1.83-3(d) and the call option does not have a readily ascertainable fair market value as defined in Reg. §1.83-7(b) at the time the option is issued.

Safe Harbor Options and Warrants.

In *Santa Clara Valley Housing Group v. United States*,⁷⁷ involving a KPMG tax shelter (“*S Squared*”), the taxpayer sought reconsideration of an earlier ruling that the issuance of warrants resulted in termination of the taxpayer’s status as an S corporation.

⁷⁴ See also PLRs 9821006 and 199918050.

⁷⁵ Reg. §1.1361-1(l)(4).

⁷⁶ Regs. §§1.1361-1(l)(4)(iii)(A), 1.1361-1(l)(4)(iv)(B).

⁷⁷ 109 AFTR 2nd 2012-360 (N.D. CA 2012).

In its earlier ruling, the Court determined that a warrant could be classified as a second class of stock under Reg. §1.1361-1(l)(4)(ii) [equity under general tax principles *and* purpose to circumvent the rights to distribution or liquidation proceeds], even if the warrant satisfied the requirements of the *not in the money* safe harbor of Reg. §1.1361-1(l)(4)(iii)(A).

Issuance of the warrants clearly had a principal purpose “to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock.” The taxpayer argument was that the warrants were not “substantially certain to be exercised”, because it was a specific premise of the shelter structure that the options would not be exercised, and so the options could not be treated as a second class of stock under Reg. §1.1361-1(l)(4)(iii)(A). The Court agreed - no one intended or expected the options to be exercised.

However the Court had held that even though Reg. §1.1361-1(l)(4)(iii)(A) may have been satisfied, Reg. § 1.1361-1(l)(4)(ii) could create a second class of stock, and was applicable here because the court concluded the options were equity under general tax principles and had a circumvention purpose.

The taxpayer asserted that the Court erred in applying Reg. §1.1361-1(l)(4)(ii) and failing to consider whether the warrants fall within the safe harbor established in Reg. §1.1361-1(l)(4)(iii)(C). In its earlier ruling, the Court did not address the safe harbor provision established by subsection (l)(4)(iii)(C).

Subsection (l)(4)(iii)(C), entitled “*Safe harbor for certain options,*” provides as follows:

A call option is not treated as a second class of stock if, on the date the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this Section to a person who is not an eligible shareholder under paragraph (b)(1) of this Section, or materially modified, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. For purposes of this paragraph (l)(4)(iii)(C), a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence to obtain a fair value. Failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock.⁷⁸

In its modified ruling, the Court stated that application of the *not in the money* safe harbor provision turns upon whether the strike price of the warrants was at least 90 percent of the fair market value of the underlying stock on the date the warrants issued, which is an issue of fact. Accordingly, the Court’s ruling that the warrants constituted a second class of stock under Reg. §1.1361-1(l)(4)(ii) was modified to reflect a determination that triable

⁷⁸ Reg. §1.1361-1(l)(4)(iii)(C).

issues of material fact exist as to whether the safe harbor provision of Reg. §1.1361-1(l)(4)(iii)(C) is satisfied.

Use of convertible debt.

The regulations provide that convertible debt will be considered a second class of stock if: (i) it would be treated as a second class of equity under general tax principles, i.e., Section 385, and (ii) it embodies rights equivalent to those of a call option that would be treated as a second class of stock under the portion of the regulations pertaining to options. In various instances involving an acquisition, particularly a non-taxable acquisition, the resolution of whether unretired debt, including convertible debt, of the target corporation will have substantial tax implications including (i) possible termination of S status; (ii) debt cancellation income under Section 108; (iii) original issue discount issues; (iv) creation of market discount or bond issue premium; (v) dividend issues under Section 305(5), and (vi) the existence of a taxable sale or exchange.⁷⁹

Short Term Unwritten Advances.

Reg. §1.1361-1(l)(4)(ii)(B)(1) provides that unwritten advances by a shareholder that do not exceed \$10,000 in the aggregate at any time during the year, which are treated as debt by the parties and are expected to be repaid within a reasonable time, are not treated as a second class of stock.

Proportionately Held Debt.

Reg. §1.1361-1(l)(4)(ii)(B)(2) provides that obligations of the same class owned proportionately by the shareholders are not treated as a second class of stock. An obligation held by the sole shareholder is always held proportionately to the outstanding stock.

Use of straight debt.

Section 1361(c)(5)(b) provides that certain debt, which qualifies as “straight debt,” will not result in a second class of stock despite its equity features or characteristics. The definition of straight debt requires, among other things, that the holder be an individual (other than a non-resident alien), or an estate or trust eligible to own S stock. If the holder were, for example, a financial institution, prior to 1997 it would not qualify under safe harbor debt. Under the straight debt safe harbor, indebtedness of an S corporation will not be treated as a second class of stock if it is (i) in writing; (ii) contains an unconditional promise to pay a sum certain in money on demand or at a specified date; (iii) does not bear interest contingent on corporate profits, the corporation’s discretion or similar factors, (iv) is not convertible into stock and (v) is owned by a person who is eligible to be an S corporation shareholder. The

⁷⁹ See Reg. §1.1001-3; Rev. Rul. 89-122, 1989-2 CB 200 (change in interest rate or reduction in face material); Rev. Rul. 79-155, 1979-1 CB 153 (same); Rev. Rul. 73-160, 1973-1 CB 365 (postponement of maturity date not exchange); Rev. Rul. 72-265, 1972-1 CB 222 (conversion of debt into stock of same debtor was tax-free); See also landmark Supreme Court’s decision in *Cottage Savings Association v. Comm’r*, 499 US 554 (1991) (swap of economically equivalent mortgage pools created deductible losses).

regulations provide that the fact that an obligation is subordinated to other debt of the corporation does not prevent the obligation from qualifying as straight debt. The regulations further provide that where an obligation qualifies as straight debt it will lose its status under the safe harbor where (i) the obligation is materially modified so that it no longer satisfies the definition of straight debt; or (ii) is transferred to a third party who is not an eligible shareholder. Where an obligation of an S corporation satisfies the definition of straight debt it still may be treated as equity for other tax purposes. Thus, for example, where a straight debt obligation bears a rate of interest that is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest.

As a reform introduced by SBJPA, after 1996 a financial institution now qualifies for holding safe harbor debt provided such institution is actively engaged in the business of lending money.⁸⁰ This requirement should not be difficult to satisfy. Still, the non-convertibility requirement of safe harbor debt, as well as the restriction that interest payments not be contingent on profits, remain impediments for achieving transactional neutrality among pass through entities in this area. S corporations remain disadvantaged in this area.

Use of Stock Appreciation Rights and Phantom Stock.

Stock Appreciation Rights.

A stock appreciation right (SAR), which is similar to a phantom stock arrangement, is basically a contractual right to receive cash, stock, or a combination of both, measured by the appreciation in a corporation's stock from the date of grant to the date of exercise. SARs allow the recipient, typically a corporate executive or a key employee, to participate in the future growth of the corporation without having to commit any resources or undertake any real economic risk. If properly structured, the SAR will not constitute a prohibited second class of stock under Subchapter S.

Phantom Stock Plans.

A phantom stock plan works similarly to an SAR by rewarding the employee based on the performance of the employer's stock. In a phantom stock plan, however, the compensation is based on appreciation of units, the value of which are tied to the value of the employer's stock. For example, the value of one unit at the date of grant can be 75% of the then current market value of one share of stock, or it may be tied to book value. As with the SAR, if properly structured, the phantom stock plan will not constitute a prohibited second class of stock under Subchapter S.

Use of Joint Venture.

Where the Subchapter S limitations concerning the one class of stock requirement or the shareholder eligibility limitations pose a formidable obstacle in structuring a business combination involving an S corporation, consideration should be given to the use of a joint venture. While the Service has backed off to a certain extent its concern that a joint venture

⁸⁰ Section 1361(c)(5)(iii).

involving an S corporation may not be used to end run the Subchapter S limitations, the outer limits of this liberal attitude have not been tested.⁸¹

Section 707(a)(2)(A) applies to an allocation and distribution to a partner who has transferred property to a partnership if (1) the allocation and distribution are “related” to the property transfer and (2) the property transfer and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership. The principal targets of this aspect of the provision are situations in which all or a portion of the purchase price of property is paid through partnership allocations in order to give other partners the practical equivalent of immediate deductions for payments of the purchase price. Section 707(a)(2)(B) provides that a partner’s transfer of money or other property to a partnership is deemed made in a nonpartner capacity if (i) the partnership makes a “related” transfer of money or other property to the partner or another partner and (ii) the transfers of the partner and partnership, “when viewed together, are properly characterized as a sale or exchange of property.” This rule is “intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership and thereby to defer or avoid tax on the transaction.”⁸² Reg. §1.707-3(c) provides that if within a two-year period, a partner transfers property to a partnership and the partnership transfers money (or other consideration) to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish otherwise. Reg. §1.707-5(b)(1) provides that, for purposes of the disguised sale rules, if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under Reg. §1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner’s allocable share of the partnership liability.⁸³

Use of “Tax Nothings” or Single Member Entities.

A single member LLC owned by an individual (who otherwise constitutes an permitted S corporation shareholder), disregarded as an entity for federal tax purposes (a “tax nothing”), may own stock in an S corporation⁸⁴ much in the same way as a grantor trust is ignored and the grantor is treated as the “owner” of the trust assets for federal income tax purposes.

⁸¹ See Rev. Rul. 94-43, 1994-2 C.B. 198; Reg. §1.701-2(d), Example 2. Compare Rev. Rul. 77-220, 1977-1 C.B. and GCM 36966 (12/27/76); Application of Disguised Sales Provisions; Section 707(a)(2)(A).

⁸² Staff of Joint Comm. on Tax’n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 231 (Comm. Print 1984).

⁸³ See Rubin, “Here Comes the Kitchen Sink: IRS Throws “Everything But” at Two Partnership Tax Deferral Structures,” PLI Tax Law and Practice, June, 2006.

⁸⁴ PLR 9739014.

Nominee Status.

Prior to the issuance of the check-the-box regulations (CTB) under Subchapter S that is a nominee is not treated as a shareholder for eligibility purposes. Instead, the shareholder is the beneficial owner.⁸⁵ The Service has ruled, for example, that a corporation’s S election did not terminate when its stock was held by a non-resident alien under a particular uniform gift to minors act transfer.⁸⁶ Thus, if the tax owner of the LLC “tax nothing” is otherwise an eligible shareholder, and such owner acts accordingly for Subchapter S purposes, e.g., signs Form 2553, is indicated as the owner with the Service via the K-1, etc., the corporation’s S election should be respected notwithstanding the nominee shareholder’s state law separate identity.⁸⁷

CTB Regulations.

The CTB regulations permitting certain single member controlled entities to be disregarded for federal income tax purposes such as a branch or division.⁸⁸ An entity engaged in business operations with two or more members generally will be classified as a corporation or a partnership. Certain entities designated in the regulations will be required to be “per se” corporations. Where there is only one owner, it is treated as either a corporation or a disregarded entity. Where a business entity is unincorporated and has only a single owner, it is a disregarded entity.⁸⁹ A business entity with two or more members is classified as either a corporation or a partnership. A business entity with only one owner is classified as either a corporation or a disregarded entity. Thus, a business entity that is not a corporation and that has a single owner is disregarded as an entity separate from its owners-it is a disregarded entity. A business entity that is not a per se corporation and that has at least two members is classified as a partnership absent a reverse default election to be treated as a corporation.⁹⁰

Tiered Defective Entities.

Where an entity is owned by disregarded entities, then the upper tier disregarded entity will be disregarded.⁹¹

⁸⁵ Ozier v. Comm’r, T.C. Memo 1977-53, aff’d, 600 F.2d 594 (6th Cir. 1979). See PLRs 9010042 and 8934020 (momentary ownership of S stock by partnership ignored).

⁸⁶ Rev. Rul. 71-287, 1971-2 C.B. 316.

⁸⁷ Reg. §1.1362-6(b)(3)(i). See Kean v. Comm’r, 51 T.C. 337 (1968), aff’d 469 F. 2d 1183 (9th Cir. 1972); Hook v. Comm’r, 58 T.C. 267 (1972).

⁸⁸ T.D. 8697, 61 Fed. Reg. 66,584 (Dec. 18, 1996); Regs. §§301.7701-1(a)(4), 301.7701-2(a).

⁸⁹ As to whether an entity only has a single owner see, e.g., Rev. Proc. 89-12, 1989-1 C.B. 798 (for LLC ruling purposes, Service required the aggregate interest of all member managers must equal at least 1% of each material item of the LLC’s income, gain, loss, deduction or credit (reduced for certain large LLCs); PLR 199911033 (12/18, 98) (bankruptcy remote entity did not have a two or more members for purposes of Section 1031).

⁹⁰ See Reg. §301.7701-3(b). Littriello v. United States, 95 AFTR 2d 2005-2581, 2005-1 U.S.T.C. 50, 385 (WD Ky. May 18, 2005)(validity of CTB regulations upheld). See Silverman, Zarlenga and Cain, “Use of Limited Liability Companies in Corporate Transactions,” 80 Tax Notes 1469 (Sept. 21, 1998).

⁹¹ See PLR 199915030 (1/12/99) (partnership treated as disregarded entity where its “partners” were

Conversion of Partnership to Disregarded Entity.

Where an eligible entity classified as a partnership is converted to a single member, the conversion would be treated as a liquidation of a partnership.⁹² In Rev. Rul. 99-6,⁹³ the Service analyzed two situations where one person purchased all of the interests in a multi-person LLC, causing the LLC to change from partnership to a disregarded entity. In each situation, the sellers are treated as selling their partnership interest under Section 741(a) and subject to Section 751(a) (“hot assets”). The purchaser in each instance is treated as the purchase of assets which first are distributed in liquidation.⁹⁴ Thus, to the sellers, each may recognize gain to the extent that money treated as distributed exceeds the seller’s basis in his or her partnership interest immediately before the distribution under Section 731(a)(1), and loss is not recognized unless only money and unrealized receivables and inventory items are distributed and the sum of such items exceeds the partners’ adjusted basis in his or her partnership interest per Section 731(a)(2). Under Section 732(b), the distributee’s basis in the partnership will be the same as his basis in his partnership interest, reduced by any money treated as having been distributed to him, and must be allocated in the manner described in Section 732(c).⁹⁵

Conversion of Disregarded Entity to Partnership.

Rev. Rul. 99-5⁹⁶ provides that: (1) where original member of single member domestic LLC, holding only capital assets or Section 1231 property, that is disregarded for tax purposes as entity separate from the owner under Reg. §301.7701-3, and converted to partnership when new non related member purchases 50% interest in LLC, recognizes gain or loss from deemed sale of 50% interest in each asset to new member under Section 1001; but under Section 721 partners won’t recognize gain or loss as a result of the conversion of the disregarded entity to a partnership (2) where new member’s cash contribution to LLC, which converts it from disregarded entity to partnership, is treated as contribution in exchange for ownership interest; and under Section 721(a); partners recognize no gain or loss due to conversion.

In both situations, under Section 722, the new member’s basis in the partnership interest is equal to the amount paid for the assets which the new member is deemed to contribute to the newly-created partnership. The original member’s basis is equal to his basis in his share of the assets in the LLC. In situation one, under Section 723, the basis of the property treated as contributed to the partnership by both partners is the adjusted basis of that property in their hands immediately after the deemed sale. In situation two, under Section 723, the basis of the property contributed to the partnership by the original member is the adjusted basis of that property in his hands, and the new member’s basis is equal to the amount of cash contributed. In both situation one and two, under Section

a corporation and an LLC wholly owned by the same corporation). Accord. PLR 200008015 (11/18/99); PLR 20033407 (5/13/03).

⁹² See Reg. §1.708-1(b)(1)(i).

⁹³ 1999-1 C.B. 432.

⁹⁴ See *McCauslen v. Comm’r*, 45 T.C. 588 (1966); Rev. Rul. 67-65, 1967-1 C.B. 168.

⁹⁵ See Section 735(a)(2)(holding period).

⁹⁶ 1999-1 C.B. 434.

1223(1), the original member’s holding period for the partnership interest received includes his holding period in the capital assets and property described in Section 1231 held by the LLC prior to converting to a partnership. The new partners holding period for the partnership interest begins on the day following the date of his purchase of the LLC interest.

Conversion of Disregarded Entity to Corporation.

Upon the conversion of a disregarded entity to corporation status, Section 351 will apply in straightforward fashion.⁹⁷

Conversion of Corporation to Disregarded Entity.

The conversion of a corporation to disregarded entity status constitutes a complete liquidation of the corporation pursuant to Sections 331 and 336 and is taxable to the corporation and its shareholders. Exception from taxable treatment is provided where the liquidation meets of the requirements for the liquidation of a controlled subsidiary pursuant to Sections 332 and 337.⁹⁸ The conversion of an eligible entity to a disregarded entity can be accomplished by election. An election should be treated as a distribution of the assets in liquidation of a corporation. In general, the tax consequences of the conversion are deemed to occur at the end of the day preceding the election.

Mergers Involving Disregarded Entities.

On May 17, 2000, the Service issued a proposed rulemaking⁹⁹ on mergers involving disregarded entities. The proposed regulations revised paragraph (b)(1) of Reg. §1.368-2(b)(1) and adopted the view that a merger involving a corporation and a disregarded entity is not a statutory merger for purposes of qualifying as a tax-free reorganization under Section 368(a)(1)(A).¹⁰⁰ The proposed regulations would have extended to a qualified subchapter S subsidiary or QSub, a limited liability company (LLC) with a single corporate owner which does not elect to be treated as a separate corporation, or a qualified REIT subsidiary.¹⁰¹

Section 368(a)(1)(A), discussed below, requires that a qualifying reorganization constitute a “statutory merger or consolidation.”¹⁰² Under the Proposed Regulations, the merger of a disregarded entity (“DRE”) (including a QSub or qualified REIT subsidiary) into a tax corporation would not be a Type A reorganization because the merging entity is not a tax corporation. In Rev. Rul. 2000-5, the Service held that a Type A merger must involve the transfer of the assets of a target corporation to a single transferee corporation

⁹⁷ See Reg. §301.7701-3(g)(1)(iv). See Rev. Rul. 80-228, 1980-2 C.B. 115.

⁹⁸ See Reg. §301.7701-3(g)(2)(ii)(plan of liquidation “deemed adopted” immediately before the deemed liquidation incident to an elective change in entity classification). Reg. §301.7701-3(g)(1)(iii).

⁹⁹ REG-106186-98, 65 FR 31115-01.

¹⁰⁰ See also Rev. Rul. 2000-5, 2000-5 IRB 1.

¹⁰¹ See, Hirschfeld and Wild, “LLCs Provide Broad Tax Planning Possibilities For Corporate Groups in Both Domestic and Cross-Border Transactions,” 18 J. Tax’n Investments, 3, 8 (2000).

¹⁰² Reg. §1.368-2(b)(1) provides that a statutory merger or consolidation must be effectuated in accordance with the “corporation laws” of the United States or a state, territory, or the District of Columbia.

ceasing to exist as a result of the “merger” Rev. Rul. 2000-5 implies that a merger of a DRE (single member) owned by a corporation (including a QSub), cannot be a Type A reorganization because it will be divisive and will not necessarily result in the termination or liquidation of the member. Due to the additional requirements for a Type C (“substantially all of the transferor’s assets,” no more than 20% boot, including liability assumptions, and “solely for voting stock” requirements) and Type D (“substantially all”/liabilities in excess of basis) reorganization, many of the DRE mergers would constitute taxable transactions under the 2000 proposed regulations.¹⁰³

The final regulations, issued in 2003, retain much of the conceptual background to the proposed regulations, including the definition of a disregarded entity.¹⁰⁴ Examples are set forth in the regulations which apply to disregarded entities, such as a domestic, single member LLC which does not elect to be treated as a corporation for federal income tax purposes, a qualified REIT subsidiary per Section 856(i)(2) and a QSub per Section 1361(b)(3)(B).¹⁰⁵ Defined terms included the following:

- (i) Disregarded Entity; a business entity that is disregarded as an entity separate from its owner for Federal tax purposes;
- (ii) Combining Entity; a business entity that is a corporation that is not a disregarded entity;
- (iii) Combining Unit; is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such entity for Federal tax purposes;
- (iv) Transferor Unit; and
- (v) Transferee Unit.¹⁰⁶

Under a Type A reorganization, i.e., a statutory merger or consolidation effected pursuant to the statute or statutes necessary to effect the merger or consolidation, the following events occur simultaneously at the effective time of the transaction; (i) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and (ii) the combining entity of each transferor unit ceases its separate legal existence for all purposes; provided, however, that this requirement will be satisfied even if, under applicable law, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents)

¹⁰³ See Rev. Rul. 70-107, 1970-1 C.B. 78 (assumption of target liabilities by wrong corporation in an attempted triangular acquisition resulted in invalid Type C reorganization treatment).

¹⁰⁴ Reg. §301.7701-2(b)(5).

¹⁰⁵ These proposals were adopted as Temporary Reg. §1.368-2T(b)(1) by TD 9038 on Jan. 24, 2003; and became final in TD 9242 (Jan. 23, 2006).

¹⁰⁶ Reg. §1.368-2(b)(1)(i)(C).

may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the requirements of Reg. §1.368-2(b)(1)-(ii)(A).

Employment Tax Regulations.

Reg. §301.7701-2(c)(2)(iv), finalized in August 14, 2007 and effective for employment tax purposes on January 1, 2009,¹⁰⁷ provides that a disregarded entity is responsible for withholding employment taxes on wages paid to its employees and satisfying other employment tax obligations such as backup withholding, making timely deposits of taxes, filing returns, and providing wage statements to employees. An individual owner of a single-member LLC who is self-employed and subject to self-employment tax on his net earnings from self-employment with respect to the LLC’s activities is not an employee of the LLC for employment tax purposes. The individual would be entitled to deduct trade or business expenses paid or incurred with respect to activities carried on through the LLC, including the employer’s share of employment taxes imposed under Sections 3111 and 3301 on his Form 1040, Schedule C.

Similar to the payroll tax regulations, Reg. §§1.34-1, 1.1361-4(a)(8), and 301.7701-2(c)(2)(v) finalized on August 14, 2007 effective for excise tax purposes on January 1, 2008, provide that a disregarded entity itself will be required to pay and report excise taxes, register, and claim any credits (other than income tax credits), refunds, and payments related thereto. As a disregarded entity does not file an income tax return, the Section 46 credit for federal tax paid on fuels will be claimed on the disregarded entity’s owner’s income tax return with appropriate identification of the disregarded entity and its EIN. The general business credit (including the Section 40 credit for alcohol used as a fuel and the Section 40A credit for biodiesel and renewable diesel used as a fuel) would not be affected by the regulations.

For periods beginning before the effective date of the excise tax regulations, the IRS will treat payments made or other actions taken by a disregarded entity as having been made or taken by its sole owner. Thus, for such periods, the owner of the disregarded entity will be treated as satisfying the owner’s obligations with respect to the excise taxes affected by the regulations so long as those obligations are satisfied either (a) by the owner himself or (b) by the disregarded entity on behalf of the owner.

The Grantor or Deemed Owner Trust as a Permitted S Corporation Shareholder.

Section 1361(c)(2)(A)(i) of the Code permits a grantor trust described in Subpart E of Part 1 of Subchapter J of the Code to hold S corporation stock. A revocable inter vivos trust under which income is or may be paid to the grantor during the grantor’s life is the most

¹⁰⁷ T.D. 9356.

common example of a grantor or “deemed owner” trust. The grantor or deemed owner is treated as the shareholder of the S corporation for all purposes.

Similarly, an irrevocable trust in which the grantor is treated as the owner of all the income and principal of the trust pursuant to Subpart E will be treated as a grantor trust qualifying as a permitted S corporation shareholder. A trust that qualifies as a grantor retained annuity trust (GRAT), a grantor retained unitrust (GRUT), or an intentionally defective grantor trust (IDGT), may qualify as a permitted S corporation shareholder, as discussed below.

Any of a number of interests and powers retained by the grantor or vested in the deemed owner may result in a trust being treated as a grantor trust under Sections 671 through 678 of the Code, and accordingly qualify the trust as a permitted shareholder under Section 1361(c)(2)(A)(i). For example, in an early private letter ruling, the Service held that the right of the grantor to substitute property with other property of equivalent value resulted in a trust qualifying to hold S corporation stock as a grantor trust.¹⁰⁸

If a person other than the grantor of a trust is treated as the owner under Section 678, as a result of powers over the income or corpus exercisable solely by such person, the trust qualifies as a deemed owner trust under Section 1361(c)(2)(A)(i) and Subpart E of the Code. The trust can own S corporation stock in a manner similar to a grantor trust.

In order to be treated as a permitted shareholder under Section 1361(c)(2)(A)(i), the entirety of the trust must be treated as owned by a single deemed owner. According to one private letter ruling, the trust may permit the distribution of income and principal to other beneficiaries, provided only one beneficiary is treated as the deemed owner of the entire trust.¹⁰⁹ A general inter vivos power of appointment, exercisable currently, held by a single deemed owner beneficiary, should qualify a trust as a Section 678 trust.

It also appears that a noncumulative annual power, such as a Crummey withdrawal power, will qualify a portion of a trust as a Section 678 trust.¹¹⁰ In a 1992 private letter ruling, the Service ruled that a beneficiary holding a Crummey withdrawal power would be treated as the owner of the trust, and therefore the trust would be an eligible S corporation shareholder. The Service required the trust to meet the following conditions: (1) no transfer to the trust could exceed the beneficiary’s withdrawal power, and (2) the donor could not restrict the beneficiary’s withdrawal power with respect to the contribution.¹¹¹

¹⁰⁸ PLR 9227013 (Mar. 30, 1992).

¹⁰⁹ PLR 9037011 (June 14, 1990).

¹¹⁰ A so-called Crummey power enables the holder to withdraw amounts transferred to the trust for a period of time after the transfer is made. As a result, the transfer qualifies for the annual donee exclusion for gift tax purposes. Unless the power is exercised within a specified period of time, the power will lapse and the amounts transferred to the trust remain part of the corpus of the trust. See Crummey v. Commissioner, 937 F.2d 82 (9th Cir. 1968).

¹¹¹ PLR 9226037 (Mar. 27, 1992).

The Qualified Subchapter S Trust or QSST.

A qualified subchapter S trust, or “QSST”, is a permitted shareholder of an S corporation if it distributes currently, or is required to distribute currently, all of its income to an income beneficiary who is a citizen or resident of the United States and meets certain specific requirements set forth in Section 1361(d). The qualification requirements of a QSST may be summarized as follows:

1. there must be only one income beneficiary during the life of the current income beneficiary,¹¹²
2. any corpus distributed during the life of the current income beneficiary must be distributed to such beneficiary,¹¹³
3. all income of the trust must be distributed currently (or be required to be distributed currently) to the income beneficiary,¹¹⁴
4. the income interest must terminate on the earlier of the death of the beneficiary or the termination of the trust,¹¹⁵ and
5. the trust must distribute all of its assets to the beneficiary upon termination of the trust during the life of the current income beneficiary.¹¹⁶

If the trust instrument does not require the distribution of income currently, and the trustee does not in fact distribute all income currently (or during the 65-day grace period provided in Section 663(b)), it will be disqualified on the first day of the following tax year.¹¹⁷

A qualified terminable interest property trust (QTIP), a life estate and testamentary general power of appointment trust, a single beneficiary trust providing for the distribution of income currently, or a similar trust may qualify as a QSST. In Rev. Rul. 92-48, the Service ruled that a charitable remainder trust cannot qualify as a QSST.¹¹⁸ In Rev. Rul. 93-31, the Service ruled that a trust did not qualify as a QSST when the trust instrument authorized the trustee to distribute the trust corpus to someone other than the current income beneficiary of the trust if necessary for such person’s health, education, support or maintenance (after taking into account such other person’s income).¹¹⁹ The Service disqualified the trust even though

¹¹² Section 1361(d)(3)(A)(i).

¹¹³ Section 1361(d)(3)(A)(ii).

¹¹⁴ Section 1361(d)(3)(a)(iii). For this purpose, “income” means trust accounting income as defined in Section 643(b). It appears that the trust will only have to distribute amounts actually received by the trust from the S corporation. See JAMES S. EUSTICE & JOEL D. KUNTZ, FEDERAL INCOME TAXATION OF SUBCHAPTER S CORPORATIONS, ¶ 3.03[11][B].

¹¹⁵ Section 1361(d)(3)(A)(iv).

¹¹⁶ Section 1361(d)(3)(B).

¹¹⁷ Section 1361(d)(4)(B).

¹¹⁸ 1992-1 C.B. 301.

¹¹⁹ 1993-1 C.B. 186.

the substantial resources of the other person nearly eliminated the possibility that the trustee would exercise the power to distribute the trust corpus.

In order for a QSST to be a permitted shareholder, the income beneficiary of the QSST must file a QSST election with the Service within two months and fifteen days of the transfer of the shares to the trust.¹²⁰ If stock in more than one S corporation is held by the trust, a separate election is required with respect to each S corporation.¹²¹ An individual holding a durable power of attorney with respect to an income beneficiary of a trust may make the QSST election on behalf of the income beneficiary.¹²² In the event the income beneficiary is a minor, the QSST election should be filed by a parent or legal guardian. If the QSST income beneficiary either dies or assigns his interest as beneficiary to another U.S. citizen or resident individual, the successor is deemed to have consented to the election unless he files an affirmative refusal to consent within two months and fifteen days after becoming an income beneficiary.¹²³ A QSST for which the income beneficiary’s election has been filed is treated as a Subpart E trust and the income beneficiary is treated as the deemed owner of the shares in the trust for purposes of Section 678(a).¹²⁴

Electing Small Business Trusts as Shareholders.

After 1996, as part of the reforms to Subchapter S provided by the SBJPA, an accumulation (domestic) trust, referred to as an electing small business trust (“ESBT”) under Section 1361, is permitted to own stock in an S corporation provided that the trustee of the trust files the appropriate election. Special rules are provided in determining the eligible beneficiaries of the ESBT.¹²⁵ In contrast to a qualified Subchapter S trust which taxes the individual beneficiary on his or her share of the S corporation’s income, the ESBT is treated as the taxpayer and is subject to federal income tax.¹²⁶

Taxation of ESBTs.

Under the ESBT regime, the portion of the trust which consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust is taxed at the highest individual rate (currently 35 percent on ordinary income and generally 15 percent on net capital gain) on this portion of the trust’s income. The taxable income attributable to this portion includes (i) the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of Subchapter S, (ii) gain or loss from the sale of the S corporation stock, and (iii) to the extent provided in regulations, any state or local income taxes and

¹²⁰ Section 1361(d)(2)(D).

¹²¹ Section 1361(d)(2)(B)(i).

¹²² PLR 9314022 (Jan. 7, 1993).

¹²³ Regs. §1.1361-1(j)(9).

¹²⁴ Section 1361(d)(1)(B).

¹²⁵ Section 1361(c)(2)(B)(v), as amended by the TCJA, allows a potential current beneficiary of an electing small business trust to be a non-resident alien.

¹²⁶ August, Huffaker and Agran, “Clarifications Made by ESBT Final Regulations Demonstrate the Need for More Statutory Changes,” *Journal of Taxation*, Aug 2002.

administrative expenses of the trust properly allocable to the S corporation stock. Otherwise allowable capital losses are allowed only to the extent of capital gains.

Application of Subchapter J.

Section 641(d)(1) provides that the portion of an ESBT that consists of stock in one or more S corporations (“S portion”) is taxed as a separate trust. Section 641(d)(2)(c) specifies that the only items of income, loss, deduction, or credit to be taken into account by the S portion (“S portion items”) are (i) the items required to be taken into account under Section 1366; (ii) any gain or loss from the disposition of stock in an S corporation; and (iii) to the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii) Section 641(d)(3) provides that the S portion items are excluded for purposes of determining the amount of tax on the portion of the trust that is not treated as a separate trust under Section 641(d)(1) (“non-S portion”) and are excluded in determining the distributable net income (DNI) of the entire trust. Because the S portion items are not included in the computation of the ESBT’s DNI, they are treated for purposes of determining the treatment of trust distributions in the same manner as any other item that does not enter into the DNI computation (e.g., capital gains and losses allocated to corpus). For example, for the tax year an ESBT has \$40 of DNI from the non-S portion and \$70 of net fiduciary accounting income from the S portion, if the ESBT makes a distribution of \$100, the distribution includes \$40 of DNI.¹²⁷

Purchase of S Corporation Stock.

The final regulations provide that interest expenses paid by the trust on indebtedness incurred in connection with the purchase of S corporation stock must be allocated to the S portion of the ESBT.¹²⁸ When the regulations were finalized, such interest expenses are not deductible by the S portion because they are not administrative expenses. However, the 2007 Act provides that the interest paid or accrued on indebtedness to acquire S corporation stock is deductible in computing the taxable income of the S portion of an ESBT.¹²⁹

Termination of ESBT Status.

The final regulations provide that except where an ESBT fails to meet the definitional requirements of an ESBT, a trustee must seek the consent of the Commissioner by obtaining a private letter ruling to revoke an ESBT election. Consent of the Commissioner is not required when the trust wishes to convert from an ESBT to a QSST, provided the trust meets all of the requirements to be a QSST and the trustee and the current income beneficiary of the trust sign the QSST election. Similar to the procedures for converting an ESBT to a QSST under Rev. Proc. 98-23, the QSST must state at the top of the filing that it is a conversion of an ESBT to a QSST pursuant to Reg. §1.1361-1(m) of the regulations and include all information otherwise required for a QSST election under Reg. §1.1361-1(j)(6). A separate election must be made with respect to the stock of each S corporation held by the trust. Finally, to convert from an ESBT to a QSST under the automatic procedure, the trust

¹²⁷ See Notice 97-49.

¹²⁸ Reg. §1.641(c)-1(d)(4)(ii).

¹²⁹ Section 641(c)(2)(C)(iv), as amended by Section 8236 of the 2007 Act.

must not have converted from a QSST to an ESBT within the 36 month period immediately preceding the effective date of the new QSST election.¹³⁰

As noted above, a trust that ceases to meet the ESBT requirements has its ESBT election terminated. The last day the trust is treated as an ESBT is the day before the day on which the trust fails to meet the definition of an ESBT.¹³¹

The final regulations provide that a trust ceases to be an ESBT on the first day following the day the trust disposes of all of its S corporation stock. However, if the trust is using the installment method to report income from the sale or disposition of its stock in S corporation, the ESBT status continues until the day following the day the last installment payment is received by the trust, or the day the trust disposes of the installment obligation, if earlier. Under the special divestiture rule, if a potential current beneficiary is treated as an ineligible shareholder, or if an ineligible shareholder becomes a potential current beneficiary, the trust may dispose of all its S corporation stock within 60 days. The ineligible shareholder is not considered a potential current beneficiary during the 60 day period ending on the date of such disposition.¹³²

On the termination of the ESBT status, the loss carryovers or excess deductions referred to in Section 642(h) are taken into account by the entire trust, subject to the usual rules on termination of the entire trust.

Sale of S Corporation Stock by ESBT.

Reg. §1.641(c)-1(d)(3) requires that the resulting gain or loss from the sale of S corporation stock by an ESBT be reported by the S portion. As mentioned, capital losses are permitted only to the extent of capital gains. Consistent with the final regulations under Section 1361¹³³ which treat gains on the sale of S corporation stock on the installment basis by a QSST as income of the trust, the final ESBT regulations permit the use of the installment method upon the sale or disposition of stock in an S corporation by an ESBT. The gain recognized under the installment method is taken into account by the S portion of the ESBT.¹³⁴ Although the trust no longer holds the S corporation stock, it continues to pay trust-level taxes on the gain as recognized under the installment method. The final regulations provide that the interest on the installment obligation from the sale or disposition of stock in an S corporation is included in the gross income of the non-S portion of the ESBT.¹³⁵

In effect, the final regulations keep the ESBT election alive with respect to the S portion as long as the installment payments are made upon the disposition of S corporation stock. On the other hand, the interest portion is carved out and allocated to the non-S portion, subject to the normal rules of Subchapter J. If all of the proceeds of the sale are distributed

¹³⁰ Reg. §1.1361-1(m)(7)(i)-(iv).

¹³¹ Reg. §1.1361-1(m)(5)(i).

¹³² Reg. §1.1361-1(m)(5)(iii), cross referencing paragraph (m)(4)(iii).

¹³³ Reg. §1.1361-1(j)(8).

¹³⁴ Reg. §1.641(c)-1(d)(3)(ii).

¹³⁵ Reg. §1.641(c)-1(g)(3).

to beneficiaries, the interest amount would be passed out as a separately stated component of DNI. The capital gain portion, on the other hand, would be taxed at the trust level and then distributed tax-free to the beneficiary as a return of capital or non-taxable principal distribution of the trust.

It would appear that the \$5 million limitation rule of Section 453A(c)(6) will apply to the S portion of an ESBT as a separate taxpayer. Where the ESBT has partial owners, presumably each partial owner will be treated as in receipt of a corresponding portion of the installment obligation. Presumably, the S portion also will bear the tax on gain from a disposition of an installment obligation or the burden of the interest charge on the tax from large deferred installment sale gains.

Distributions With Respect to S Stock.

With respect to distributions from the S corporation, where dividend treatment results under Section 1368(c)(2), Reg. §1.641(c)-1(g)(2) provides that such amount is includable in the gross income of the non-S portion of the trust. Where gain results from a distribution in excess of stock basis, then such gain is allocable to the S portion of the trust. Presumably, this result will apply for a non-dividend-equivalent redemption of the trust’s S stock in a particular corporation to the extent such proceeds are not characterized by reference to Section 1368(c)(2).¹³⁶

Tax-Free Reorganizations.

Where the ESBT receives boot as part of a tax-free reorganization or spinoff of an S corporation, it would appear that a dividend-equivalent distribution described in Section 356(a)(2) or (b) will be taxable to the non-S portion, while gain recognized under Section 356(a)(1) presumably will be taxable to the S portion. Additional guidance should be issued in identifying and resolving these and other overlap issues involving ESBTs and distributions or exchanges described in Subchapter C that apply to S corporations and their shareholders.

Removal of Prohibition on Affiliation; Subsidiaries Permitted by SBJPA.

Prior to 1997.

Prior to the SBJPA, an S corporation had not been permitted to own stock in another S corporation, because the second corporation would have had another corporation as a shareholder.¹³⁷ A second limitation barred an S corporation from owning 80% or more of the voting and value of the issued and outstanding stock in a C corporation.¹³⁸ Still, Section 1361(c)(6) provided that an inactive subsidiary, e.g., one which never has conducted business and merely reserves a corporate name in another state, is permitted.¹³⁹ Furthermore, the

¹³⁶ Section 302(a), 302(d).

¹³⁷ See Section 1361(b).

¹³⁸ See Section 1504(b)(8).

¹³⁹ But see May v. United States, 644 F.2d 578 (6th Cir. 1981), rev’g 42 AFTR 2d 5328 (E.D. Ky. 1978); Coca Cola Bottling Company of Gallup v. U.S., 23 AFTR 2d 1763 (D.N.M. 1869), aff’d on other grounds, 443 F.2d 1253 (10th Cir. 1971).

Service ruled that the “momentary ownership” of a subsidiary will not disqualify the parent corporation’s S election.¹⁴⁰ Momentary affiliation may also be the first step in a tax-free division or split-up. The Tax Court has issued a warning on more than momentary affiliations despite the Service’s more liberal attitude.¹⁴¹

The rationale for prohibiting an S corporation from being a member of a consolidated or affiliated group presumably was to avoid complex intercompany transaction and distribution rules. This reasoning is unimpressive when one recognizes that tiered partnerships or LLCs or combinations of the two are common. These restrictions frequently complicated the structuring of acquisitions by S corporations because an S corporation that acquired all the stock of a target corporation had to immediately liquidate the target in order to avoid terminating its S election. In addition, if shareholders wanted to set up two distinct corporations for legal liability reasons and to have each benefit from flow through federal income tax treatment, they were forced to form multiple S corporations. Prior efforts to escape this limitation consisted of (i) issuing different classes of stock in the C corporation subsidiary in failing the definition of affiliation under Section 1504 or (ii) simply issuing more than 20% of the C subsidiary stock (voting or value) to the individual shareholders of the S corporation parent since there is no attribution rule under Section 1504.

Ownership of C Subsidiary Permitted.

Under the SBJPA, an S corporation may own stock in a C corporation subsidiary without causing the termination of the parent corporation’s S election. The obvious advantage is the segregation of assets and liabilities from less risky operations from those subject to greater legal risk. The SBJPA also added Section 1504(b)(8), which excludes an S corporation from the “affiliated group” of corporations that may elect to file a consolidated federal income tax return under Section 1502. Thus, if an S corporation owns all of the stock of S1, and S1 owns all of the stock of S2, S1 may elect to file a consolidated return with S2, assuming the other affiliated group requirements are met.

Repeal of Former Inactive Subsidiary Rule.

As a result of the ability to own a (S or C corporation) subsidiary, the inactive subsidiary exception in Section 1361(c)(6) has been repealed as no longer necessary. Furthermore, the issue of momentary affiliation is substantially reduced in its importance; the only issue being whether momentary affiliations incident to an acquisition or reorganization are to be ignored for federal income tax purposes. Thus, for example, an S corporation may acquire all the stock of a C corporation (and its lower tier subsidiaries) without having to liquidate immediately. Similarly, an S corporation that is purchased by another S corporation no longer will have to be liquidated immediately in order to preserve the application of the flow through rules with respect to its income and losses. Loss of either

¹⁴⁰ Rev. Rul. 73-496, 1973-2 C.B. 312; Rev. Rul. 72-32, 1972-1 C.B. 270. See Reg. §1.1502-76(b)(5)(ii)(election to treat subsidiary as not a member of group for that year).

¹⁴¹ Haley Brothers Constr. Corp. v. Comm’r, 87 T.C. 498 (1996).

the purchaser’s or the target’s S corporation election could have resulted in built-in gains tax, passive investment income, and LIFO recapture tax implications.¹⁴²

Still, an S corporation may not file a consolidated return with one or more C subsidiaries, although a C subsidiary may be a member of an affiliated group. This would result in non-application of the deferred intercompany transaction rules, and dividends up to the parent S corporation will be taxable without benefit of a dividends received deduction. This excludes application of the inter-company transaction and investment basis rules among other things. Where the acquired C subsidiary is affiliated with other C corporations, it is still permitted to file a consolidated return with members of the affiliated group.

Generally, dividends received from a C corporation which are from current or accumulated earnings and profits under applicable rules under Subchapter C, will constitute passive investment income for termination purposes under Section 1362(d)(3) as well as for purposes of the entity termination rule under Section 1375.¹⁴³ Again, a dividends received deduction under Section 243 is unavailable. Final regulations dealing with dividends received from affiliated C corporation subsidiaries by an S corporation parent were recently issued.¹⁴⁴

Where the S corporation parent owns at least 80% of the stock of a C corporation, subsidiary dividends which are attributable to earnings and profits of the subsidiary will not be treated as passive investment income provided such earnings are derived from the active conduct of a trade or business. The legislative history is silent on how the allocation or tracing of the subsidiary dividend to its active business operations is to be made. This problem will be especially pronounced where dividend distributions are from accumulated earnings and profits over a span of years. Application of the same rule will also be complex where the C subsidiary receives a dividend from a controlled affiliate. Where the distribution from the controlled C corporation constitutes gain (distribution in excess of earnings and profits and basis) presumably such gains will constitute passive investment income even if such distribution is from the conduct of active business operations. The passive income problem for S corporations is only faced where the S corporation parent itself has undistributed earnings and profits from prior C years. Dividends, even passive dividends, do not increase or create C year earnings and profits as provided in Section 1371(c)(1).

Final regulations issued by the Service address the question of tracing active earnings and profits in a C subsidiary or from a C affiliated group.¹⁴⁵ Under the regulations, earnings and profits of a C corporation derived from the active conduct of a trade or business are the earnings and profits of the corporation derived from activities that would not produce passive investment income under Section 1362(d)(3) if the C corporation were an S corporation. A safe harbor is provided by which the corporation may determine the amount of the active earnings and profits by comparing the corporation’s gross receipts derived from non-passive

¹⁴² See TAM 9245004, PLR 9323024 revoking PLR 8818049. August, “Taxable Stock Acquisitions by S Corporations: Technical Advice Memorandum 9245004 Permits Use of Sections 332 and 338,” 5 J. S. Corp. Tax’n 203 (1994).

¹⁴³ See Sections 1375(b)(3), 1362(d)(3)(D).

¹⁴⁴ See Reg. §1.1362-8.

¹⁴⁵ Reg. §1.1362-8.

investment income-producing activities with the corporation’s total gross receipts in the year the earnings and profits are produced. If less than 10 percent of the C corporation’s earnings and profits for a taxable year are derived from activities that would produce passive investment income, all earnings and profits produced by the corporation during the taxable year are considered active earnings and profits. The regulations also provide that a C corporation may treat all earnings and profits accumulated by the corporation prior to the time an S corporation held stock meeting the requirements of Section 1504(a)(2) as active earnings and profits in the same proportion as the C corporation’s active earnings and profits for the three taxable years ending prior to the time when the S corporation acquired 80 percent of the C corporation bears to the C corporation’s total earnings and profits for those three taxable years. Provisions also address the allocation of distributions from current or accumulated earnings and profits.¹⁴⁶

The final QSub regulations generally apply to taxable years that begin on or after January 20, 2000, but taxpayers may elect to apply the regulations in whole, but not in part, for taxable years beginning on or after January 1, 2000.

Qualified Subchapter S Subsidiary.

Section 1361(b)(3)(B) defines the term qualified subchapter S subsidiary (“QSub”) generally as any domestic corporation that is not an ineligible corporation if, (i) an S corporation holds 100 percent of the stock of the corporation, and (ii) that S corporation elects to treat the subsidiary as a QSub. An “ineligible corporation includes a financial institution that uses the reserve method of accounting for bad debts; an insurance company subject to tax under Subchapter L; a possessions tax credit entity described in Section 936 or a DISC or former DISC. Except as otherwise provided in regulations, a corporation for which a QSub election is made is not treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of the QSub are treated as assets, liabilities, and items of income, deduction and credit of the parent S corporation.¹⁴⁷ Thus, the QSub rule removes not only the controlled subsidiary impediment, but also serves as an important exception to the prohibition on a corporation from owning stock in an S corporation.¹⁴⁸

QSub as a Disregarded Entity Upon Effective Date of Election.

Once effective, the QSub election requires that the assets, liabilities, tax items, tax history, etc., of the QSub are treated as directly owned and realized by the S corporation parent for federal income tax purposes. All intercompany transactions presumably will be eliminated for federal tax purposes.¹⁴⁹ A similar rule is contained in Section 856(i), permitting a REIT’s ownership of a 100% subsidiary. As to the QSub, it would no longer add/subtract to its tax history, e.g., earnings and profits, AAA, etc., during the applicable period. There is a carryover of tax basis, which in turn triggers application of Section 1374

¹⁴⁶ See Reg. §1.1362-8.

¹⁴⁷ Section 1361(b)(3).

¹⁴⁸ Cummings and Starr, “The Impact of the New S Corporation Revisions,” 85 J Tax’n 197 (October, 1996). Proposed Regulations to the QSub rules were published on April 22, 1998. Final regulations were issued on January 20, 2000 (65 FR 3843).

¹⁴⁹ See S. Rept. No. 104-281, 104th Cong., 2d Sess. 54-55 (1996).

with respect to transferred basis assets.¹⁵⁰ Where the subsidiary uses the LIFO method of inventory accounting, the making of the QSub election triggers the four year LIFO recapture rule. For state law purposes, the QSub is still recognized as a separate legal entity.¹⁵¹ Final regulations to the QSub rules were issued on January 25, 2000.¹⁵² The final regulations generally apply to taxable years that begin on or after January 20, 2000; however, taxpayers previously could have elected to apply the regulations in whole, but not in part (aside from those Sections with special dates of applicability), for taxable years beginning on or after January 1, 2000, provided the corporation and all affected taxpayers apply the regulations in a consistent manner. To make the election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. The rules relating to the treatment of banks apply to all taxable years beginning after December 31, 1996.¹⁵³ The provision relating to transitional relief from application of the step transaction doctrine applies to certain QSub elections effective on or before the end of calendar year 2000.¹⁵⁴ Reg. §1.1361-5(c)(2), relating to automatic consent for an S or QSub election made for a corporation whose QSub election has terminated within the five-year period described in Section 1361(b)(3)(D), applies to certain QSub elections effective after December 31, 1996.¹⁵⁵

Ownership Through Disregarded Entities.

A corporation may be a QSub even if all its stock is not actually owned by an S corporation, as long as all of its stock is treated as owned by an S corporation for federal income tax purposes. Therefore, an S corporation can make a QSub election for a subsidiary which it owns through other entities that are “disregarded” for federal income tax purposes.

Debt, Options and Other Instruments, Arrangements.

While the parent electing QSub must own all of the stock of the subsidiary, the question is whether there is any disguised equity floating around the QSub orbit through the issuance of debt, options or other arrangements held by third parties which would violate the QSub rules.¹⁵⁶ The Proposed Regulations did not provide any bright line rules or safe harbors. Instead, general federal tax principles are to be applied, including the safe harbors for options and straight debt instruments under Subchapter S. Instead, the amorphous set of 14 factors would be used to make this determination.¹⁵⁷

In response to criticism of the rule applying general tax principles for determining if the parent owns all of the QSub stock, the final regulations adopt the position

¹⁵⁰ Section 1374(d)(8).

¹⁵¹ See IRS Notice 97-4. Reg. §1.1361-4.

¹⁵² 65 FR 3843.

¹⁵³ Reg. §1.1361-4(a)(3)(iii).

¹⁵⁴ See Reg. §1.1361-4(a)(5)(i).

¹⁵⁵ Reg. §301.6109-1(i), relating to EINs, applies on or after January 20, 2000.

¹⁵⁶ See Reg. §1.1361-1(l)(4)(ii)(B), (iii)(B), (iii)(C)(safe harbor rules for certain debt and option arrangements).

¹⁵⁷ See Plumb, “The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal,” 26 Tax L. Rev. 369 (1971).

that arrangements that are not considered to be stock under the one class of stock rules set forth in Reg. §1.1361-1(l) will be disregarded. Commentators recommended that, for purposes of determining whether a subsidiary is wholly owned by the parent S corporation, arrangements that are not considered to be stock under the one-class-of-stock rules of Reg. §1.1361-1(l) should be disregarded. The final regulations provide a straight debt safe harbor if the obligation would meet the requirements under Reg. §1.1361-1(l)(5).¹⁵⁸ The commentators noted that applying the principles of these regulations would provide certainty with respect to the subsidiary’s eligibility to be a QSub and avoid difficult debt/equity determinations. Similar relief is provided for deemed exercise of an option under Reg. §1.1504-4.¹⁵⁹ An example of the use of straight debt to maintain QSub status is provided in Reg. §1.1361-2(d).

Election of QSub Status.

Section 1361(b)(3) requires that an S corporation must file a QSub election for each applicable subsidiary otherwise the subsidiary will be treated as a C corporation. The election mechanics are set forth in Reg. §1.1361-3 which generally follows the rules set forth in the proposed regulations including the provision that a QSub election may be made by the S corporation parent at any time during the taxable year. The election form, which is still to be prescribed by the IRS, must be signed by the appropriate officer of the corporation under Section 6037. The election is filed with the Service center where the subsidiary filed its most recent tax return, or if a newly organized subsidiary, where the S corporation parent filed its most recent return.¹⁶⁰ The QSub election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. For this purpose, the definition of the term “month” found in Reg. §1.1362-6(a)(2)(ii)(C) applies. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed. The final regulations further acknowledge that relief is available under the 9100 regulations for a late filing.¹⁶¹

An S corporation may revoke a QSub election under Section 1361 by filing the appropriate statement with the service center where the S corporation’s most recent tax return was properly filed. The revocation of a QSub election, provided the QSub election has not otherwise terminated for eligibility reasons, is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified.¹⁶² The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than

¹⁵⁸ Reg. §1.1361-2(b)(2), -2(c).

¹⁵⁹ See Reg. §1.361-4(a)(2)(v).

¹⁶⁰ Reg. §1.1361-3(a)(2).

¹⁶¹ Reg. §1.1361-3(a)(6).

¹⁶² Reg. §1.1361-2(b)(2).

12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

Reg. §1.1361-5 provides that an extension of time to make a QSub election may be available under the late election relief rule in Reg. §301.9100 by filing a request with the National Office explaining the reason for the failure.¹⁶³ The final regulations acknowledge that 9100 relief is available for late QSub elections.¹⁶⁴

Rev. Proc. 98-55¹⁶⁵ contains relief provisions for late-filed QSub elections. The Revenue Procedure applies only to a corporation (i) for which a timely QSub election under Section 1361(b)(3)(B) was not filed for the desired effective date, (ii) for which a QSub election is filed within 12 months of the date that an election for the desired effective date should have been filed, and (iii) for which the due date for the S corporation’s tax return (excluding extensions) for the first taxable year for which the S corporation desired QSub status for the subsidiary has not passed. The procedural requirements for this relief are as follows. Within 12 months of the due date for filing a QSub election to be effective on the desired effective date (but in no event later than the due date for the S corporation’s tax return (excluding extensions)) for the first taxable year of the S corporation for which the S corporation intended to treat the subsidiary as a QSub, the corporation must file with the applicable service center a completed QSub election. The QSub election must state at the top the form “FILED PURSUANT TO REV. PROC. 98-55.” Attached to the form must be a statement explaining the reason for the failure to file a QSub election within the time period required for the desired effective date.¹⁶⁶

Rev. Proc. 2003-43,¹⁶⁷ in superseding the earlier Rev. Proc. 98-55, supra, provides for making a late QSub election within 2 years of its original due date by filing the form with the service center in the normal manner, but with a statement of reasonable cause attached. If the two-year period has passed, an S corporation may seek 9100 relief by filing a private letter ruling request with the National Office of the Service.¹⁶⁸

While an S corporation can obtain relief for a defective election under Subchapter S in Section 1362(f), neither the QSub provision, nor the regulations had set forth a specific rule providing relief in this area. The proposed regulations indicated that the Service would allow for an inadvertent termination of QSub status.

Example: A, the S corporation parent of B, inadvertently transfers one share of B stock to another person causing the QSub election to terminate. B is not eligible to have a QSub election in effect for the period during which the parent does not own

¹⁶³ See PLRs 9834010, 9828025, 9827029 (granting late filed QSub elections).

¹⁶⁴ Reg. §1.1361-1(a)(6).

¹⁶⁵ 1998-46 I.R.B. 27.

¹⁶⁶ See also Rev. Proc. 97-48, 1997-43 I.R.B. 19, 97-40, 1997-33 I.R.B. 50.

¹⁶⁷ 2003-1 C.B. 998.

¹⁶⁸ Reg. §1.1361-3(a)(6).

100 percent of its stock. If the QSub election terminates because of the inadvertent termination of the parent’s S election, however, relief may be available under Section 1362(f). A favorable determination under that Section causes the subsidiary to continue to satisfy the requirements of Section 1361(b)(3)(B)(ii) during the period when the parent is accorded relief for inadvertent termination of its S election. The final regulations do not include the provision relating to the inadvertent termination of a QSub election. Despite its refusal to provide relief, the Treasury indicated that the provision is not intended to suggest that relief under Section 1362(f) is not available in appropriate circumstances.

As a result of the amendment to Section 1362(f) under the 2004 Act, relief is now provided for defective QSub elections provided there are adequate grounds for establishing relief.

The 2005 Act provides that a QSub is a separate entity for purposes of making information returns, except to the extent otherwise provided by the Secretary. In other words, Treasury and the IRS have the authority to treat a QSub as a disregarded entity for purposes of information returns; the 2004 Act had mandated separate entity treatment for information return purposes.

The final regulations confirm the rule set forth in the proposed regulations which provide that a QSub election can be effective at any time during its tax year as long as the QSub eligibility requirements are satisfied at the time that the election is made and for all periods for which the election is to be effective.¹⁶⁹

Tax Treatment Of QSub Election.

Although the relevant statutory language does not specifically provide, the QSub election is treated as a deemed liquidation of a wholly owned subsidiary into its electing S corporation parent.¹⁷⁰ Under Section 337, no gain or loss is generally recognized by the liquidating subsidiary. Similarly, no gain or loss is recognized by the parent.¹⁷¹ In accordance with Section 381, the S corporation parent will succeed to the QSub’s entire tax history as well as the adjusted basis in its assets. Where the subsidiary has been a C corporation, the liquidation will cause the parent S corporation to become subject to the built-in gains tax under Section 1374 with respect to the target’s assets. If the target C corporation used the LIFO method of inventory accounting, the special recapture rule in Section 1363(d) comes into play. Post-QSub election problems may also be attributable to inheriting the target’s C earnings and profits. Obviously, such will have an impact on characterizing post-QSub election distributions by a parent S corporation to its shareholders.¹⁷² Where there is a significant amount of passive investment income, the carryover of the target’s earnings and

¹⁶⁹ Reg. §1.1361-3(a)(3); Reg. §§1.1361-3(a)(2), -3(a)(3).

¹⁷⁰ See Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted by the 100th Cong., supra.

¹⁷¹ Section 332.

¹⁷² Section 1368(c).

profits may result in an entity level tax under Section 1375 and/or eventually pose a termination risk under Section 1362(d)(3).

Although Section 1361(b)(3) allows the IRS to issue regulations to make exceptions to the general rule disregarding a QSub’s separate status for federal tax purposes, the proposed regulations provided only one exception for banks described in Section 581. Final Reg. §1.1361-4(a)(3)(i) provides that for any QSub that is a bank, all of its assets, liabilities and items of income, deduction and credit, determined in accordance with the special bank rules, are treated as being the assets, liabilities, etc., of the S corporation parent.

Debt instruments issued by a QSub to a shareholder of the S corporation-parent are also treated as debts of the parent under Section 1366(d)(1)(B). This rule permits the flow through of losses up the S tier to the ultimate shareholder. However, it would appear that the at-risk rules apply at the shareholder level and require a determination of the extent to which each shareholder is “at-risk” with respect to the QSub’s operations. There will also be instances where shareholders of the parent hold debt of both the parent S corporation and the QSub. The legislative history indicates that the Treasury may issue regulations regarding the order that the losses pass through.

For states which have “piggyback” statutes which borrow from federal definitions of Subchapter S, it would appear that the QSub rules will be respected for state income tax purposes. Uncertainty is present however for those states which have separate definitions or modifiers, or, for states which do not recognize or otherwise tax S corporations,

Section 332(b) requires that the parent must adopt a plan of liquidation when it owns 80% or more of the stock of the liquidating subsidiary. A QSub election is, by design, a constructive liquidation. Since the subsidiary will not liquidate under state law, the question arises as to whether the adoption of a plan of liquidation is necessary. The timing of the deemed liquidation may also affect its tax consequences. The deemed liquidation is effective at the close of the date prior to the QSub election is becoming effective.¹⁷³ For the conversion of a consolidated group (and its parent corporation), the S corporation/QSub election deemed liquidation of the QSubs will be deemed to occur in the last consolidated return year. This means that ELA will be eliminated.¹⁷⁴

Generally the ordering of the QSub elections is from the “bottom up” in order to avoid ELA recapture unless the election form designates a QSub election sequence.¹⁷⁵ For example, if A, an S corporation, owns all of the stock of B and C, and B and C each own 50% of the stock of D, A should specify that the B and C liquidations occur first, in order to qualify the entire set of deemed liquidations.¹⁷⁶

¹⁷³ Reg. §1.1361-4(b)(1).

¹⁷⁴ Reg. §1.1502-19(b)(2)(i).

¹⁷⁵ Reg. §1.1361-4(b)(2).

¹⁷⁶ See Form 8869.

Where the QSub election is made after the acquisition of another corporation, the liquidation is deemed to occur immediately after the stock ownership requirement is met.¹⁷⁷

The deemed liquidation occurs immediately after the deemed asset purchase.¹⁷⁸ The regulations provide that, for purposes of satisfying the requirement of Section 332(b) that the parent corporation own stock in the subsidiary meeting the requirements of Section 1504(a)(2) on the date of adoption of the plan of liquidation of the subsidiary, the plan of liquidation is deemed adopted immediately before the deemed liquidation incident to a QSub election unless a formal plan of liquidation that contemplates the filing of the QSub election is adopted on an earlier date.¹⁷⁹ Still if as a result of the application of general tax principles the transactions that include the QSub election are treated as an asset acquisition, and as further subject to transitional relief, Section 332 is not applicable and this rule has no relevance.

Criticism Over Application of Step Transaction Doctrine.

Applying step transaction to the acquisition of stock that precedes a QSub election can cause the transaction to be recast as an asset acquisition under Section 368 with unfortunate results for the unwary or unsophisticated, which again, is inconsistent with the legislative history to QSub. Under step transaction principles, for example, if, pursuant to a plan, a shareholder contributes the stock of one wholly owned S corporation (S2) to another wholly owned S corporation (S1), and makes a QSub election for S2, the transaction generally would be a reorganization under Section 368(a)(1)(D), with the possibility of gain recognition under Section 357(c).¹⁸⁰

The final regulations provide that general principles of tax law, including the step transaction doctrine, will apply to determine the tax consequences of the transactions that include a QSub election. The final regulations provide examples illustrating the results of applying step transaction in the context of a QSub election.

In Bausch & Lomb Optical Co. v. Commissioner,¹⁸¹ the taxpayer owned 79 percent of the stock of a subsidiary corporation. In order to acquire its assets, the taxpayer issued its stock in exchange for all the assets; the subsidiary then liquidated, distributing the parent’s stock pro rata to all of its shareholders. The outside shareholders of the subsidiary thus became minority shareholders of the parent. The various steps were held to constitute a single plan having the effect of a taxable liquidation (to the extent of the assets received in

¹⁷⁷ Reg. §1.1361-4(b)(3)(i).

¹⁷⁸ Reg. §1.1361-4(b) and (d), Example 3.

¹⁷⁹ Reg. §1.1361-4(a)(2)(iii), (iv).

¹⁸⁰ See generally, Rev. Rul. 67-274 (1967-2 C.B. 141) (which treats as a Type C reorganization an acquisition of the stock of one corporation by another corporation, solely in exchange for voting stock of the acquiring corporation, followed by a liquidation of the target corporation pursuant to a plan). For a defense of the Service’s application of the step transaction doctrine to the deemed liquidation resulting from the making of a QSub election see Anderson, “Reexamining the Qualified Subchapter S Subsidiary—Years Later,” 40 Tax Mgt. Mem., No. 24 (Nov. 22, 1999).

¹⁸¹ 267 F.2d 75 (2d Cir. 1959) cert denied 361 U.S. 835 (1959).

exchange for the parent’s 79 percent stock interest), rather than a tax-free Type C reorganization, on the theory that the assets were acquired by the taxpayer in consideration for its stock of the subsidiary rather than in exchange for its own voting stock, as required by Section 368(a)(1)(C).

*Examples of Step Transaction and QSub Election.*¹⁸²

Qualified Stock Purchase Followed by QSub Election.

In the first example, a C corporation acquires all of a solvent, target corporation from an unrelated individual for cash and short-term notes. As part of the same plan, the acquiring corporation immediately makes an S election for itself and a QSub election for the target. The example provides that since the stock purchase is “qualified” per Section 338(d)(3), the deemed liquidation is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under Sections 332 and 337.¹⁸³

Acquisition of Stock Through Type C Reorganization Followed by QSub Election for Target Corporation.

In this example, target corporation is acquired by acquiring corporation solely for voting stock of acquiring corporation as part of a transaction intended to meet the requirements under Section 368(a)(1)(C). Immediately upon making the acquisition, acquiring corporation makes an S election and files a QSub election for target. The example concludes that the transaction will be a type C reorganization, assuming that the other conditions for reorganization treatment are satisfied.

Deemed Liquidation Recharacterized as Type D Reorganization.

Another example in the final regulations raises the potential problem under Section 357(c) in connection with a QSub election. Of course, this problem was removed temporarily under a transactional rule contained in Reg. §1.1361-4(a)(5)(i). Individual A contributes all of the outstanding stock of Y to his wholly owned S corporation, X, and immediately causes X to make a QSub election for Y. The example concludes that the transaction will be a Type D reorganization, assuming the other conditions for reorganization treatment are satisfied, and consequently, that if the sum of the Y liabilities treated as assumed by X exceeds the total of the adjusted basis of Y’s property, Section 357(c) will apply to the transaction and the excess will be gain from the sale of the contributed assets as allocated under relative FMVs.

QSub Election Involving Insolvent Subsidiary.

Despite receiving comments that insolvent subsidiaries should qualify for a deemed 332 liquidation, the final regulations treat insolvent subsidiary liquidations, even as part of a QSub election, as outside of Section 332. In general, Section 332 does not apply to

¹⁸² Reg. §1.1362-4(a)(2)(ii).

¹⁸³ See Rev. Rul. 90-95; Reg. §1.338.

the liquidation of an insolvent corporation, because the parent corporation does not receive at least partial payment for the stock of its subsidiary. An example is provided in the final regulations.¹⁸⁴ In such instance the tax attributes and adjusted basis of the assets of the subsidiary will not carry over to the parent. As far as transitional relief is concerned, the final regulations provide that for related party acquisitions followed by a QSub election, the step transaction will not apply provided the QSub election is made prior to January 1, 2001.¹⁸⁵ Examples are provided in the regulations as to the application of transitional relief.

Application to Newly Formed Subsidiaries.

Where an S corporation forms a subsidiary and makes a valid QSub election for the subsidiary effective as of the date of the formation of the subsidiary, no deemed liquidation should be treated as having occurred since the subsidiary will never have been a separate corporation.

Example: X is an S corporation which operates retail and manufacturing divisions. In January, 2005, X contributes the retail operations, subject to liabilities, which liabilities exceed the adjusted basis of the retail assets, to a newly formed corporation Y in exchange for all of Y’s stock and makes a QSub election effective as of the date of formation of Y. If Section 332 applied, the liquidation would be taxable since Y is insolvent. Similarly, Section 357(c) should not apply since there is no Section 351 transaction. Reg. §1.1361-1(a)(2) applies step transaction analysis to ignore the deemed liquidation under Sections 337 and 332 and treat the transaction simply as the formation of a newly organized subsidiary.

“F” Reorganizations.

While the step transaction was adopted in the proposed and final regulations to the QSub rules, some argued that during the transition period where the step transaction is not applicable, per se, the formation of a new shell S corporation (Newco) by the shareholders of an existing S corporation in a mid-year formation, qualify as a Type F reorganization if all of the other requirements of the Section are met. As a Type F reorganization, the taxable year of the existing S corporation does not close. The preamble to the final regulations provides that during the extended transition period set forth in the final regulations, the Service will not challenge taxpayers who, through use of the step transaction doctrine to an acquisition of stock followed by a QSub election, employ the tax treatment applicable to a Type F reorganization.

In Ltr. Rul. 201007043, the IRS ruled that an S corporation’s merger into its wholly owned QSub constituted a tax-free reorganization under Section 368(a)(1)(F) without adversely affecting S corporation status. In the ruling, the S corporation and one of its two wholly owned QSubs desired to combine their assets and operations into a single corporation in order to take advantage of planned efficiencies and to reduce expenses and redundancies. Because certain legal agreements of the QSub prohibited the QSub from merging upstream

¹⁸⁴ Reg. §1.332-4(d), Ex. 5.

¹⁸⁵ Reg. §1.1361-4(a)(5)(i).

into the S corporation, it was decided that the S corporation should merge downstream into the QSub.

Citing Rev. Rul. 64-250,¹⁸⁶ the IRS concluded that pursuant to the F reorganization, the S corporation election would continue in effect with respect to the surviving QSub following the merger. Additionally, citing Rev. Rul. 2004-85,¹⁸⁷ the IRS found that the status of the S corporation’s other QSub would not terminate as a result of the F reorganization.

Interestingly, the ruling does not address whether the surviving entity should continue to use the federal identification number previously used by the S corporation or the federal identification number of the QSub into which it was merged. In Rev. Rul. 73-526,¹⁸⁸ the IRS ruled that where an S corporation merges into another corporation in a transaction qualifying as an F reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation. However, more recently in Rev. Rul. 2008-18,¹⁸⁹ discussed further below, the IRS ruled that in the two situations presented in the ruling, which both qualified as F reorganizations within the meaning of Section 368(a)(1)(F), the newly formed corporations would be required to obtain new employer identification numbers and that the existing corporation which became a QSub would retain its same employer identification number.

Timing of Deemed Liquidation.

Where Parent Already Owns 100% of Subsidiary.

Under Reg. §1.1361-4(b), rules are set forth for the date on which the deemed liquidation resulting from a QSub election occurs. Where the S corporation parent owns all of the subsidiary stock prior to the effective date of the QSub election, the proposed regulations provide that the deemed liquidation occurs at the close of the day prior to the effective date of the QSub election. This was the same rule previously contained in the proposed regulations. Thus, if a C corporation elects to be treated as an S corporation and makes a QSub election effective on the same date, the liquidation occurs immediately prior to the S election becomes effective, while the S electing parent is still a C corporation. This timing rule has significant implications for consolidated groups which convert to S corporation and QSub status.

Acquisitions by S Corporations of Stock of Target/QSub Election.

A second rule pertains to acquisitions of target corporations, i.e., where an S corporation does not own all of the subsidiary’s stock on the day before the QSub election is to be effective. In this situation, the regulations provide that the deemed

¹⁸⁶ 1964-2 CB 333.

¹⁸⁷ 2004-2 CB 189.

¹⁸⁸ 1973-2 CB 404.

¹⁸⁹ 2008-1 CB 674.

liquidation occurs immediately after the time at which the S corporation’s owns 100% of the subsidiary’s stock.¹⁹⁰

Qualified Stock Acquisitions Under Section 338.

The QSub election is not effective for the target until the day after the acquisition date. The deemed liquidation resulting from the QSub election occurs immediately after the date of the deemed asset purchase by the new target corporation under Section 338.¹⁹¹ Where the S corporation makes an election under Section 338 (without a Section 338(h)(10) election) with respect to a target, the target must file a final or deemed sale return as a C corporation for the deemed sale.¹⁹²

Effect of QSub Election on S Corporation’s Basis in Subsidiary Stock.

Aside from the tax history issues generated by a deemed liquidation, perhaps the most immediate drawback to the QSub is the disappearing basis problem. Suppose, for example, that an S corporation purchases all of the stock of a target C corporation (in a non-Section 338 transaction) at a purchase price of \$2,000x. Assume the target’s basis in its assets is \$500x. By purchasing all of the target’s stock and making the QSub election (or, alternatively, by immediately liquidating the target into the purchaser), the parent’s cost basis in the subsidiary stock, i.e., \$2,000x, disappears. The only relevant basis to the parent is the adjusted basis of the subsidiary’s assets. The \$2,000x basis is not reinstated if there is a termination of the QSub election because the subsidiary is treated as a newly-formed corporation at that time under Section 1361(b)(3)(C). Again, the inside versus outside value differential will present built-in gains tax problems to the purchaser with respect to the QSub’s assets. The total net unrealized built-in gain is allocated on an asset-by-asset basis including goodwill and going concern value.¹⁹³

Acquisitions of S Corporations—AAA and Suspended Losses.

The Treasury Regulations acknowledge that the AAA of a target S corporation which is acquired in a tax-free reorganization or liquidation described in Sections 337/332 will be inherited by the acquiring corporation.¹⁹⁴ Reg. §1.1361-4(c) further provides that suspended losses also carry over where one S corporation acquires the stock of another S corporation referencing Reg. §1.1366-2(c)(1).

Application of Built-In Gains Tax to QSub Elections.

Section 1374 imposes a corporate level tax on the built in gains of an S corporation after it has converted from C corporation status. The tax is imposed on net

¹⁹⁰ Reg. §1.1361-4(b)(2).

¹⁹¹ Section 338(h)(2). Reg. §1.1361-4(b)(2).

¹⁹² Reg. §1.338-10T(a). Reg. §1.1361-4(d), Ex. 3.

¹⁹³ Sections 334(b)(1), 1374(d)(8), 1374(d)(1). Regs. §§1.334-1(b), 1.1361-4(a)(4)(except for purposes of Section 1361(b)(3)(B)(i) and Reg. §1.1361-2(a)(1), the stock of a QSub is disregarded for federal tax purposes).

¹⁹⁴ Reg. §1.1368-2(d)(2).

recognized built-in gains for the subsequent 10 year period following the effective date of a C to S conversion. Section 1374(d)(8) provides the Section 1374 tax carries over with respect to an S corporation’s receipt of transferred basis property from another C corporation or S corporation having an unexpired recognition period under Section 1374 from a prior conversion event. Therefore, Section 1374(d)(8) will apply with respect to the purchase of all of the stock of a target corporation and subsequent QSub election under the deemed liquidation rule. In such case, a separate determination of tax is made with respect to the assets acquired by each particular target corporation. Regulations under Section 1374 provide that the tax attributes of the target, e.g., net operating loss and capital loss carryovers, may only be used against the target’s subsequent recognized built-in gains.¹⁹⁵ Furthermore, Section 1374 attributes acquired in one Section 1374(d)(8) transaction may only be used to reduce the tax on the disposition of assets acquired in that transaction. This results in a “Libson Shops” type separate pooling approach.

Reorganizations Involving QSubs.

QSubs can be part of a tax-free reorganization, such as a Section 368(a)(1)(A) merger or consolidation.¹⁹⁶ Provision is made that if a target S corporation that has a QSub merges into a disregarded entity, the termination of the QSub election followed by the deemed contribution of the former QSub’s assets to a new C corporation immediately prior to the merger does not disqualify the merger under Section 368(a)(1)(A).¹⁹⁷ These regulations generally apply to transactions occurring on or after January 23, 2006.¹⁹⁸

As discussed further above, the Service and Treasury proposed regulations in January 2005 containing a revised definition of statutory merger or consolidation that allows transactions effected pursuant to the statutes of a foreign jurisdiction or of a United States possession to qualify as a statutory merger or consolidation. Simultaneously with the publication of the 2005 proposed regulations, the IRS and Treasury Department published a notice of proposed rulemaking proposing amendments to the regulations under Sections 358, 367, and 884 to reflect that, under the 2005 proposed regulations, a transaction involving a foreign entity and a transaction effected pursuant to the laws of a foreign jurisdiction may qualify as a statutory merger or consolidation (the foreign regulations). The regulations were finalized in January, 2006.¹⁹⁹

Termination of QSub Election.

A QSub election may be terminated: (i) by revocation; (ii) by reason of the parent no longer being an S corporation; or (iii) by the subsidiary’s failing to meet the QSub

¹⁹⁵ Reg. §1.1374-8(b).

¹⁹⁶ Reg. §1.368-2(b)(iv) ex. 2.

¹⁹⁷ See Reg. §1.368-2(b)(1)(iii) Ex. 3 (providing that the deemed formation by the target S corporation of a C corporation subsidiary as a result of the termination of its subsidiary’s QSub status is disregarded for federal income tax purposes; the target S corporation is viewed as transferring the assets of its subsidiary to the acquirer followed by the acquirer contributing those assets to a new C corporation subsidiary in exchange for stock); see also Reg. §1.1361-5(b)(3) Ex. 9.

¹⁹⁸ Reg. §1.368-2(b)(1)(v).

¹⁹⁹ 71 FR 4259-01, 2006-7 I.R.B. 422, 2006 WL 173491 (F.R.).

eligibility requirements. Where a QSub election is terminated due to a disqualifying event, Reg. §1.1361-5(a)(2) requires the S corporation to attach a statement to its return for the tax year in which the termination occurs, notifying the IRS that a QSub election terminated. This notification also must include the date of the termination and the names, addresses, and employer identification numbers of both the parent S corporation and the QSub. Reg. §1.1361-5(a)(3) provides, alternatively, that where a QSub election terminates because the S corporation becomes a member of a consolidated group (and no election under Section 338(g) is made), principles contained in Reg. §1.1502-76(b)(1)(ii)-(A)(2) (special rules for S corporations joining consolidated groups) apply. This regulation eliminates the “one-day return problem” by providing that an S corporation that is acquired by a consolidated group in a transaction other than a Section 338 transfer, becomes a member of the consolidated group at the beginning of the day on which termination of its S election is effective.²⁰⁰

Effective Date of Termination.

The final regulations provide that the effective date of a QSub termination is: (i) on the effective date contained in the revocation statement if a QSub election is revoked under Reg. §1.1361-3(b); (ii) at the close of the last day of the parent’s last taxable year as an S corporation if the parent’s S election terminates under Reg. §1.1362-2; or (iii) at the close of the day on which a disqualification event occurs that results in the QSub not being described under Section 1361(b)(3)(B).²⁰¹

Example: A terminates its S election effective on January 1, 2006. A wholly owned QSub B no longer qualifies as a QSub at the close of December 31, 2006.

Example: A sells 1 share of its QSub B on December 10, 2006. B is no longer a QSub at the close of December 10, 2006.

Example: A has a QSub election for B and C while B owns 100% of C. B transfers all of its C stock to A. No termination occurs since A is already treated as owning all of the C stock through B.

Example: A, an S corporation owns 100% of B a QSub. Z, the common parent of a consolidated group purchases 80% of the stock of A on June 1, 2006. Z does not make a Section 338 election. A’s S election terminates its election as of the close of the preceding date, May 31, 2006. The QSub election for B is also terminated as of the close of May 31, 2006. Pursuant to Reg. §1.1502-76(b)(1)-(ii)(A)(2), A and B

²⁰⁰ See, however, Rev. Rul. 2004-85, 2004-2 C.B. 189 which provides that (i) an election to treat a wholly owned subsidiary of an S corporation as a QSub, does not terminate solely because the S corporation engages in a transaction that qualifies as a reorganization under Section 368(a)(1)(F); (ii) an election to treat a subsidiary as a QSub terminates if the S corporation transfers 100 percent of the QSub stock (whether by sale or reorganization under Section 368(a)(1)(A), (C), or (D)), to another S corporation in a transaction that does not qualify as a reorganization under Section 368(a)(1)(F); and (iii) an entity classification election of an eligible entity, as described in Reg. §301.7701-3(b), does not terminate solely because the owner (whether by sale, reorganization under Section 368(a)(1)(A), (C), (D), or (F), or otherwise) transfers all of the membership interest in the eligible entity to another person.

²⁰¹ Reg. §§1.1361-5(a)(1),-5(a)(2) (information required to be filed upon failure to qualify as QSub).

become members of Z’s consolidated group as of the start of June 1, 2006. If instead of purchasing 80% of A, Z purchased 80% of B, A’s QSub election terminates as of the close of June 1, 2006 and B becomes a member of the consolidated group at such time.

Under the final regulations, where a tier of QSubs have their elections terminated on the same day, the formation of any higher tier subsidiary is deemed to have occurred prior to the formation of a lower tier subsidiary, a so-called “top to bottom” approach.²⁰²

Effect of Termination of QSub Election; Sale or Other Disposition of QSub Stock.

In the event of a termination of the QSub’s election, the corporation is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the S corporation in exchange for stock of the new corporation immediately before the termination.²⁰³ Without specifically providing that there is a deemed Section 351 transaction, Reg. §1.1361-5(b)(1) provides that the tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Code and general principles of tax law, including the step transaction doctrine. The sale of 100% of the stock of a QSub is treated as the sale of the assets of the QSub followed by a Section 351 transfer of the assets to a new corporation by the purchaser (or purchasers).²⁰⁴

Prior to the 2007 Act, it was necessary to consider the control requirement (80% transferor group) in Section 368(c) for the termination of a QSub election, for example upon the sale of some or all of the shares, as well as assessing the potential impact of Section 357(c) and the other potential exceptions to tax free treatment. Under the 2007 Act, if a QSub election terminates because some or all of the QSub stock is sold, the sale is treated as a sale of an undivided interest in the assets of the QSub followed by a deemed Section 351 transfer of the assets to the new corporation by the purchaser (and the seller to the extent of any unsold shares).²⁰⁵

If a QSub election terminates because the S corporation distributes its QSub stock to some or all of its shareholders in a transaction which qualifies under Section 368(a)(1)(D) and Section 355, then the Section 351 model will yield to the greater transaction (per step analysis). Reg. §1.1361-5(b)(2) provides that any loss or deduction disallowed under Section 1366(d) with respect to a shareholder of the parent S corporation immediately before the distribution will be allocated between the parent S corporation and the former QSub with respect to each shareholder. The amount allocated to the parent S corporation

²⁰² Reg. §1.1361-5(b)(1)(ii).

²⁰³ Section 1361(b)(3)(C).

²⁰⁴ Reg. §1.1361-5(b)(1)(i), -5(b)(3)-Example 9.

²⁰⁵ Section 1361(b)(3)(C)(ii), added by Section 8234(a)(1)-(2) of the 2007 Act. This amendment to the Code makes Example 1 of Reg. §1.1361-5(b)(3) obsolete (providing that the sale of 21% of the stock of a QSub does not qualify under Section 351 because immediately after the transfer, the selling S corporation is not in control of the QSub within the meaning of Section 368(c)). The regulations have not been updated to reflect the statutory change.

will bear the same ratio to each item of disallowed loss or deduction as the value of the shareholder’s stock in the parent S corporation bears to the total value of the shareholder’s stock in both the parent S corporation and the former QSub, determined immediately after the distribution.

A termination of QSub status may result through a revocation by the parent or a consequence of transferring a single share of subsidiary stock to a shareholder or third party. More specifically, Section 1361(b)(3)(c) provides that a upon termination, the QSub is treated as a new corporation acquiring all of its assets and assuming all of its liabilities from the S corporation parent in exchange for its stock. The former QSub is prohibited from re-electing S status or QSub status for 5 years unless permission is received from the Service.²⁰⁶ The final regulations provide some relief. For S and QSub elections effective after 1996, where a QSub election terminates, the corporation may, without obtaining IRS consent, make an S election or be subject to a new QSub election prior to the end of the five year waiting period provided: (i) immediately following the termination, the corporation (or its successor) is otherwise eligible to make an S election or be subject to a QSub election, and (ii) the relevant election is made effective immediately following the termination of the QSub election.²⁰⁷

Example: Assume X, an S corporation, owns 100% of Y, a QSub and distributes all of its Y stock to X shareholders. The distribution terminates the corporation’s QSub election.²⁰⁸ Assuming Y is otherwise eligible to elect S, Y’s shareholders may elect S status without IRS consent within the 5 year period. The same result applies were X to instead sell 100% of its Y stock to an unrelated S corporation, Z, where Z intends to make a QSub election effective on the date of the acquisition.

I. *Shareholder Basis in S Corporation Stock and Debt.*

On July 23, 2014, the Department of the Treasury issued Final Regulations on basis increases for back-to-back loans involving S corporations. The Final Regulations adopt the proposed regulations without substantive change, except for changes allowing a retroactive effective date (which is a positive change to the Proposed Regulations) and minor clarifying revisions. The Proposed Regulations (and now the Final Regulations) constitute a vast improvement over the current state of the law which has applied the “actual economic outlay” test and the “poorer in a material sense concept to determine whether a shareholder is entitled to a basis increase under Section 1366(d)(1)(B). Rather, the Final Regulations allow for a basis increase under Section 1366(d)(1)(B) if the debt running from the S corporation to the shareholder is a “bona fide debt under general Federal tax principles. In view of the uncertainty and inconsistent judicial decisions regarding basis increases with respect to back-to-back loans, the guidance is welcome and the IRS should be applauded for its response to the request for regulations made by the ABA Tax Section, the AICPA and many tax practitioners, and for its abandonment of the “actual economic outlay” test with respect to back-to-back loans. The Final Regulations may be relied on by taxpayers with respect to

²⁰⁶ Section 1361(b)(3)(D). See Reg. §1.1361-5.

²⁰⁷ Reg. §1.1361-5(c)(2).

²⁰⁸ See also Sections 368(a)(1)(D), 355, 311.

indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2014.

The preamble to the Final Regulations state that the “Treasury Department and the IRS continue to study issues relating to stock basis and may address these issues in future guidance.”

TAX FREE REORGANIZATIONS

Basic Reorganization Patterns.

The types of reorganizations qualifying for tax free treatment under the Code are as follows:

Statutory merger/consolidation. Type A. Section 368(a)(1)(A).²⁰⁹

Stock “solely” for voting stock. Type B. Section 368(a)(1)(B).

All or “substantially all” assets for voting stock. Type C. Section 368(a)(1)(C).

All or part of assets transferred to corporation controlled by transferor. Type D. Section 368(a)(1)(D).

Recapitalization. Type E. Section 368(a)(1)(E).

Place of Organization. Type F. Section 138(a)(1)(F). Mere Change in Form, Identity.

Bankruptcy Reorganization. Type G. Section 368(a)(1)(G).

The transfer of assets to a corporation and the liquidation of a corporate subsidiary may also be tax-free under Sections 351 and 332.

Type A Reorganizations.

Application to S Corporations.

In various favorable public and private letter rulings, the Service has permitted an S corporation to be a party to a reorganization which is a qualifying merger between two corporations under state law.²¹⁰ Although stock of a surviving S corporation which is transferred momentarily to an acquired corporation could be treated as resulting in an ineligible shareholder, this “foot fault” has been ignored by the Service in a Type A (as well as other types) of tax-free reorganizations.²¹¹

²⁰⁹ See also Sections 368(a)(2)(D), 368(a)(2)(E).

²¹⁰ Rev. Rul. 79-52, 1979-1 C.B. 283, Rev. Rul. 69-566, 1969-2 C.B. 164; See GCM 39768, TAM 9245004 (discussed above).

²¹¹ See West Shore Fuel, Inc. v. U.S., 598 F.2d 1236 (2d Cir. 1979).

Two other methods for effectuating Type A treatment but which are treated separately under Section 368 are the forward triangular merger (Section 368(a)(2)(D)) and the reverse triangular merger (Section 368(a)(2)(E)), each having separate requirements. A forward triangular merger under Section 368(a)(2)(D) involves the merger of the target into a wholly owned subsidiary of the acquiring corporation. The target must transfer “substantially all” of its assets²¹² and no shares of the subsidiary corporation can be used. It is not necessary for all of the assets be acquired solely for voting stock, and any other consideration is satisfactory as long as continuity of interest is met. A reverse triangular merger under Section 368(a)(2)(E) involves the merger of a subsidiary of the acquirer into the target corporation, with the target continuing as the surviving corporation. The target corporation must retain “substantially all” of its assets and the shareholders of the target corporation must exchange 80% or more of the target stock for voting stock of the acquiring corporation or its parent company in exchange for voting stock of the acquiring company or parent.

With the revisions in SBJPA permitting ownership of C subsidiaries, an S corporation can be an acquiring corporation in a forward or reverse triangular merger. Where a QSub is involved, the S corporation parent is treated as a party to the reorganization based on the “tax nothing” status of the QSub.²¹³

Impact on Subchapter S Status.

Acquiring S Corporation.

The S election of an acquiring S corporation in a Type A reorganization will not terminate, per se, as a direct result of receiving the assets (and assuming the liabilities) of the merged or target corporation.²¹⁴

The question will be whether the shareholders of the target corporation are each eligible to own stock in the acquiring S corporation, whether the permitted number of shareholder requirement and the other ineligible shareholder rules will be triggered. In such instances, consideration should be given to taking out ineligible shareholders of the target with cash payments or notes without violating the continuity of interest requirements.²¹⁵

²¹² Generally, “substantially all” means that the merger subsidiary must acquire 90% of the net assets and 70% of the gross assets of the target corporation.

²¹³ Reg. §301.7701-2(b)(5).

²¹⁴ Rev. Rul. 69-566, 1969-2 C.B. 165 (the election and the taxable year of a small business corporation are not terminated where, in a statutory merger, it acquires the assets of another corporation that is not an electing small business corporation); Rev. Rul. 79-52-1979-1 C.B. 283. See also Rev. Rul. 64-94, 1964-1 (Part 1) C.B. 317 (merger of an S into a C corporation, per Section 368(a)(1)(A), does not terminate the electing small business corporation’s election under Section 1372 with respect to its final taxable year ending on the date of the merger); Rev. Rul. 70-232, 1970-1 C.B. 178 (statutory consolidation of two S corporations into a new S corporation does not terminate the elections of the corporations for their respective taxable years, which ended on the date of consolidation). See PLR 200112053 briefly summarized in 4 Business Entities 52 (July/August 2001); 2001 (WL 931479).

²¹⁵ Reg. §1.368-1(b). Southwest Natural Gas Co. v. CIR, 189 F.2d 3332 (5th Cir.), cert. denied, 342 U.S. 860 (1951); John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935). Compare Yoc Heating Corp., 61 T.C. 168, 1973); May B. Kass, 60 T.C. 218 (1973), aff’d, by court order, 491 F.2d 749 (3d Cir. 1974). See Reg. §1.368-1(e) for retention of a sufficient proprietary interest by the target shareholders (proprietary interest in the

However, a proprietary interest in the target corporation is not preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or the stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved. For purposes of the continuity of interest requirement, a mere disposition of stock of the target corporation prior to a potential reorganization to persons not related to the target corporation or to persons not to the issuing corporation is disregarded and a mere disposition of stock of the issuing corporation received in a potential reorganization to persons not related to the issuing corporation is disregarded).

Debt issued to target shareholders, although potentially taxable as “boot,” may also have to be tested as not constituting a disguised second class of stock. The debt could be drafted to qualify as qualified straight debt in order to preserve the S corporation’s election.

The issuance of stock in the corporation to shareholders of the target may give the target shareholders the power to revoke the corporation’s S election, such as where the target shareholders receive more than 50% of the acquiring corporation’s stock.²¹⁶

Where the election of an acquiring S corporation is terminated as a result of a Type A merger, it presumably will not be able to reelect S status for a succeeding period of 4 years after the year in which the terminating event took place unless early consent is received by the Service.²¹⁷ This rule applies to the corporation and any “successor corporation.” A successor corporation is defined as any corporation: (i) of which 50 percent or more of its stock is owned, directly or indirectly, by the same persons who, on the date of termination, owned 50 percent or more of the stock of the S corporation whose election was terminated, and (ii) which acquires a “substantial portion” of the assets of such small business corporation, or a “substantial portion” of the assets of which were assets of such small business corporation.²¹⁸ Generally, a corporation will not be a successor to a terminated S corporation unless there is both a continuity of shareholder interest of at least 50 percent and the new corporation acquires the assets of the S corporation or a substantial portion of the assets it holds are the former S corporation’s assets.²¹⁹

Arguably, a C corporation which acquires the assets of an S corporation in a tax-free Type A reorganization should be able to make an S election without having a 5 year wait even if it meets the definition of a “successor corporation” since its S status was not terminated pursuant to Section 1362(d), with the exception being whether the C corporation

issuing is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or it otherwise continues as a proprietary interest in the target corporation.

²¹⁶ Section 1361(d)(1).

²¹⁷ Section 1362(g).

²¹⁸ Reg. §1.1362-5(b).

²¹⁹ See PLRs 199918031, 94190010, 9340047. See also IRS INFO 2002-0163, 2002 WL 31991721.

was already a former S corporation or successor to an S corporation and was in the five year waiting period.

S Corporation Acquired.

Where an S corporation is a target corporation and is acquired or consolidated with a C corporation, its S status will end because the corporation ceases to exist and its taxable year will end on the date that it transfers its assets.²²⁰ The Service has ruled that the termination of S status does not occur “with respect to” the corporation’s final taxable year.²²¹ This means the S corporation will continue its S status through the last day of its existence. Where it is important to preserve the target corporation’s S election, consideration should be given to structuring the acquisition as a “reverse merger” so that the target S corporation is the surviving corporation. Where an S corporation and its target form a new entity in a consolidation, the S corporation elections of both entities terminate as a practical matter but the Service views this as not resulting in a termination of either election. The new entity should be allowed to make a new S election without regard to the waiting period of Section 1362(g) based on an outstanding ruling.²²²

Allocation of Income and Loss in Reorganization.

Acquiring S Corporation’s Election Remains in Effect.

If the acquiring corporation’s S election does not terminate as a result of the merger, income will be allocated in the same manner as if the acquisition had not occurred, i.e., on a per-share/per-day basis.²²³ Pre-acquisition income (loss) of the acquiring S corporation, A, may be shifted to the target T shareholders. Post-acquisition income (loss) attributable to T’s assets may be shifted to A’s shareholders. With respect to income generated by the acquired assets, only post-acquisition income would be included in A’s income.²²⁴ If a shareholder terminates his interest as a result of the merger, consideration should be given to closing the corporation’s books as of the date of termination.²²⁵ Reg. §1.1368-1(g)(2) provides that where there is a “qualifying disposition” of S stock, the

²²⁰ Section 381(b)(1).

²²¹ Rev. Rul. 64-94, 1964-1 (Part 1) C.B. 317, 318; Rev. Rul. 70-232, 1970-1 C.B. 177, 178.

²²² Rev. Rul. 70-232, 1970-1 C.B. 177; PLR 9206011; PLR 9040066.

²²³ Section 1377(a)(1).

²²⁴ Section 381(b)(1).

²²⁵ Section 1377(a)(2). Reg. §1.1377-1. Reg. §1.1377-1(b)(1) clarifies that the §1377(a)(2) election cannot be made where there is a termination of S status, i.e., §1362(e)(3) election could be made. See also Reg. §1.1377-1(b)(4)(options not constituting “stock” under Subchapter S regulations (Reg. §1.1361-1(l)) and other non-shareholder interests, such as a creditor, employee, director, are regarded in determining whether shareholder completely terminated his or her interest. c.f., *Hightower v. Comm’r*, 2005 WL 3157924 (unreported)(taxpayer who unsuccessfully opposed buyout of his shares in S corporation was required to include in his income distributive share of S corporation’s income for year in which he received payment for his shares. Taxpayer was record owner of shares during year in question despite his diminished role in corporation as result of his poor relationship with other shareholder, and because taxpayer received through arbitrator’s award payment compensating him for his increased federal income tax liability, he would receive windfall if he were not required to pay tax which was already paid to him as part of sale of his stock).

corporation can elect to treat the tax year as if it consisted of separate taxable years with the first ending at the end of the day in which the qualifying disposition occurs. For this purpose, a “qualifying disposition” is (i) disposition of stock of 20% or more of the issued and outstanding stock of the corporation during any 30 day period during the corporation’s tax year; (ii) a redemption treated as an exchange per Sections 302(a) or 303 of 20% or more of the outstanding share of stock again within the applicable 30 day period; or (iii) the issuance of stock at least equal to 25% of the previously outstanding stock to one or more shareholders.²²⁶

Acquiring S Corporation’s Election Terminates.

If the acquiring corporation’s S election does terminate such as result of being acquired or through a termination by revocation or three years of excess passive investment income, i.e., and an S termination year occurs, income is allocated on a per-share/per-day basis between the short S and short C years.²²⁷ Accordingly, only the acquiring S corporation’s pre-merger shareholders will be allocated its income or loss on a per-share/per-day basis. However, A’s shareholders can elect to close the books on the date of termination.²²⁸ The pro rata method, however, can not apply to a Section 338 transaction involving a qualified acquisition of S stock.²²⁹ If there is a 50 percent or more change in ownership of A in the S termination year, A is required to close its books unless the issuance of its stock in the reorganization is not considered a sale or exchange under Section 1362(e)(6)(D).²³⁰

Under Section 1366(d), the excess of a shareholder’s pro rata share of corporate loss and deductions over basis in stock and debt is carried over indefinitely, subject to other applicable limitations, including Sections 465 and 469. The carryover of the excess loss retains its character through a pro rata rule contained in the regulations.²³¹ Thus, excess losses can be used, for example, in reporting gain from the sale of assets or deemed sale under Section 338(h)(10) by a shareholder of a target S corporation. Stock and debt is carried forward to future years, where it is deductible to the extent of the shareholder’s basis in those years. Suspended losses, with limited exception, are “personal” to the shareholder who was allocated the deductions and losses in the prior year(s). Where a shareholder retains a portion of his or her S stock, the excess losses will remain intact until the shareholder disposes all of the remaining shares. Where stock is transferred to a spouse per Section 1041, however, the transferee succeeds to any carryover with respect to the transferred stock.²³²

²²⁶ See Reg. §1.1368-1(g)(2)(i).

²²⁷ Section 1362(e)(2).

²²⁸ Section 1362(e)(3); Reg. §1.1362-6(a)(5).

²²⁹ Reg. §1.1362-3(b)(3).

²³⁰ See, e.g., Section 354(a)(1) (relating to the target shareholder’s “exchange” of stock or securities); See Reg. §1.1362-3(c)(terminating election by S corporation that is a partner (member) in a partnership (LLC taxable as a partnership) is treated as a sale or exchange of the corporation’s entire interest in the partnership (LLC) for purposes of Section 706(c)).

²³¹ Reg. §1.1366-2(a)(5).

²³² Section 1366(d)(2)(B) (applicable for taxable years beginning after 2004).

Where, for example, the acquiring S corporation’s election terminates as part of an acquisition, its shareholders’ losses which were suspended under Section 1366(d)(2) will be treated as incurred on the last day of the post-termination transition period.²³³ The losses will be deductible to the extent of the shareholder’s basis in the stock on such date.²³⁴ However, if an S corporation acquires the assets of another S corporation in a transaction to which Section 381(a)(2) applies, a post-termination transition period does not arise.²³⁵

The special treatment under Section 1371(e)(1) of distributions of money by a corporation with respect to its stock during the post-termination transition period is available only to those shareholders who were shareholders in the S corporation at the time of the termination. A post termination transition period can occur as a result of a reorganization but also simply by the filing of a revocation of S status or the occurrence of a terminating event, including an adverse determination as to S status.

St. Charles Investment Company v. Commissioner²³⁶ involved a closely-held C corporation under Section 469(j)(1). During years in which it engaged in real estate rental activities, it had PALs which were suspended and carried forward under Section 469(b). St. Charles, in 1991, converted to S status and in accordance with Section 469(g)(1)(A), claimed a deduction against gains from the sale of several rental properties after the conversion occurred. The Service disallowed the deduction for the suspended PALs per Section 1371(b)(1) which prohibits S corporations from carrying forward PALs created in its C years to S years. The Tax Court agreed that Section 1371(b)(1) prevailed over the PAL carryover rule. The Tenth Circuit, however, reversed the Tax Court and held that Section 469(b) permits St. Charles to use its C year PALs to offset income in its post-conversion gains based on its finding that Congress did not expressly want Section 469(b) to be preempted by Section 1371(b)(1).

Impact on Acquired S Corporation.

The taxable year of T will end as of the effective date of the reorganization. The merger will not, however, be viewed as having “terminated” the target corporation’s S election and the election will remain in effect for all of its final tax year. Income or loss of T will pass through to its shareholders on a per-share/per-day basis. Although the target’s shareholders will not face a potential shifting of income or loss to persons other than the pre-reorganization shareholders, the termination of the corporation’s taxable year could create a “bunching” of income for the shareholders in the termination if the target’s taxable year were not a calendar year.

²³³ Section 1366(d)(3).

²³⁴ See Reg. §1.1377-2(b)(tax free acquisition from S to a C corporation results in a post-termination transition period but only with respect to the shareholders of the target S corporation).

²³⁵ See Reg. §1.1368-2(d)(2) (for the treatment of the acquisition of the assets of an S corporation by another S corporation in a transaction to which Section 381(a)(2) applies).

²³⁶ 232 F.3d 773 (10th Cir. 2000), rev’g 110 T.C. 46 (1998).

Tax Attributes.

Net Operating Losses.

The acquiring corporation will generally succeed to the tax attributes of the target corporation, T, under Section 381. However, the acquiring S corporation will be precluded from using any net operating loss carryovers of the target in computing its taxable income as long as it continues to be an S corporation.²³⁷ In addition, Section 1371(b)(1) prevents any carryover between an S year and C year at the corporate level, although it is unclear whether Section 1371(b)(1) applies only to attributes generated by the acquiring corporation itself or those inherited from a target corporation under Section 381. An S corporation which is acquired generally will not have net operating or capital loss carryovers, although it could have such items from pre-Subchapter S years or from other prior acquisitive transactions.

Built-in Gains Tax.

In the case of the Section 1374 built-in gains tax, Section 1374(b)(2) provides that a net operating loss carryover arising from the taxable year for which the S corporation was a C corporation can be used to offset net recognized built-in gains.²³⁸ If Section 382 applies to the net operating loss carryforward on the first day of the recognition period, such limitation will continue to apply in limiting the utilization of the net operating loss carryforward in computing the Section 1374 tax.²³⁹ An S corporation’s Section 1374 tax attributes when it became an S corporation may only be used to reduce the tax imposed on the dispositions of such assets of the S corporation held at that time.

The regulations require an acquiring S corporation to individually account for separate asset acquisitions for Section 1374 purposes. Accordingly, an acquiring S corporation may only apply Section 381 attributes of a target corporation when computing the built-in gains tax on such acquired corporation’s assets and not against any built-in gain in other assets of the acquiring corporation.²⁴⁰

Earnings and Profits from C Years.

If the target corporation is a C corporation with earnings and profits, T’s earnings and profits will carry over to the S acquiring corporation under Section 381. Accordingly, the S corporation may be subject to restrictions on passive investment income.²⁴¹ Moreover, post-acquisition distributions will be tested for dividend status under Section 1368(c) rather than Section 1368(b).

²³⁷ Sections 1363(b)(2), 703(a)(2)(D).

²³⁸ See Reg. §1.1374-5.

²³⁹ See also Reg. §1.1374-6 for utilization of credit carryforwards.

²⁴⁰ See Reg. §1.1374-8(b).

²⁴¹ See Sections 1375 (sting tax) and 1362(d)(3)(termination of S election).

LIFO Recapture.

A transfer of a C corporation’s LIFO inventory to an S corporation results in LIFO recapture under Section 1363(d) even though the transaction is otherwise generally non-taxable to the transferor (C corporation).²⁴²

Distributions.

Pre-Merger.

Pre-merger distributions generally should be governed by Section 1368.²⁴³ Where the target is an S corporation and its election is terminated as a result of being acquired by a C corporation, pre-merger distributions of the target of AAA should be made. Otherwise, the AAA account will evaporate as a result of the reorganization unless the acquiring corporation is an S corporation on the date of the reorganization. Still, the regulations allow for a post-termination transition period distribution to the target shareholders of the now acquiring corporation in accordance with Section 1371(e).²⁴⁴ On the other hand, if the acquiring corporation provides the consideration for the distributions, the reorganization distributions rules should apply.

Distributions as Part of Tax-Free Reorganization.

In the case of distributions made, pursuant to the plan of reorganization, it is unclear whether such distributions are governed by Section 356 or Section 1368. Under Section 356, boot distributions could result in the recognition of gain by a shareholder of the target S corporation. Section 356 generally treats gain as a dividend if the exchange “has the effect of the distribution of a dividend.”²⁴⁵ Alternatively, Section 1368 generally would allow an S corporation to make a tax-free distribution to the extent of the target shareholder’s basis in the corporation’s stock or, if the corporation has earnings and profits, its accumulated adjustments account.

Post-merger Distributions.

The tax treatment of post-merger distributions will depend on whether the surviving corporation retains its S corporation status, and the extent to which the target corporation’s tax attributes such as accumulated adjustments account and earnings and profits carry over to the acquiring corporation. The distribution provisions of Section 1368 will apply to a surviving S corporation’s distributions to its shareholders, including former shareholders of target C and S corporations.

²⁴² Reg. §1.1363-2(a)(2).

²⁴³ Cf. Rev. Rul. 71-266, 1971-1 C.B. 262.

²⁴⁴ See Section 1377(b)(1).

²⁴⁵ See *Comm’r v. Clark*, 49 U.S. 726 (1989) (Supreme Court applied a post-reorganization redemption test in determining whether the payment of boot has the “effect of a dividend”); Rev. Rul. 93-61, I.R.B. 1993-30.

AAA is maintained by the corporation and generally constitutes the post-1982 accumulated taxable income (less nondeductible expenses not chargeable to capital) related to the corporation most recent uninterrupted period as an S corporation. AAA becomes extremely relevant for distributions by an S corporation which was a former C corporation due to application of Section 1368(c) for operating distributions, and for all types of S corporations in a post-termination transition period for distributions of AAA in money under Section 1371(e).

Section 1368(e)(1)(A) provides that AAA is adjusted in a manner similar to the basis adjustments under Section 1367(a) with certain exceptions for tax exempt income and related expense, redemptions, federal income taxes and certain expenses.

After AAA is adjusted for the year, then the tax impact to any distributions is assessed.²⁴⁶ Where distributions exceed AAA, AAA is applied pro rata to the distributions made during the year.²⁴⁷ Under a recent change in the law, distributions may be made from AAA to the extent of the ending AAA for the prior year where there is a net loss during the current year.²⁴⁸ Redemptions are charged against AAA based on whether the redemption is treated as an exchange under Sections 302(a) or 303(a) or a dividend equivalent redemption.

Prior to the issuance of regulations under SSRA, and although not specifically identified under Section 381(c), the Service has consistently ruled that an acquiring S corporation's and target S corporation's AAA are combined after the merger.²⁴⁹ Reg. §1.1368-2(d)(2), provides that in the case of a Type A merger, the acquiring corporation succeeds to and merges its AAA with the AAA of the target. Accordingly, the AAA of an acquiring S corporation following a Type A merger with a target S corporation will be the sum of the AAAs of the respective corporations immediately prior to the reorganization.²⁵⁰ The regulations further provide for the carryover of a negative AAA account of the acquired corporation.²⁵¹ If the acquiring C corporation makes an S election effective for its tax year that includes the date of the reorganization, the AAA of the target S corporation carries over in that both corporations are S corporations at the time of the transaction but only for purposes of permitting shareholders of the target S corporation to receive qualifying distributions from AAA during the post-termination transition period. In a spin off transaction, the AAA of the distributing corporation is allocated in a manner similar to the method by which earnings and profits are allocated in such transaction under the regulations.

²⁴⁶ Section 1368(d)(2).

²⁴⁷ Reg. §1.1368-2(b).

²⁴⁸ Section 1368(c)(1)(C).

²⁴⁹ See, e.g., PLR 9115059, 9115029 and 9002051.

²⁵⁰ Reg. §1.1368-2(d)(2).

²⁵¹ See Reg. §1.1368-2(d)(2). See also Reg. §1.1368-2(d)(3)(Type D reorganizations and AAA). But, see, PLR 9046036 (negative AAA was required to be segregated from positive AAA in a reorganization and permitted the negative AAA to be used as an offset only with respect to post-reorganization positive AAA).

Type B Reorganization.

In General.

The requirements of a Type B reorganization are the most stringent for a tax-free reorganization. The consideration must be “solely in exchange for voting stock or for the voting stock of its parent.” An S corporation can be an acquiring corporation in a Type B reorganization followed by a QSub election without necessarily having the transaction recast into an asset purchase.

S Corporation as the Acquiring Corporation.

If the S corporation is the acquiring corporation, it can immediately make a QSub election with respect to the purchased target which arguably recasts the transaction into a Type C reorganization.²⁵²

S Corporation as the Acquired Corporation.

Where an S corporation is acquired in a Type B reorganization, the target corporation’s S status will terminate because of the presence of an ineligible corporate shareholder.²⁵³ The taxable year is divided into two years, the first of which is subject to the rules applicable to Subchapter S.²⁵⁴ The same rules apply with respect to the allocation of income and loss as with respect to a tax-free acquisition of assets.

Tax Attributes.

Unless the acquiring S corporation liquidates the target corporation, or is deemed to liquidate the target corporation by virtue of making a QSub election, the tax attributes of the target corporation will remain with the acquired subsidiary subject to the limitations of Section 382-384. Where a liquidation or deemed liquidation occurs, the transaction is recast into a Type C reorganization and the tax attributes of the acquired corporation are inherited by the acquiring corporation.

Type C Reorganization.

In General.

A Type C reorganization entails the issuance by an acquiring corporation of its voting stock to another corporation in exchange for substantially all of the assets of the acquired corporation. The acquiring corporation may also transfer a small amount of boot (cash or other property, and/or assumption of liabilities of the target) as long as 80 percent of the value of the assets of the target is acquired solely in exchange for voting stock.²⁵⁵ The stock and

²⁵² See Reg. §1.1361-4 Ex. 2.

²⁵³ Section 1362(d)(2)(B). See also Section 1362(e)-(6)(D)(automatic closing of books if an exchange of 50% or more of stock).

²⁵⁴ Section 1362(e)(1). See *Versitron, Inc. v. U.S.*, 38 AFTR 2d 6119 (Ct. Cl. 1976); Rev. Rul. 69-168, 1969-1 C.B.

²⁵⁵ Section 368(a)(2)(B).

other consideration, as well as any assets retained, must generally be distributed to the shareholders of the target corporation in complete liquidation unless the Service waives the requirement.²⁵⁶ Based on the authority set forth in GCM 39768, S corporations may act as either acquiring corporations or target corporations in a Type C reorganization.

S Corporation as Acquiring Corporation.

Where an S corporation acts as an acquiring corporation in furtherance of a C reorganization, a risk exists that the corporation’s S election will be terminated since the corporation will technically have a corporate shareholder in violation of Section 1361(b)(1)(B). The issuance of voting shares by the acquiring S corporation to another corporation raises a basic concern that temporary ownership of some of the acquiring S corporation’s stock by an ineligible shareholder (the target corporation) will terminate its S election. But in GCM 39768, the Service stated that an S corporation will not lose its S status merely because it has a momentary corporate shareholder while effectuating a reorganization, including a Type C reorganization.

The same general rules described above with respect to Type A reorganizations will apply. Therefore, the allocation of the tax items will be per share per day and post-reorganization income or loss will be allocated, in effect, to the shareholders of the target receiving shares of the acquiring S corporation’s stock. However, where the acquiring S corporation loses its Subchapter S election as a result of the acquisition, income or loss for the pre-reorganization period will pass through to the shareholders of the acquiring corporation.

In a transferred basis transaction, Section 1374(d)(8) requires that the assets of the target C corporation or former C corporation are subject to the built-in gains tax in the hands of the acquiring corporation.

Where the acquiring S corporation loses its S election as a result of the Type C reorganization, it is subject to the limitation under Section 1362(g) in filing a re-election under Subchapter S.

S Corporation as Target Corporation.

Since the Service’s position is that an S corporation may engage in a Type C reorganization, the target S corporation does not forfeit its S election as a consequence, its existence merely terminates. This will result in an acceleration of income or loss attributable to the target S corporation’s short taxable year.²⁵⁷

Momentary Affiliation.

In GCM 39768, the Service stated that an S corporation will not lose its S status merely because it has a momentary corporate shareholder while effectuating a reorganization, including a C reorganization. In the case of a target S corporation’s ability

²⁵⁶ Section 368(a)(2)(G); Rev. Proc. 89-50, 1989-2 C.B. 631.

²⁵⁷ Section 381(b)(1).

to participate in a Type C reorganization, any concern regarding same was substantially reduced by the issuance of GCM 39768. The Service relied on Revenue Ruling 71-266, 1971-1 C.B. 262, evidencing its established policy that an S corporation can be acquired in a Type C reorganization without a termination of its S status. This will avoid a Section 1362(g) five-year waiting period with respect to the acquiring corporation and will allow it to elect S status as soon as possible after the reorganization if it is not already an S corporation.

Regulatory Repeal of Bausch & Lomb Doctrine; Prior Stock Ownership of Target.

Under the 1999 revisions to Reg. §1.368-2(d)(4) pertaining to Type C reorganizations, the Bausch & Lomb doctrine impediment that prior ownership of a target would prevent tax reorganization in a subsequent acquisition of target stock was removed. More particularly, the regulations, as revised, provide that the prior ownership by the acquiring corporation of stock in a target corporation “will not by itself” prevent the solely for voting stock requirement contained in Section 368(a)(1)(C) and Reg. §1.368-2(d)(1), and (d)(2)(ii) to fail. Where the acquiring corporation has prior stock ownership in the target, the 20% boot rule limitation contained in Reg. §1.368-2(d)(2)(ii) will be satisfied “only if the sum of the money or other property that is distributed in pursuance of the plan of reorganization to the shareholders of the target corporation other than the acquiring corporation and to the creditors of the target corporation pursuant to Section 361(b)(3), and all of the liabilities of the target corporation assumed by the acquiring corporation (including liabilities to which the properties of the target corporation are subject), does not exceed 20 percent of the value of all of the properties of the target corporation.”

Example: Old and Cold Prior Ownership of Target. P Corp. (P) owns 60% of Target (T) that P purchased several years ago in an unrelated transaction. The remaining 40% of T is owned by X Corp (X) which is unrelated to P. T has assets of \$110x and liabilities of \$10x. If (T) transfers its assets and liabilities to P for \$30 of P voting stock and \$10 cash which T distributes the P voting stock and cash to X (not also P of course) and liquidates. The example in the regulation states that the transaction meets the solely for voting stock requirement of Reg. §1.368-2(d)(2)(ii) since the \$10x cash and assumption of debt of \$10x does not exceed 20% of the value of the assets of T (which is \$110x). Under Bausch & Lomb, this transaction would have instead been treated as the liquidation of a 60% owned subsidiary which would be fully taxable to the corporation and the shareholders since Sections 337 and 332 would not apply. This effectively removes the QSub problem that was faced under the regulations (after the transitional relief rule was eliminated). Reg. §1.368-4(d)(4) applies to transactions occurring after December 31, 1999 unless pursuant to a prior written agreement that is binding prior to such date.

Example: Integrated Steps Cause Failure to Qualify as a Type C Reorganization. The facts are the same as in Example 1 except that P purchased the 60 shares of T for \$60x in cash in connection with the acquisition of T’s assets. The transaction does not satisfy the solely for voting stock requirement of paragraph (d)(2)(ii) of this Section because P is treated as having acquired all of the T assets for consideration consisting of \$70x of cash, \$10x of liability assumption and \$30x of P voting stock, and the sum

of \$70x of cash and the assumption by P of \$10x of liabilities exceeds 20% of the value of the properties of T.

Tax Attributes.

A Type C reorganization results in a carryover of the basis of the assets acquired from the target as well as the tax history and attributes of the subsidiary, including its earnings and profits account. Accordingly, an S corporation acquiring a target in a Type C reorganization may have passive investment income issues as well as falling into the three tier distribution system under Section 1368(c)(3) if the target has C earnings and profits. A target C corporation presumably would be subject to the LIFO recapture rule were it acquired by a S corporation in a Type C reorganization.²⁵⁸ The regulations divide the liability resulting on the LIFO recapture tax between the C corporation target and the acquiring S corporation.²⁵⁹

Type D Reorganization.

Acquisitive Type D Reorganization.

In an acquisitive (nondivisive) D reorganization, a corporation (transferor) transfers substantially all of its assets to another corporation (transferee) in exchange for stock of the transferee.²⁶⁰ This stock, along with any other consideration received and all retained assets, is then distributed in complete liquidation to the shareholders of the transferor.²⁶¹ The shareholders must then be in control (50 percent of the voting power or 50 percent of the value test set forth in Section 304(c), using modified Section 318 attribution rules). The transfer of assets may be accomplished through either a statutory merger or C reorganization structure. In the latter instance, Section 368(a)(2)(A) provides that where a Type C and Type D reorganization overlap, the transaction is controlled by Section 368(a)(1)(D). Where the transfer is effectuated through a statutory merger or consolidation, the transaction may overlap with a type A reorganization.²⁶² There does not appear to be anything in Subchapter S which is inconsistent with permitting an S corporation to engage in a Type D reorganization.²⁶³ Prior to SBJPA, Section 1371(a)(2), which treated an S corporation as an “individual” in owning stock of another corporation, suggested that an S corporation could not technically engage in a Type D reorganization or Section 355 transaction unless its ownership of the subsidiary was momentary. Still several revenue rulings and GCM 39786 provided authority for spin-off and split-off transactions by S corporations.²⁶⁴

²⁵⁸ Reg. §1.1363-2(a)(2).

²⁵⁹ Reg. 1.1363-2(b).

²⁶⁰ §368(a)(1)(D).

²⁶¹ §354(b)(1)(B).

²⁶² See Rev. Rul. 57-465, 1957-2 C.B. 250.

²⁶³ §1371(a)(1); GCM 39768 (12/1/88); PLR 9108059.

²⁶⁴ Rev. Rul. 72-320, 1972-2 C.B. 270 (momentary affiliation in a Type D reorganization did not terminate S corporation status of a distributing corporation under Section 355); Rev. Rul. 73-496, 1973-2 C.B. 312 (similar result in Kimbell-Diamond type acquisition/precursor to Section 338 involving momentary affiliation of 30 days or less). But see Haley Brothers Construction Corp., 87 T.C. 498 (1966).

Similarity to Type A Reorganization.

The tax consequences to an acquisitive Type D reorganization should have the same effects as a Type A, including the carryover of tax attributes in accordance with Section 381. A critical exception is that in a Type D reorganization Section 357(c) will trigger gain recognition to the transferor corporation where the aggregate amount of liabilities transferred are in excess of the aggregate adjusted basis of the assets transferred.²⁶⁵ Such Section 357(c) gain, in certain instances, could also fall within the built-in gains tax if the transferred assets were subject to Section 1374.

Divisive Type D Reorganization.

In a divisive Type D reorganization only a part of the corporation’s assets are transferred to another corporation which is controlled immediately thereafter by the transferor corporation and/or its shareholders. The shares of stock (or securities) of the controlled corporation are then distributed to the shareholders of the transferor corporation under Sections 355 or 356. Control for this purpose is 80% of the voting power and of all other classes of stock of the corporation. While a divisive Type D reorganization can only occur in conjunction with a qualified distribution of stock or securities under Section 355 or 356, a Section 355 division can occur without a Type D reorganization, e.g., a distribution of subsidiary stock by a holding corporation owning several controlled subsidiaries.

Business Purpose.

If the transaction is to qualify as a tax-free reorganization, it must satisfy the business purpose test; it must have one or more real and substantial non-federal tax corporate business purpose.²⁶⁶ Eligibility for an S election alone will not qualify as a requisite business purpose.²⁶⁷ Reduction in non-federal taxes will not satisfy the business purpose if: (i) both federal and state taxes are reduced, and (ii) the federal tax reduction is greater than the reduction in any state taxes.²⁶⁸ A distribution solely to make an S election to save state income or other taxes may be a valid business purpose.²⁶⁹ Close scrutiny to business purpose is given by the Service.²⁷⁰ To ensure a tax-free transaction, the shareholders will need to identify a business purposes other than Newco’s S corporation election.

When a valid non-tax corporate business purpose does exist, a subsequent S election by either the distributing corporation or controlled corporation may be viewed by the Service as tantamount to tax avoidance, possibly triggering the Service’s “no ruling” policy.²⁷¹ This no ruling position will not apply, however, where the distributing corporation already has an

²⁶⁵ See Rev. Rul. 75-161, 1971 C.B. 114 (Section 357(c) applicable in a Type D reorganization which also constituted a Type A reorganization).

²⁶⁶ Reg. §§1.355-2(b)(1) and (2).

²⁶⁷ See Reg. §1.355-2(b)(2).

²⁶⁸ Reg. §§1.355-2(b)(2) and (5) (Ex. 7).

²⁶⁹ PLR 8825085.

²⁷⁰ Reg. §1.355-2(b)(1). Rev. Proc. 96-30, 1996-1 C.B. 696.

²⁷¹ See Rev. Proc. 92-3, I.R.B. 1991-1, 55.

S election in place, since an S election by the spun-off corporation merely represents a continuation of the distributing corporation’s S status.²⁷²

Allocation of Income or Loss in Year of Division.

If the distributing corporation is an S corporation, the Type D reorganization and the divisive transaction under Section 355 ordinarily will not terminate that status. Accordingly, the distributing S corporation’s income or loss for its entire tax year will pass through to its shareholders under Section 1366. In the case of a split-off transaction, a Section 1377(a)(2) election to bifurcate the year will be available with respect to a shareholder’s complete termination of his interest in the corporation as a result of the split-off.

Distributions.

Generally, pre-divestiture distributions should be governed by Section 1368, although any distribution that bears a close connection in time or planning to the division may be analyzed by the Service under the boot rules of Section 356. In the case distributions pursuant to the divisive reorganization, the application of Section 356 to boot distributed in a Section 355 transaction requires a different analysis from that applicable to boot distributed in other acquisitive reorganizations. In such cases, as required for Section 1368 to apply, there would be a distribution “made by an S corporation with respect to its stock.” Moreover, in a pro-rata spin-off transaction, Section 356(b) would apply to characterize the boot as a distribution to which Section 301 applies. This Section 301 characterization would necessarily implicate Section 1368(a) treatment.

Built-in Gains Tax /Section 1374.

The Service has consistently ruled that Section 1374 will not apply to the spun-off corporation if it elects S status effective on the first day of its existence and the assets received from the distributing corporation would not have been subject to Section 1374 in the hands of the distributing corporation. Accordingly, Section 1374 should apply to the spun-off control corporation only to the extent that Section 1374 would have applied to the distributing corporation.²⁷³ A spun-off corporation that does not elect S status for its first year will face exposure to Section 1374 upon its subsequent Subchapter S election.

Tax Attributes.

In general, the Section 381 attribute carryover rules do not apply to divisive reorganizations. However, Reg. §1.1368-2(d)(3) confirms that the accumulated adjustments account of the distributing corporation immediately before the divisive reorganization is to be allocated between the distributing and controlled corporation similar to the allocation of the earnings and profits of a distributing corporation under Section 312(h). Under such rules,

²⁷² See, e.g., PLR 9230028; PLR 9117062; PLR 9117054.

²⁷³ See, e.g., PLR 9202028; PLR 9151998; PLR 9140054.

earnings and profits are generally allocated in proportion to the relative value of the assets transferred and retained by the distributing corporation.²⁷⁴

Section 368(a)(1)(E) Reorganization.

A Type E reorganization involves a recapitalization of a corporation and contemplates a reshuffling of the capital structure within the framework of an existing corporation. A tax free Type E reorganization involves the exchange of stock and/or “securities” of the issuing corporation. Rights issued to a party to a reorganization to acquire stock are treated as securities.²⁷⁵ Notably, the continuity of business and continuity of interest requirement do not apply to Type E recapitalizations.²⁷⁶ A Type E recapitalization may be the first step in a two-step, two company Type A, B, C, D, F or G reorganization.²⁷⁷

Section 368(a)(1)(F) Reorganization.

A Type F reorganization occurs where there is a “mere change in identity, form, or place of organization of one corporation, however effected.” There are various overlap issues between a Type F and a Type A, Type C or Type D reorganization. For example, both a Type F and a Type A reorganization may occur when a corporation merges into a corporation newly created in another state by the same shareholders.²⁷⁸ An application of an F reorganization would be where an S corporation merges into a QSub.²⁷⁹ A similar application would be where an S corporation transfers its assets to a newly organized corporation. If this is a Type F reorganization, the “new” corporation is simply a continuation of the old S corporation which has merged into Newco.²⁸⁰

In Ltr. Rul. 201007043, the IRS ruled that an S corporation’s merger into its wholly owned QSub constituted a tax-free reorganization under Section 368(a)(1)(F) without adversely affecting S corporation status. In the ruling, the S corporation and one of its two wholly owned QSubs desired to combine their assets and operations into a single corporation in order to take advantage of planned efficiencies and to reduce expenses and redundancies. Because certain legal agreements of the QSub prohibited the QSub from merging upstream into the S corporation, it was decided that the S corporation should merge downstream into the QSub.

²⁷⁴ See Reg. §1.312-10(a).

²⁷⁵ Reg. §1.354-1(e). However, an exchange of solely securities, including warrants, for stock is not tax free. Reg. §1.354-1(d), Ex. 4.

²⁷⁶ Reg. §1.368-1(b). Prop. Reg. §1.368-1(b)(1) would further clarify that an exchange of net value is not required for a transaction to qualify as a Type E or F reorganization.

²⁷⁷ See Rev. Rul. 59-222, 1959-1 C.B. 80 (E followed by B); Rev. Rul. 61-156, 1961-1 C.B. 62. (E followed by F); Rev. Rul. 77-227, 1977-2 C.B. 120 (E followed by A). The Service has also issued a number of private letter rulings involving E recapitalizations coupled with F reorganizations.

²⁷⁸ See Rev. Rul. 64-250, 1964-2 CB 333 (Type F reorganization occurred when S corporation merged into new corporation set up by same shareholders in another state; corporation’s S status did not terminate).

²⁷⁹ Reg. §1.1361-5(b)(3), Ex. 8.

²⁸⁰ See PLR. 8843026 (Aug. 1, 1988).

Citing Rev. Rul. 64-250,²⁸¹ the IRS concluded that pursuant to the F reorganization, the S corporation election would continue in effect with respect to the surviving QSub following the merger. Additionally, the IRS found that the status of the S corporation’s other QSub would not terminate as a result of the F reorganization.

In Rev. Rul. 2008-18,²⁸² the IRS ruled that in the two situations presented in the rulings, which both qualified as F reorganizations within the meaning of Section 368(a)(1)(F), the S election of the existing corporations did not terminate (and were carried over to the newly formed corporations), but that the newly formed corporations would be required to obtain new employer identification numbers.

In situation 1 of the ruling, B, an individual, owned all of the stock of Y, an S corporation. In year 1, B forms Newco and contributes all of the Y stock to Newco, which meets the requirements for qualification as a small business corporation. Newco timely elects to treat Y as a qualified subchapter S subsidiary (QSub) effective immediately following the transaction. The ruling states that the transaction meets the requirements of an F reorganization under Section 368(a)(1)(F). In year 2, Newco sells 1% of the stock of Y to D, an unrelated party.

In situation 2, C, an individual, owns all of the stock of Z, an S corporation. In year 1, Z forms Newco, which in turn forms Mergeco. Pursuant to a plan of reorganization, Mergeco merges with and into Z, with Z surviving and C receiving solely Newco stock in exchange for his stock of Z. Consequently, C owns 100% of Newco, which in turn owns 100% of Z. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Z as a QSub effective immediately following the transaction. Again, the ruling expressly states that the transaction meets the requirements of an F reorganization.

The ruling first cites Rev. Rul. 64-250,²⁸³ which provided that when an S corporation merges into a newly formed corporation in a transaction qualifying as a reorganization under Section 368(a)(1)(F) and the newly formed surviving corporation also meets the requirements of an S corporation, the reorganization does *not* terminate the S election, and as such, the S election remains in effect for the new corporation (without the new corporation being required to file a new S election). The ruling then cites Rev. Rul. 73-526,²⁸⁴ in which the IRS concluded that where an S corporation merged into another corporation in a transaction qualifying as an F reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation.

Rev. Rul. 2008-18 provides, however, that since the publication of Rev. Rul. 73-526, the Code has been amended to provide the classification of certain wholly-owned subsidiaries of S corporations as QSubs and the regulations under Section 6109 have been amended to address the effect of QSub elections under Section 1361. Specifically, Reg. §301.6109-1(i)(1) provides that any entity that has a federal employer identification number will retain that employer identification number if a QSub election is made for the entity under Reg.

²⁸¹ 1964-2 CB 333.

²⁸² 2008-13 IRB 674.

²⁸³ 1964-2 C.B. 333.

²⁸⁴ 1973-2 C.B. 404.

§1.1361-3 or if a QSub election that was in effect for the entity terminates under Reg. §1.1361-5. Additionally, Reg. §301.6109-1(i)(2) provides that, except as otherwise provided in regulations or other published guidance, a QSub must use the parent S corporation’s employer identification number.

Additionally, for tax years beginning after December 31, 2004, Section 1361(b)(3)(E) was amended to provide that except to the extent provided by the IRS, QSubs are not disregarded for purposes of information returns. Further, QSubs are not disregarded for certain other purposes as provided in the regulations. For example, Reg. §1.1361-4(a)(7) provides that a QSub is treated as a separate corporation for purposes of employment tax and related employment requirements effective for wages paid on or after January 1, 2009. Because a QSub is treated as a separate corporation for certain federal tax purposes, the QSub must retain and use its employer identification number when it is treated as a separate corporation for federal tax purposes.

Because of these recent changes, the IRS concluded that it would not be appropriate for the acquiring corporation in a reorganization under Section 368(a)(1)(F) to use the employer identification number of the transferor corporation that becomes a QSub. Thus, in situation 1, although Y’s original S election will not terminate but will continue for Newco, Newco will be required to obtain a new employer identification number and Y will retain its employer identification number even though a QSub election is made for it and will be required to use its original employer identification number anytime Y is otherwise treated as a separate entity for federal tax purposes. Additionally, in year 2, when Newco sells 1% of the stock of Y to D, Y’s QSub election will terminate under Section 1361(b)(3)(C) and Y will be required to use its original employer identification number following the termination of its QSub election.

Likewise, in situation 2, Z’s original S election will not terminate as a result of the F reorganization but will continue for Newco, and as such, Newco will not be required to file a new S election. Again, however, Newco will be required to obtain a new employer identification number and Z must retain its employer identification number even though a QSub election is made for Z and must use its original employer identification number any time it is otherwise treated as a separate entity for federal tax purposes or if its QSub election terminates.

Rev. Rul. 2008-18 applies to F reorganizations occurring on or after January 1, 2009. For F reorganizations occurring on or after March 7, 2008 and before the effective date of the ruling, taxpayers may rely on Rev. Rul. 2008-18. The ruling acknowledges that the IRS is aware that prior to the effective date of the ruling, S corporations have undergone F reorganizations in a manner similar to those described in situations 1 and 2 in which the acquiring corporation continued to use the transferor corporation’s employer identification number consistent with Rev. Rul. 73-526. In those cases, the IRS provides that the acquiring corporation should continue to follow Rev. Rul. 73-526 and use the transferor corporation’s employer identification number and that after the F reorganization, the transferor QSub should use the parent’s employer identification number until such time as the QSub is otherwise treated as a separate corporation for federal tax purposes or until such time as the QSub terminates. At such time, the QSub must obtain a new employer identification number.

The IRS also states in the ruling that for an F reorganization occurring prior to January 1, 2009, it may be prudent for the acquiring corporation to make a protective S election.

Rev. Rul. 2008-18 is consistent with a number of prior rulings issued by the IRS to the extent that the newly formed corporation making a QSub election for the existing (transferor) corporation is not required to make a new S election. On the other hand, Rev. Rul. 2008-18 reverses the holdings in a number of prior rulings which provided that the newly formed corporation should use the employer identification number of the existing corporation (which becomes a QSub).²⁸⁵ The ruling does state, however, that in situations not involving a QSub, such as the specific situation set forth in Rev. Rul. 73-526 involving the merger of one S corporation with and into another corporation that constitutes an F reorganization, the surviving corporation in those circumstances would use the employer identification of the transferor corporation.

In EEC 200941019, dated October 9, 2009, the IRS issued email guidance to a taxpayer providing that the taxpayer could rely on Rev. Rul. 2008-18.²⁸⁶ In the email advice, C owns all of the stock of Z, an S corporation with an existing employer identification number. In year 1, Z forms Newco, which in turn forms Mergeco. Pursuant to a plan of reorganization, Mergeco merged with and into Z with Z surviving and C receiving solely Newco stock in exchange for Z stock. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Z as a QSub effective immediately following the transaction.

The email advice provides that the taxpayer may rely on the principles set forth in Rev. Rul. 2008-18, and consequently, Z’s original S election will *not* terminate but will continue for Newco, but Newco will be required to obtain a new employer identification number and Z will retain its existing employer identification number even though a QSub election is made for it. Additionally, the IRS provided in the email advice that Z would *not* file a final Form 1120S, but rather that Newco would report all of Z’s and Newco’s income on its Form 1120S.

Section 351 Transactions and National Starch.

Under Section 351, an acquisition may be structured to give selling shareholders stock tax free in a transaction that may not meet the continuity of interest requirements. Under Section 351, eligible shareholders may transfer property to a corporation in exchange for stock (and boot) of such corporation and immediately after the exchange, the transferor(s) must be in control of the corporation within the meaning of Section 368(c).

Section 351(g) treats nonqualified preferred stock issued to a shareholder in a Section 351 transaction as boot. This places some restrictions on the National Starch structure inspired by Letter Ruling 7839060.²⁸⁷ In this structure, the purchaser (P), and the selling shareholder or shareholders desiring tax free treatment (A) contribute cash and stock in the target (T) to a new corporation (New S) in exchange for stock in New S. New S can either

²⁸⁵ See, e.g., Ltr. Ruls. 200701017 and 200725012.

²⁸⁶ 2008-13 IRB 674.

²⁸⁷ June 23, 1978.

purchase the remaining shares from the shareholders desiring cash, or in the event the remaining shareholders are not cooperative, a subsidiary (D) can be formed to merge with the target, and merge with T forcing out the remaining shareholders.

In the National Starch ruling, the Service ruled that (i) A did not recognize gain or loss on the exchange of T voting shares for New S shares, and (ii) under Rev. Rul. 73-427,²⁸⁸ the formation of D and the merger of D into T will be disregarded, and the transaction is viewed as a purchase by S for cash of the remaining stock in T held by shareholders other than T.

Two years later, the Service reversed its approach in two published rulings, Rev. Ruls. 80-284²⁸⁹ and 80-285.²⁹⁰ In 1984, however, the Service revoked the 1980 published ruling in Rev. Rul. 84-71,²⁹¹ and readopted the position in the National Starch ruling, concluding that the fact that the larger acquisitive transaction failed to meet the continuity of interest requirements for a tax free reorganization, does not preclude the applicability of Section 351 to transfers that may be described as part of such larger transactions, but also, either alone or in conjunction with other transactions, meet the requirements of Section 351(a).

As noted above, the nonqualified preferred stock rules result in the taxation of the shareholder receiving preferred stock in a National Stock transaction, precluding the use of the redemption and call provisions involved in the National Starch ruling. Preferred stock would not be permissible if the acquisition vehicle is an S corporation. Otherwise, as the transferee corporation in a National Starch structure, an S corporation will qualify as the new acquisition vehicle under Section 351. No gain or loss will be recognized on the transfer of its stock under Section 1032. Still, Section 351 transfers are problematic for S corporations, not only for the control requirement under Section 368(c) and liability in excess of basis issues, but in order to maintain eligibility. In particular, the one class of stock requirement places a strait jacket on the type of consideration that can be issued by an S corporation in exchange for its stock. Where an S corporation is a transferor in a Section 351 transfer, the normal rules applicable to Section 351 will apply.²⁹²

An alternative structure is the “horizontal double-dummy” or “top hat” approach for the combination of two corporations wholly or partly tax free, when not otherwise permitted by the reorganization provisions. A new corporation (“Newco”) is formed along with two wholly owned subsidiaries, S1 and S2. The target is merged into S1 and the acquirer (or other target) is merged into S2, with the shareholders of each target receiving stock in Newco and other consideration, including boot and convertible debentures. Newco, S1 and S2 file a consolidated federal income tax return, with the interest on the convertible debentures deductible in computing taxable income.

²⁸⁸ 1973-2 C.B.301.

²⁸⁹ 1980-2 C.B. 117.

²⁹⁰ 1980-2 C. B. 119.

²⁹¹ 1984-1 C.B. 106.

²⁹² Prior to SBJPA, an S corporation could not own 80% or more of the stock (voting and value) of a subsidiary. For taxable years beginning after 1996, this limitation has been eliminated.

If the boot in the transaction, including the debentures, exceeds 20% of the consideration to the shareholders of either transaction, it would not qualify as a reverse subsidiary merger under Section 368(a)(2)(E). However, the two simultaneous reverse triangular mergers should qualify as a Section 351 transaction so long as the mergers are not interdependent.²⁹³ The former target shareholders, taken as a group, are in control of Newco within the meaning of Section 368(c) immediately thereafter.²⁹⁴ Only the shareholders receiving debentures or other boot will recognize taxable gain in the transaction.

TAXABLE ASSET ACQUISITIONS AND STOCK PURCHASES AND DISPOSITIONS TREATED AS ASSET ACQUISITIONS

The Acquiring S Corporation.

Where an S corporation purchases the assets of another corporation or business entity, the tax impacts are substantially the same as with any other asset purchase. The acquiring corporation gets a cost basis in the acquired assets, which includes any liabilities which are assumed or to which the purchased assets are subject. Gain, including recapture gain is taxable to the selling entity in the year of sale, subject to potential application of the installment sales rules for qualifying deferred payment obligations of eligible sellers. The consideration paid for the assets is allocated in accordance with Section 1060 and the regulations issued thereunder. Cost recovery deductions for tangible personal property and rules applicable to the amortization of purchased intangibles, including goodwill and going concern value, permit annual deductions for depreciation and amortization.²⁹⁵

Taxable Merger.

An asset sale may be effectuated through a forward taxable merger of the target into the purchasing corporation, which generally has the same tax consequences as a direct purchase of assets.

Buyer's Basis in Purchased Assets.

Direct Asset Acquisition.

Where the target's assets are purchased in a taxable transaction, the buyer's aggregate basis in the purchased assets will equal: (1) cash and value of property paid; and (2) liabilities assumed or taken subject to.²⁹⁶ Interest, including OID, is not added to basis. Thus, the principal amount of any fixed payment obligations is included in basis even if the

²⁹³ See Rev. Rul. 76-123, 1976-1 C.B. 95; PLR 9610031 (December 12, 1995). In PLR 8817079 (February 4, 1988), the Service ruled that if either of the subsidiary mergers had qualified as a reverse subsidiary merger under Section 368(a)(2)(E), the exchange would not have qualified as tax free under Section 351, since the target shareholders participating in the reverse subsidiary merger would not have been considered transferors of property to Newco, and the remaining transferors of property would not be in control of Newco immediately thereafter.

²⁹⁴ Newco should take care not to be an investment company within the meaning of Section 351(e)(1). See Reg. §1.351-1(c)(1).

²⁹⁵ See Sections 168, 197, 263 and the regulations thereunder.

²⁹⁶ Section 1012.

seller is reporting under Section 453. For contingent payments, generally basis is not established until the amount of the contingency is determined and resolved.

Regular Section 338 Election.

In a deemed asset sale per Section 338, Section 338(b)(and the regulations thereunder) require that the new target’s aggregate basis in the target’s assets is equal to the sum of: (i) buyer’s cost or basis in the qualified stock purchase gross-up to reflect shares retained by minority shareholders; (ii) the buyer’s basis in any nonrecently purchased stock of the target; (iii) the liabilities of the target, including liability for taxes resulting from the deemed sale; and (iv) other adjustments required by the regulations.

Section 338(e) Election; Section 338(h)(10) Election.

Where a deemed asset sale occurs pursuant to a Section 336(e) election or a Section 338(h)(10) election, both discussed further below, the new target’s basis is adjusted under the same rules as a regular Section 338 election except: (i) basis of assets to new target does not include any liability for tax arising out of the deemed asset sale (i.e., since the consolidated group of the seller will be bearing the tax liability); and (ii) a basis step-up is made with respect to nonrecently purchased stock.²⁹⁷

Allocation of Basis Among Purchased or Deemed Purchased Assets.

As mandated by Section 1060, the residual method of valuation is required to allocate the purchase price in actual asset sales as well as deemed asset sales under Section 338.²⁹⁸ Sellers will tend to allocate to assets that produce long term capital gain, or, on the other hand, ordinary loss. As to purchased goodwill and similar items, Section 197 eliminates the issues of whether an intangible’s useful life can be estimated with reasonable accuracy and, if so, the length of that useful life; if an intangible is covered by Section 197(a) its cost is amortized over 180 months, regardless of the period during which the intangible is expected to be useful in the business. In order to trigger application of Section 1060, the acquisition must involve the purchase of any “active trade or business” (per Section 355 definition) or any other group of assets where “goodwill or going concern value could under any circumstances attach to such group.”²⁹⁹ Under Section 1060, the allocation of the purchase price is to be made upon the following classes, in the following order:

First: cash and general deposit accounts (including savings and checking accounts) (“Class I”);

Second: “actively traded personal property” under Section 1092(d)(1) (with some modifications), including publicly traded stock and U.S. government securities, as well as CDs and foreign currency (“Class II”);

²⁹⁷ See Reg. §1.338(b)-1(e)(3)(ii).

²⁹⁸ See Section 1060(c)(definition of “applicable asset acquisition”).

²⁹⁹ Reg. §1.1060-1T(b)(2).

Third: accounts receivables, mortgages and credit card receivables from customers (“Class III”);

Fourth: inventory, stock in trade and property held for sale to customers in the ordinary course of business (“Class IV”);

Fifth: all assets other than Class I, II, III, IV, VI and VII assets, which would include property, plant and equipment (“Class V”);

Sixth: Section 197 intangible assets, except goodwill and going concern value (“Class VI”); and

Seventh: goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a Section 197 intangible) (“Class VII”).

Purchase of Section 197 Intangibles.

Under Section 197, amortization is permitted for acquisition or capitalized costs of certain intangible property, referred to as Section 197 intangibles, that a taxpayer acquires and holds in connection with the conduct of a trade or business or activity engaged in for profit.

Definition of Section 197 Intangible.

Section 197 intangibles include: (i) goodwill; (ii) going concern value; (iii) work-force in place; (iv) information base; (v) customer based intangibles; (vi) supplier based intangibles; (vii) licenses, permits or other governmental issued rights; (viii) covenants not to compete or similar agreements entered into in connection with any interest in a trade or business, i.e., liquor licenses, taxi medallions, airport rights, regulated transportation routes, and broadcasting licenses; and (ix) any franchise, trademark or trade name (except intangibles described in Section 1253(d)(1)). Thus, for example, if the buyer pays a lump sum for the target’s franchise, Section 197 would provide for 15 year amortization instead of a contingent payout method described in Section 1253. On the other hand, buyers who are not adverse to the seller’s or other third party’s control over the subject intangibles, generally will prefer the current deductibility of payments subject to Section 1253, which produce ordinary income to the recipient.

Use of Separate Company to Purchase Intangibles.

As part of the acquisition, consider use of a holding company with the acquisition subsidiary acquiring the business assets and the holding company purchasing the licenses and similar intangibles which it then leases to its subsidiary. This planning strategy may avoid state income tax on the royalty payments.³⁰⁰

³⁰⁰ See Sections 446(b), 482.

Consideration for Covenant Not to Compete.

Prior to the introduction of Section 197 in 1993, consideration paid for a covenant not to compete was generally deductible in level amounts over the term of the covenant period. However, under Section 197, the period is 15 years even if the actual contract period is shorter.

Anti-churning Rules.

Under special anti-churning rules in Section 197, goodwill, going concern value, or any other Section 197 intangible acquired after the enactment date (August 10, 1993, or July 25, 1991, where an election has been made) which would not have been amortizable prior to the enactment of Section 197, are generally not treated as Section 197 intangibles if they were held or used by the taxpayer (or a related person) before the effective date and in certain other situations. The definition of “related person” borrows from Sections 267 and 707(b) and commonly controlled business definitions but using lower percentage of ownership thresholds.

Non-Section 197 Intangibles.

Certain property is excluded from the definition of Section 197, including interests in corporations or partnerships, futures and notional contracts, land, certain computer software, lease rights, rights under debt instruments, and sports franchises.

Information Reporting Requirements.³⁰¹

Buyers and sellers are not required to agree on asset allocations, but once an agreement is made, both buyer and seller (but not the Service) are generally bound. The allocation is reported on IRS Form 8594.³⁰²

Allocation to Non-Corporate Assets.

In trying to avoid double tax for an asset or deemed asset, sale of a corporation, note cases providing that non-corporate assets, include covenants not to compete from key shareholders, and, possibly, customer relationships or goodwill retained by shareholders are not corporate assets.³⁰³ In Howard v. U.S.,³⁰⁴ the court denied the taxpayer’s motion for a summary judgment and granted the government’s motion for summary judgment in finding that goodwill in connection with the sale of a dental practice was corporate goodwill rather than personal goodwill.

³⁰¹ See Section 1060(e).

³⁰² See also Form 8023 (Section 338 transactions).

³⁰³ See Martin Ice Cream Company v. Comm’r, 110 T.C. 189 (1998)(in the absence of an employment agreement or covenant not to compete, client relationships and goodwill personal to shareholder are not assets of target corporation); Norwalk v. Comm’r, T.C. Memo. 1998-279 (1998) (presence of shareholder level goodwill on liquidation of accounting firm not included in amount realized).

³⁰⁴ 2010 WL 3061626 (E.D. Wash.) (July 30, 2010).

Under the facts of Howard, the taxpayer incorporated his practice as the sole shareholder, officer and director in 1980, and also entered into an employment agreement and a covenant not to compete with the corporation. The covenant not to compete provided that for so long as the taxpayer held any stock and for a period of three years thereafter, he would not engage in any business which was competitive to that of the corporation within 50 miles of Spokane, Washington. In 2002, the taxpayer and his corporation sold the practice to another personal service corporation. In the Asset Purchase Agreement, the taxpayer was allocated \$549,900 for his “personal goodwill” and \$16,000 for consideration regarding a covenant not to compete with the acquiring personal service corporation. The selling corporation itself received \$47,100 for its assets.

Following an audit by the IRS, the IRS recharacterized the sale of goodwill as a corporate asset and treated the amount received by the taxpayer from the sale to the acquiring personal service corporation as a dividend from the selling professional service corporation to the taxpayer. The government argued that the goodwill was corporate goodwill versus personal goodwill for three main reasons. First, the goodwill at issue was a corporate asset because the taxpayer was an employee with the corporation and had a covenant not to compete with the corporation. Second, the corporation earned the income and correspondingly earned the goodwill. Third, attributing the goodwill to the taxpayer would not comport with the economic reality of the taxpayer’s relationship with his personal service corporation.

The government, citing *Furrer v. Comm’r*,³⁰⁵ *Martin Ice Cream v. Comm’r*,³⁰⁶ *Norwalk v. Comm’r*,³⁰⁷ and *MacDonald v. Comm’r*,³⁰⁸ found that the goodwill was an asset of the corporation and not of the taxpayer personally because of the contractual obligation of the taxpayer under the Employment Agreement to continue to work for and not to compete against his corporation. In granting summary judgment in favor of the government, the court found no merit in the taxpayer’s argument that Washington state dissolution case law supported the proposition that professional goodwill is a community property right in dissolution cases, and as such, is of a personal nature.

The Selling S Corporation.

Where a selling S corporation never has had a C history, the impact of an asset sale is rather straightforward. The decision of whether it is more advantageous and to what extent the target should sell its assets or its stock will require consideration of four tax issues: (i) the comparison of inside (asset) basis versus outside (stock) basis; (ii) the character of gain differential between an “inside” sale versus an “outside” sale (long term capital gain); (iii) whether a corporate-level tax will be imposed because of the sale; and (iv) whether (and to what extent) the installment method of reporting is available. Where the target has been a

³⁰⁵ 566 F.2d 1115 (9th Cir. 1977).

³⁰⁶ 110 TC 189 (1998).

³⁰⁷ TCM 1998-279.

³⁰⁸ 3 TC 720 (1944).

qualified electing small business corporation for its entire history and has not acquired the assets of a C corporation within the past 10 years in an exchanged basis transaction, then the corporate level gain from an asset sale is, for federal (and most state) income tax purposes, passed through to the shareholders and results in a single level of tax. The amount realized is allocated among the basis of the individual assets in accordance with the residual method of valuation in accordance with Section 1060 and Section 338 regulations, to the extent applicable. Allocated gain or loss is characterized by reference to the nature of the corporation’s purpose in holding the particular asset sold, e.g., depreciable real property used in a trade or business or Section 1231 property, inventory, depreciation subject to recapture, or property held for investment, including corporate goodwill. Where the corporation has acquired assets in a C corporation in a tax-free reorganization within the past 10 years and/or otherwise converted to Subchapter S within the past 10 years (7 years in for sales of assets occurring in 2009 and 2010, and 5 years for sales occurring in 2011 through 2014, discussed further below), then there is a special corporate level tax on the corporation’s built-in gains (and losses) to the extent of such unrealized built-in gain (or loss) on the effective date of the conversion (exchange).

Prior to the enactment of the American Recovery and Reinvestment Act of 2009 (the “2009 Recovery Act”),³⁰⁹ the “recognition period” for built-in gains under Section 1374 was generally defined as the 10-year period following the first day of the tax year for which the corporation was an S corporation.

As a way to provide relief to small businesses faced with the need to dispose of assets to satisfy debts, the 2009 Recovery Act amended Section 1374(d)(7) to reduce the “recognition period” from ten years to seven years for sales of assets occurring in 2009 and 2010.³¹⁰ Section 1374(d)(7) provides that for the 2009 and 2010 taxable years, “no tax shall be imposed on the net recognized built-in gain of an S corporation if the 7th taxable year in the recognition period preceded such taxable year.” For property acquired from a C corporation in a carryover basis transaction, the recognition period is reduced to 7 years from the date the property is acquired, for sales occurring in 2009 and 2010.³¹¹

The Small Business Jobs and Credit Act of 2010³¹² further reduced the Section 1374 recognition period to 5 years for sales occurring in 2011. The American Taxpayer Relief Act of 2012³¹³ extended the 5 year rule for dispositions occurring in 2012 and 2013. The Section 1374 recognition period reverted to 10 years for the 2015 tax year and future years, in the absence of further legislation.

Allocation of Income.

In the year of sale, the normal pro rata allocation rules under Section 1377(a)(1) will generally continue to apply. Even in a taxable merger, the corporation will retain its S status

³⁰⁹ P.L.111-5 (February 17, 2009).

³¹⁰ See Section 1374(d)(7), as amended by the 2009 Recovery Act, Section 1251.

³¹¹ Section 1374(d)(8)(B)(i). Joint Committee on Tax’n Report on P. L. 111-5 (February 17, 2009).

³¹² P.L. 111-240 September 27, 2010.

³¹³ P.L. 112-240 (January 2, 2013).

through the close of the final S year, which will not constitute an S termination year.³¹⁴ The character and amount of the gain will generally be determined at the corporate level. The corresponding gain or loss is then passed through to the shareholders and increases or reduces outside basis in stock (and, in some instances, shareholder debt previously reduced for losses and other deductions).

Recharacterization.

A controversial provision was inserted in the final regulations to Section 1366 which permits the Service to recharacterize capital gain or Section 1231 gain allocable to a “dealer” type shareholder with respect to such property.³¹⁵

Built-in Gains Tax per Section 1374.

For the S corporation, gain from the sale of assets will result in the pass through of gain and loss to the shareholders in accordance with their proportionate stock interests. Alternative tax impacts are accounted for at the shareholder level. Where the corporation has converted to S status within the past 10 years (7 years for sales occurring in 2009 and 2010 and 5 years for sales occurring in 2011 through 2014, as explained above), Section 1374 may apply. Thus, an asset sale by an S corporation, with a prior C history, could result in a forced double tax to the extent of its recognized built-in gains. The Section 1374 tax also applies to operating and liquidating distributions. Tax history is used in determining the taxable income or loss of the corporation in the year of sale. Where the corporation does not liquidate, then the seller may need to carefully consider the potential impacts of the accumulated earnings tax under Section 531, or, alternatively, the personal holding company tax under Section 541. There are also alternative minimum tax impacts as well.

Deemed Asset Sale Treatment for Certain Qualified Stock Purchases and Qualified Stock Dispositions.

Regular Section 338 Election.

In order for an acquiring corporation to be eligible to make a Section 338 election, it must satisfy the requirement of a “qualified stock purchase,” i.e., any transaction or series of transactions in which stock (per Section 1504(a)(2), i.e., 80% or more voting and value) of 1 corporation is acquired by another corporation by purchase during the 12 month acquisition period.³¹⁶ If target makes a Section 338 election, then a stock sale by the target’s shareholders will be deemed to have sold all of its assets, subject to liabilities, to a deemed newly formed corporation in a fully taxable transaction, which is then immediately followed by the deemed liquidation of the target. Unless the target has substantial net operating losses or capital loss carryovers, a regular Section 338 liquidation is generally undesirable.³¹⁷

³¹⁴ See Rev. Rul. 66-94, 1964-1 C.B. 317; Rev. Rul. 70-232, 1970-1 C.B. 178.

³¹⁵ Reg. §1.1366-1(b)(2).

³¹⁶ See Section 338(e), (f)(asset and stock consistency rules).

³¹⁷ See Section 336(e) (permitting non-corporate purchaser to treat stock purchase as asset sale).

Section 336(e) Election.

Congress added Section 336(e) to the Code in the Tax Reform Act of 1986, intending that it be implemented using “principles similar to those of Section 338(h)(10).” Thus, Section 336(e) has a purpose similar to Section 338(h)(10), which offers taxpayers relief from a potential multiple taxation at the corporate level of the same economic gain triggered when a transfer of appreciated corporate stock is taxed without providing a corresponding step-up in basis of the assets of the corporation.

Under Section 336(e), if one corporation owns an affiliated interest in the stock of a target corporation, or if the target corporation is an S corporation, and the parent corporation or the S corporation shareholders sell, exchange, (or in the case of a transaction in which Section 355(d)(1) or (e)(2) applies, in whole or in part, distributes) all of the target corporation stock, an election may be made to treat the transfer of the second corporation’s stock as a disposition of its assets, thereby avoiding recognized gain or loss on the sale, exchange, or distribution of that stock.

Final Section 336(e) regulations were published in the Federal Register on May 15, 2013.³¹⁸ Despite many similarities with the Section 338(h)(10) regulations, the two regulatory regimes differ in several important respects. First, although both require the transfer of an affiliated interest in target stock by a corporation or S corporation shareholders, Section 338(h)(10) looks to the purchase of that stock interest, while Section 336(e) focuses on its disposition. Thus, the Section 338(h)(10) regulations (as do the Section 338 regulations generally) consider what is purchased, while the Section 336(e) regulations measure what is sold, exchanged, or distributed. Second, for Section 338(h)(10) to apply to a non-S corporation target, on the date that the affiliated interest in the target is first acquired by purchase (the “acquisition” date), the target must be a member of the consolidated group or affiliated with a selling domestic corporation. On the other hand, under the Section 336(e) regulations, a Section 336(e) election may be made for the target even if it is not affiliated with the selling corporation or a member of the selling consolidated group on the corresponding date (the “disposition” date). Finally, if a Section 338(h)(10) election is made, a gain recognition election is required, while a gain recognition election for a purchaser may not be required following a Section 336(e) election.

A Section 336(e) election can be made only for a *qualified stock disposition*, which occurs when an affiliated interest in a domestic corporation is transferred in a disposition or series of dispositions by another domestic corporation over a 12-month disposition period. The purchaser in a qualified stock disposition is not required to be a corporation, as in the case of a qualified stock purchase under Section 338(h)(10). Any stock sold, exchanged, or distributed is considered transferred in a disposition, unless –

- (i) The transferee’s basis in the stock is determined in whole or in part by reference to the transferor’s basis;
- (ii) The transferee’s basis in the stock is determined under Section 1014;

³¹⁸ 78 Fed. Reg. 28467 (May 15, 2013).

(iii) With certain exceptions, the stock is transferred in a transaction to which Section 351, 354, 355, or 356 applies (or another nonrecognition transaction described in the regulations); or

(iv) The stock is transferred to a related person.³¹⁹

If a qualified stock disposition of a target is also a qualified stock purchase for which a Section 338 election can be made, a Section 336(e) election can generally not be made for the disposition. There is an exception where the target is a subsidiary of another corporation and the target’s qualified stock disposition is a result of the deemed sale of the other corporation’s assets pursuant to a Section 336(e) election.³²⁰

The regulations use two models for the deemed transactions, a model for most qualified stock dispositions and a model that applies for those dispositions to which Section 355(d)(2) or (e)(2) apply in whole or in part. If a seller or S corporation shareholders dispose of target stock in a qualified stock disposition (other than one to which Section 355(d)(2) or (e)(2) applies in whole or in part) and a Section 336(e) election is made for the disposition, the following events are deemed to occur at the close of the disposition date in the following order:

(i) The target corporation (referred to in the regulations as the “old target”) is treated as selling its assets to an unrelated person in a single transaction at the close of the disposition date;

(ii) The target (referred to in the regulations as the “new target”) is treated as acquiring those assets from an unrelated person in a single transaction at the close of the disposition date; and

(iii) The old target is deemed to distribute its assets (*i.e.*, the proceeds from the deemed sale) to the seller or S corporation shareholders. Except as otherwise provided, the federal income tax consequences of the deemed events are the same as if the parties had actually engaged in the transactions that are deemed to occur.³²¹

If a general election is made, “old target” refers to the target on or before the close of the disposition date, while “new target” refers to the target for subsequent periods. Although the old and new targets are one corporation under corporate law, they are generally treated as separate corporations for purposes of subtitle A of the Code. However, the new target remains liable for the old target’s federal income tax liabilities (including the liabilities of its consolidated group under Reg. §1.1502-6) and the new target must use the old target’s employer identification number.

³¹⁹ Reg. §1.336-1(b)(5)(i).

³²⁰ Reg. §1.336-1(b)(6)(ii)(B), treating the disposition as a qualified stock disposition..

³²¹ Reg. §1.336-2(b)(1)(i).

The old target is treated as selling its assets for the aggregate deemed asset disposition price (“ADADP”) while the seller or the S corporation shareholders still own the old target stock. If the old target is an S corporation target, the old target’s S election continues in effect through the close of the disposition date. The ADADP is allocated among the target assets using the seven-tier residual method described in Reg. §1.338-6, an allocation that determines the amount realized for each asset in the deemed sale.³²²

On the deemed sale, the old target’s realized gain or loss on each asset equals the difference between the asset’s allocable share of the ADADP and its adjusted basis. The old target generally recognizes that realized gain and loss. It recognizes any gain, except to the extent that the installment method applies (and typically the seller succeeds to any deferred installment gain). The old target recognizes its realized loss on the deemed sale, unless the seller distributes old target stock during the 12-month disposition period. In that exceptional case, if the old target’s realized loss on its deemed asset sale exceeds its realized gain, a portion of that excess (*i.e.*, its net loss) is disallowed.

Section 338(h)(10) Election.

Section 338(h)(10) sets forth an advantageous method of converting a qualified “purchase” of 80% or more of the target stock by a corporation into an asset purchase on an elective basis. This election may only be made for a target that is a domestic corporation that before the sale of its stock, is a member of an affiliated group of corporations (whether or not the group files consolidated returns) or is an S corporation. Where a Section 338(h)(10) election is made, the target corporation recognizes gain or loss as though it sold its assets on the acquisition date, but target shareholders generally recognize no gain or loss on selling target stock to the purchasing corporation. The S status of the target corporation remains in effect through the close of the acquisition date, including the time of the deemed asset sale and liquidation.³²³ If the gain inherent in the target shareholders’ stock is similar in amount to the gain inherent in the target’s assets, Section 338(h)(10) may provide a step-up in asset basis at a tax cost not significantly greater than would be incurred with no election. Regulations further provide for deemed asset sale treatment for shareholders of an S corporation target provided all shareholders of the target consent.

Section 336(e) and Section 338 (h)(10) Election Mechanics.

The Section 336(e) election is made by an S corporation by having the target and all S corporation shareholders, whether or not they dispose of stock in the qualified

³²² Under that residual method, the ADADP is first reduced by the amount of Class I assets. The remainder is then allocated, in order, among Class II assets, then Class III assets, then Class IV assets, then Class V assets, and then Class VI assets, to the extent of, and in proportion to, the fair market value of the assets in each class.⁴³ Any residual is allocated to Class VII assets. Class I assets are cash, demand deposits, and similar accounts in financial institutions; Class II assets are certificates of deposit, foreign currency, U.S. government securities, publicly traded stock, and any other actively traded personal property (as defined in Section 1092(d)(1) without regard to Section 1092(d)(3)); Class III assets are accounts receivables and the like; Class IV assets are inventory and the like; Class VI assets are Section 197 intangibles other than goodwill or going concern value; and Class VII assets are goodwill and going concern value. Class V assets are any other assets.

³²³ Reg. §1.338(h)(10)-1(d)(3).

stock purchase, enter into a written, binding agreement to make a Section 336(e) election on or before the due date (including extensions) of the federal income tax return for the target that includes the disposition date. The target must retain a copy of that agreement and it must attach the return (including extensions) for taxable year that includes the disposition date.

The Section 336(e) election statement must include the following information:

- (i) The name, address, taxpayer identification number, taxable year, and state of incorporation (if any) of the target, each seller, any common parent of a seller, each S corporation shareholder, any 80-percent purchaser, and any purchaser that holds nonrecently disposed target stock;
- (ii) The disposition date;
- (iii) The percentage of target stock that was disposed of by each seller or S corporation shareholder in the qualified stock disposition;
- (iv) The percentage of target stock that was disposed of by each seller or S corporation shareholder in the qualified stock disposition on or before the disposition date;
- (v) The percentage of target stock that was retained by each seller or S corporation shareholder;
- (vi) A statement about whether the target realized a net loss on the deemed asset sale:
 - (a) If the target realized a net loss, a statement about whether any stock of the target (or a higher-tier corporation for which a § 336(e) election was made) was distributed during the 12-month disposition period; and
 - (b) If the target realized a net loss and such a distribution was made, a statement about whether any stock of the target (or a higher-tier corporation for which a § 336(e) election was made) was actually sold or exchanged in a qualified stock disposition;
- (vii) When required, the name, address, and taxpayer identification number of each purchaser that made a gain recognition election; and
- (viii) A statement that each of the sellers or S corporation shareholders and the target have executed a written, binding agreement to make a Section 336(e) election. The old target and new target must also report the information concerning the deemed sale and purchase of the target assets, each filing a Form 8883. Because Form 8883 describes asset allocations for

a Section 338 election, appropriate adjustments must be made in completing that form to accommodate a Section 336(e) election. Note that if a Section 336(e) election is made for a qualified stock disposition to which Section 335(d)(2) or (e)(2) applies, the old target must file two Forms 8883, one in its capacity as the buyer and one in its capacity as the seller. Note that a separate Section 336(e) statement must be filed for each target subsidiary for which a Section 336(e) election is made.

The Section 338(h)(10) election is made on Form 8023 jointly by the purchasing corporation (or its common parent) or the common parent of a target subsidiary, affiliate of a nonconsolidated subsidiary or with respect to an S corporation, by unanimous consent of all S shareholders, regardless if some shareholders do not agree to sell their shares.³²⁴ The Section 338(h)(10) election must be made no later than the 15th day of the 9th month after the month in which the acquisition date occurs.³²⁵ Once made the election is irrevocable.³²⁶ Consistency rules are provided under the Section 338(h)(10) regulations.³²⁷

Allocation of Consideration for Multiple Asset Sales.

The consideration received from the sale of a going concern must be itemized into separate sales of each asset. This allocation is performed in accordance with the residual method of allocation under Section 1060. This allocation is critical not only in computing the amount of gain or loss and its character, but also in determining which part of the sale may qualify for installment sale reporting. This allocation is made on Form 8333.³²⁸

Where Target is a Corporate Parent Corporation (Not an 80% or More Corporate Subsidiary of Another Corporation).

A taxable asset sale, including deemed asset sale under Section 338(g) or Section 338(h)(10), is generally less desirable to the target, in comparison with a stock sale, because it would result in a double tax, first to the target on the sale of its assets and second to the target shareholders on the distribution of the after-tax proceeds. Deferred intercompany transactions are accelerated.³²⁹ While the purchaser may want a step-up in basis for the price paid for goodwill and other assets having a tax basis less than fair market value on the seller's books, the amortization and cost recovery allowances to the buyer will not mitigate the double tax cost to the seller.³³⁰ However, it is important for a buyer to note that in a Section

³²⁴ Reg. §1.338(h)(10)-1(c)(2).

³²⁵ Reg. §1.338(h)(10)-1(c)(3). See Rev. Proc. 2003-33, I.R.B. 2003-16 (automatic extensions). Teas. Reg. §301.9100-3.

³²⁶ Reg. §1.338(h)(10)-1(c)(3).

³²⁷ See Forms 8023, 8333, 8806, 1096 and 1099-CAP. See Temp. Reg. §1.6043-4T.

³²⁸ See *Bar-Deb Corp. v. U.S.*, 36 AFTR 2d 75-5893 (1975, Ct. Cl. Tr. Div)(failed allocation of installment obligation by seller); *Johnson v. Comm'r*, 49 TC 324 (1968)(seller may not arbitrarily allocate payment received in year of sale); *Monaghan v. Comm'r*, 40 TC 680 (1963)(consideration for inventory separated from sale of remaining assets for ISO). See Rev. Rul. 68-13, 1968-1 CB 195, amplifying Rev. Rul. 57-434, 1957-2 CB 300.

³²⁹ Reg. §1.1502-13(c)(2).

³³⁰ As to T subsidiaries, see Section 338(h)(8). Reg. §1.338-3(b)(4).

338(g) or Section 338 (h)(10), the deemed “New” T remains liable for the tax liabilities of the old T (including the tax liability for the deemed sale tax consequences). For example, New T remains liable for the tax liabilities of members of any consolidated group that are attributable to taxable years in which those corporations and Old T joined in the same consolidated return.³³¹

Mitigation of Target Corporation’s Tax Cost on Asset Sale By Presence of Favorable Tax Attributes.

A taxable asset acquisition may lighten the impact of the double tax effect where the target has net operating loss and/or capital loss carryovers which can be used to reduce taxable income on the realized gain. Any unused losses disappear and may not be used by the target unless it continues to hold back income producing assets from being distributed to the shareholders. The tax attributes of the seller, including NOLs and CNOLs, are not portable.³³²

Where Target Corporation Is An S Corporation.

The decision of whether it is more advantageous and to what extent the target should sell its assets or its stock will require consideration of four tax issues: (i) the comparison of inside (asset) basis versus outside (stock) basis; (ii) the character of gain differential between an “inside” sale versus an “outside” sale (long term capital gain); (iii) whether a corporate-level tax will be imposed because of the sale; and (iv) whether (and to what extent) the installment method of reporting is available.

Where the target has been a qualified electing small business corporation for its entire history and has not acquired the assets of a C corporation within the past 10 years in an exchanged basis transaction, then the corporate level gain from an asset sale is, for federal (and most state) income tax purposes, passed through to the shareholders and results in a single level of tax. The amount realized is allocated among the basis of the individual assets in accordance with the residual method of valuation in accordance with Section 1060 and Section 338 regulations, to the extent applicable. Allocated gain or loss is characterized by reference to the nature of the corporation’s purpose in holding the particular asset sold, e.g., depreciable real property used in a trade or business or Section 1231 property, inventory, depreciation subject to recapture, or property held for investment, including corporate goodwill.

Where the corporation has acquired assets in a C corporation in a tax-free reorganization within the past 10 years (7 years in 2009 and 2010, 5 years in 2011) and/or otherwise converted to Subchapter S during such period, there is a special corporate level tax on the corporation’s built-in gains (and losses) to the extent of such unrealized built-in gain (or loss) on the effective date of the conversion (exchange).

³³¹ See Regs. §§1.1502-6(a), 1.338(h)(10)-1(d)(2).

³³² See Section 381(a).

Avoidance of Step-Transaction Doctrine.

A fundamental, judicially-created, doctrine of Federal income taxation is the “step-transaction” doctrine which has been frequently applied in the corporate income tax area. Basically, the step transaction, which has several rules of construction or standards which the courts have each spared over with the Service, requires that in addition to the form of the transaction taken by the taxpayer, the IRS and the courts will look to the substance of the transaction in assessing its tax impacts. Therefore, where a planned or integrated series of “steps” are part of a single transaction, the steps will be collapsed in order to determine the type and consequences of the transaction.³³³ Prior to the enactment of Section 338, the long standing rule, which was the product of the step-transaction doctrine, was where a corporation purchased the stock of a target and immediately liquidated the target in order to acquire its assets, the transaction would be treated for tax purposes as an asset sale for both the buyer and the seller. This particular setting for application of the step transaction to recast a stock sale into an asset purchase, by application of Section 334(b)(2), was known as the Kimbell-Diamond doctrine.³³⁴

Enactment of Section 338.

The Kimbell-Diamond doctrine was strongly criticized by professional commentators as creating uncertainty and the prospect for possibly whipsawing an unsuspecting seller of stock into a “double-tax” asset sale. It was replaced in 1982 by Section 338 although the use Section 338 was reduced to a large extent by the 1986 repeal of the General Utilities doctrine. The (h)(10) election provision to Section 338 apparently is the main route to Section 338 unless a target has a substantial amount of loss carryovers. Under Section 338(d)(3), a Section 338 transaction requires that there be a “qualified stock purchase,” i.e., purchase of 80% or more of the target’s stock within a testing period. Still, under step transaction principles a purchase of target stock solely for stock of the acquiring corporation in an apparent Type B reorganization could be recast into a Type C reorganization if the acquiring corporation immediately caused the target to be liquidated or otherwise liquidated the target in a planned (step transaction doctrine) sequence.

Step Transaction Doctrine Broken in Section 338(d)(3) Qualified Stock Purchase.

In Rev. Rul. 90-95,³³⁵ the Service ruled that the step transaction doctrine does not apply to treat a QSP followed by the immediate liquidation of the target into the acquiring corporation as an asset purchase. The rationale for the Service’s position was that Section 338 overrode the Kimbell-Diamond doctrine.³³⁶

³³³ See Bowen, The End Result Test, 72 Taxes 722 (1994); Mintz & Kwall & Maynard, Dethroning King Enterprises, 58 Tax Law. 1 (2004); Plumb, Step Transactions in Corporate Reorganizations, 12 NYU Inst. on Fed. Tax’n 247 (1954); Murray, Step Transactions, 24 U. Miami L. Rev. 60 (1969).

³³⁴ Kimbell-Diamond Milling Co. v. Comm’r, 14 TC 74, aff’d per curiam, 187 F.2d 718 (5th Cir.), cert. denied, 342 US 827 (1951).

³³⁵ 1990-2 C.B. 67.

³³⁶ See CCA 200230026 (4/15/02).

In Rev. Rul. 2001-46,³³⁷ the Service ruled that, under certain circumstances, such as the qualification for a statutory merger under Section 368(a)(1)(A), step transaction principles apply to characterize the transaction prior to the determination of whether a QSP has been made. In such cases, Rev. Rul. 90-95 will not apply and there will be no QSP.

In July, 2003, Service issued final and temporary regulations that permit taxpayers to turn off the step transaction doctrine and to make a Section 338(h)(10) election in certain multi-step transactions, as set forth in Rev. Rul. 2001-46.³³⁸ The regulations are effective for stock acquisitions occurring on or after July 8, 2003. The notion is that where a Section 338 election is made by the parties, then the transaction will be treated as a deemed asset sale and the step transaction doctrine will not apply even though the target corporation is immediately liquidated into the acquisition subsidiary or acquiring corporation.³³⁹ If the Section 338(h)(10) election is not made, Rev. Rul. 2001-46 will continue to apply so as to recharacterize the transaction as a reorganization under Section 368(a).³⁴⁰

Redemptions of Target Stock.

Where the purchasing corporation (P) purchases less than 80% of the T stock and as part of the same transaction T redeems stock sufficient to increase P’s holdings to more than 80%, the regulations provide that redemptions from persons unrelated to P will generally count towards the 80% qualified stock purchase requirement.³⁴¹

Going Public/Section 338 Transaction.

Although beyond the scope of this outline, it is possible, at least conceptually, to use a Section 351 template to structure an asset purchase as part of an IPO transaction provided there is: (i) a binding commitment to have the target shareholders sell at least 80% of their stock; and (ii) the Section 351 transaction has a unrelated party acquiring part of the stock prior to the IPO.³⁴²

Reverse Merger of Acquiring Corporation into Target Corporation Treated as Qualified Stock Purchase.

When the acquiring corporation (or a wholly owned subsidiary of the acquiring corporation) is merged into the target corporation (a “reverse merger”) and the former shareholders of the target receive cash consideration, the transaction is treated as a qualified stock purchase eligible for treatment as a deemed asset sale under Section 338(h)(10).³⁴³ The

³³⁷ I.R.B. 2001-42.

³³⁸ See Reg. §1.338-3(c)(1)(i), (2) and Reg. §1.338(h)(10)- 1.

³³⁹ See Reg. §1.338(h)(10)-1(c)(2).

³⁴⁰ Reg. §1.338(h)(10)-1(e) Ex. 11.

³⁴¹ Reg. §1.338-3(b)(5). §1.338-3(b)(5)(ii).

³⁴² See Rev. Ruls. 79-70, 1979-1 C.B. 144 and 79-194, 1 C.B. 145. Reg. §1.338-3(b)(3)(iv), Ex. 1. See also Section 197(f)(9). See also PLR 200427001.

³⁴³ See Rev. Rul. 73-247 and 90-95, supra.

gain from the deemed asset sale is passed through to the cashed out shareholders of the S corporation.

Forward Merger of Target into Acquiring Corporation Treated as Asset Sale.

The same tax consequences resulting from a Section 338(h)(10) election may be accomplished if the target company is acquired through a forward merger of the target into the acquiring corporation, where the selling shareholders receive cash and no stock (a “cash merger”), in which event the transaction is treated as an asset sale.³⁴⁴ Similarly, the forward cash merger of the target corporation into a LLC taxable as a partnership or disregarded as an entity separate from its sole owner is treated as a deemed asset sale, with the buyer obtaining a basis in the assets equal to the purchase price. The transaction is treated as if the assets were sold by the target and the proceeds distributed to the selling shareholders in a liquidating distribution.³⁴⁵

Transfer of Target to Newco (F Reorganization) and QSub Election/Conversion of Target to Single Member LLC and Sale of Target as Alternative to Section 338(h)(10) Election.

The tax consequences resulting from a Section 338(h)(10) election may also be accomplished if the target company is transferred to new S corporation (“Newco”) and a QSub election is made for the target. Under Reg. 1.368-1(b), no continuity of interest (COI) or continuity of business enterprise (COBE) is required for an F reorganization.

Rev. Rul. 2008-18³⁴⁶ held that the new QSub retains the employer identification number of the former S corporation and there is no need for S election by the Newco.³⁴⁷ Newco, as successor to the target, continues the target’s taxable year. The QSub target is treated as a disregarded entity.

Upon the sale of the QSub, Newco recognizes and passes through to its shareholders the gain on the asset sale, similar to effect of Section 338(h)(10) but without the deemed liquidation.³⁴⁸ The purchaser is treated as purchasing the assets of the target and contributing the assets to a new corporation.

Alternatively, the target could be converted to a single member LLC treated as a disregarded entity (via a Section 332 liquidation) followed by the sale of the membership interests, treated as an asset sale for tax purposes.

³⁴⁴ Rev. Rul. 69-6, 1969-1 C.B. 104.

³⁴⁵ PLR 2006 28008 (March 28, 2006).

³⁴⁶ 2008-1 C.B. 674.

³⁴⁷ Rev. Rul. 64-250, 1964-2 C.B. 333, provides that when an S corporation merges into a newly formed corporation in a transaction qualifying as a reorganization under Section 368(a)(1)(F), and the newly formed surviving corporation also meets the requirements of an S corporation, the reorganization does not terminate the S election. Thus, the S election remains in effect for the new corporation. See also Rev. Rul. 2004-85, 2004-2 C.B. 189.

³⁴⁸ See Reg. §1.1361-5(b)(3), Example 9 providing for asset sale treatment upon the sale of the stock of a QSub.

Either of these structures may be used to avoid the risks to the buyer of an invalid S election disqualifying the transaction from Section 338(h)(10) treatment. The first structure (transfer of stock to Newco followed by QSub election for target and sale) should be accompanied by a protective Section 338(h)(10) election reflecting Newco as the seller of target. If the S election is later challenged by the Service, the target would still qualify for the Section 338(h)(10) election as the subsidiary of a C corporation parent. However, if the S election is invalid, the new target may be liable for the old target’s federal income tax liabilities, including the tax liability for the sale.³⁴⁹ In the second structure, the sale of membership interests in an LLC should be treated as an asset sale regardless of the validity of the S election of the target prior to the transaction.

Target Shareholders.

In General.

Where the proceeds of an asset sale are distributed to the shareholders then the shareholder-distributees must report income (or loss) under the distribution rules contained in Subchapter C or such portion of Subchapter S, i.e., Section 1368, which may apply. Thus, depending on the facts and circumstances, a distribution of sales proceeds will be treated as a dividend, a return of capital or capital gain.³⁵⁰ Where the distribution of sales proceeds is accomplished by redemption of part of the stock of the target corporation, the shareholder level tax treatment may be a dividend equivalent or produce sale or exchange treatment in accordance with Sections 302 and 303.³⁵¹ The acquisition could also be structured as a “bootstrap” redemption or “Zenz” redemption.

S Corporation: Allocation of Income and Deductions in Year of Sale.

Generally, the normal allocation of tax items per share per day will apply under Section 1377(a)(1). The character of the gain or loss is determined at the corporate level. The tax items of gain or loss are passed through to the shareholders with gain increasing basis (or first restoring a previously reduced basis in debt) and loss reducing basis, including debt basis under Section 1367(b). If a Section 338(h)(10) election is made, the S status of the target corporation remains in effect through the close of the acquisition date, including the time of the deemed asset sale and liquidation.³⁵²

Attention should be given to outstanding stock options that are “in the money” on the date of the sale and intended to be “cashed out” at the closing. Provided the options are exercised on the closing date, and the Section 338(h)(10) election is made, the employer deduction is passed through to the selling shareholders (rather than accruing to the buyer). The options may then be cashed out with the proceeds of the sale, subject to tax withholding. The exercise of the options do not cause the holders to be treated as owners of stock on the

³⁴⁹ See Reg. §§1.381(b)(3)(i) and 1.1502-6(a).

³⁵⁰ See also Sections 243-246, 1059.

³⁵¹ See also Section 304 (redemptions of stock through related corporation).

³⁵² Reg. §1.338(h)(10)-1(d)(3).

closing date for purposes of the pass through of the gain from the sale or any portion of the related compensation deduction.³⁵³

If no Section 338(h)(10) election is made, the compensation must be paid or accruable at least one day before the closing to ensure that the selling shareholders obtain the compensation deductions, rather than the buyer.

If buyer funds the compensation payments on behalf of the target, and the required employee payments exceed 20% of combined payments to stockholders employees, the question may arise as to whether 80% of the stock has been acquired by purchase as required for a valid Section 338(h)(10) election.³⁵⁴

Assuming cash compensation payments are made to cash out the option holders at closing, the compensation deduction would be reported on the K-1s to the selling shareholders. At the shareholder level, the compensation deduction first offsets operating income for the year, and offsets capital gain to extent it exceeds the ordinary income of a shareholder.

Impact of Installment Sales by S or C Corporation Targets.

Certain items of income realized under an installment sale are recognized in the year of sale, such as depreciation recapture and the amount of liabilities transferred in excess of adjusted basis. Certain assets, such as inventory, do not qualify for installment sale reporting. The portion of the sale allocable to depreciated assets is also outside of the scope of Section 453 and is immediately recognized in the year of such. On the balance of qualifying gain under the installment sale obligation (ISO), gain may be deferred until the year(s) in which payments are received.

Exceptions to Installment Sale Treatment In General.

Whether the seller corporation is an S (or C) corporation, a deferred payment taxable asset sale may trigger more immediate gain recognition than a stock sale would. First, under Section 453(b)(2), installment method reporting is not available on the sale of inventory or dealer dispositions. Second, under Section 453(i), recapture income is recognized in the year of sale. Third, under Section 453A, interest may be charged on nondealer installment sales (i.e., casual sales) of property used in a trade or business or held for the production of income if (i) the sales price exceeds \$150,000, and (ii) the face amount of all such obligations held by the taxpayer for the taxable year exceeds \$5 million. Fourth, a pledge of an installment obligation arising from such a sale may be treated as a payment.³⁵⁵

³⁵³ Under Examples 1 and 2 of Reg. §1.1377-1(c), the seller or issuer of stock is treated as the owner on day of the sale or issuance of the stock and the purchaser begins ownership on following date for purposes of the allocation of S corporation income.

³⁵⁴ Section 338(h)(3)(A)(i), providing for the definition of a QSP, excludes stock acquired in a Section 351 transaction from the definition of “purchase.”

³⁵⁵ See Section 453A(d).

Distribution of ISO in Complete Liquidation.

A shareholder that is a “qualifying shareholder” receiving an installment obligation in a complete liquidation (provided no “election out” is made) may treat the payments under the obligation instead of the obligation itself, as the consideration received in exchange for her stock.³⁵⁶ In order to qualify for installment reporting, the installment obligation (ISO) must: (i) be acquired in respect to a sale or exchange of the target corporation’s assets within 12 months after the corporation adopted a plan of complete liquidation; and (ii) the liquidation is completed within that 12-month period.³⁵⁷ Exception is made for installment sales of depreciable property to certain related parties, recapture items, certain sales of inventory, and ISOs attributable to certain tax avoidance transactions.³⁵⁸ The limitation on a shareholder’s use of Section 453 for reporting gain on complete liquidation for the portion attributable to inventory property is inapplicable (and therefore Section 453 reporting is permitted) if a bulk sale requirement is met.³⁵⁹

Under Section 453B(h), a distribution by an S corporation of an ISO with respect to which the shareholder is entitled to report his stock gain on the installment method is not treated as a disposition of the obligation by the S corporation. Under Section 453B(h), when a liquidating distribution includes an ISO and cash, the shareholder’s stock basis must be apportioned between the ISO and cash (and any other property) distributed, in the manner appropriate to installment reporting, rather than the upfront basis recovery otherwise contemplated under Section 331.³⁶⁰ Thus, the shareholder is allowed to report gain over the same period of years that it could have been reported if the nonrecognition rules for 12-month liquidations had not been repealed. This rule does not apply, however, with respect to the built-in gains tax or for purposes of determining the corporation’s tax liability. Thus, except for purposes of determining the tax on certain built-in gains or on passive investment income, an S corporation-distributee shareholder is also permitted to defer the recognition of gain on the distribution of a qualifying ISO in complete liquidation. As a result, gain will be recognized and taxed to the shareholders only as payments are received. Whether the sale is effectuated by a stock sale with a Section 338(h)(10) election, the same principles apply.³⁶¹

Planning Considerations—the “One Day Note.”

Unfortunately, Section 453(h) will accelerate the tax liability of the shareholders in many cases. Section 453(h), originally designed to apply to liquidating distribution from a C corporation, treats the distributed installment obligation as arising, not on the asset sale by the corporation, but rather on a sale of stock by the shareholders. Whether the liquidation of the corporation is accomplished in one year or two, the shareholder’s tax basis in the stock must be apportioned between the installment note, any cash, and any

³⁵⁶ Section 453(h).

³⁵⁷ See Section 453(h)(1)(A). Reg. §1.453-11(a)(1).

³⁵⁸ See also Reg. §1.453-11(c)(2).

³⁵⁹ Reg. §1.453-11(c)(4)(i).

³⁶⁰ Section 453(h)(1); Section 453B(h); Reg. §1.453-11(a)(3), requiring each shareholder to reasonably estimate the gain attributable to distributions received in each taxable year and the anticipated aggregate distributions. See also, Reg. §1.338(h)(10)-1(e), Ex. 13.

³⁶¹ PLR 20060317 (10/7/05).

property distributed by the corporation in the manner appropriate to installment reporting.³⁶² This method is illustrated in Reg. §1.338(h)(10)-1(e), Example (10), and contrasts with the more favorable “up front” basis recovery method that normally applies when proceeds of sale are distributed to shareholders under Section 331.

The requirement that the shareholder’s basis in the stock be allocated among all property received by the shareholder in the liquidation under Section 453B(h)(2) creates a major trap for the unwary or unadvised taxpayer. Section 453(h) will accelerate the tax liability of the shareholders receiving ISOs in liquidation of an S corporation in many cases. Section 453(h), originally designed to apply to liquidating distribution from a C corporation, treats the distributed installment obligation as arising, not on the sale of assets by the corporation, but rather on a sale of stock by the shareholders. The shareholder’s tax basis in the stock immediately before the distribution must be apportioned between the installment note, any cash, and any property distributed by the corporation in the manner appropriate to installment reporting.

This contrasts with the front end basis recovery contemplated by Section 331. As a result, the recovery of basis by the shareholder may not take place in an optimum manner. That is, less basis is allocable to any post-sale liquidating distribution of cash, therefore increasing gain recognition in the year of sale.

The adverse tax consequences to the selling shareholders of these “basis recovery” rules may be avoided if *only* installment obligations are distributed to the shareholders and no cash or property is distributed at closing. This may be accomplished by distributing any accumulated or surplus cash to the shareholders prior to the sale and liquidation, and selling the assets solely in exchange for installment notes, with no cash down payment at closing. The cash portion of the transaction can be payable a day or so later in satisfaction of the “one day note.” The stock basis allocation contemplated by Section 453(h) does not come into play. The gross profit allocated to the notes is recognized ratably as the payments are received, based on the gross profit ratio, resulting in more deferral for the taxpayer. The one day note can be backed up by a standby letter of credit or otherwise secured.³⁶³

Since the one day note strategy can be used to avoid gain recognition that would result if the S corporation is acquired with a combination of cash and an installment note, as opposed to only installment notes, the strategy may raise questions under the economic substance doctrine, as discussed further below.³⁶⁴

³⁶² See Reg. §1.453-11(a)(3)(requiring the shareholder to “reasonably estimate” the gain attributable to distributions received during the year and anticipated aggregate distributions).

³⁶³ For a further discussion of the one day note strategy, and possible legislative solutions involving the amendment of Section 453(h), see Levin & Ginsburg, *Mergers, Acquisitions and Buyouts*, ¶1108.4, Wolters Kluwer Law & Business (March, 2015).

³⁶⁴ See “Note Strategy Raises Economic Substance Concerns, Official Says” 126 Tax Notes 768 (Nov. 15, 2010).

Complete Liquidation of Target Corporation.

Where the target corporation completely liquidates as part of the acquisition, the general characterization rule at the shareholder level will be Section 331, or as to a controlling corporate distributee, will qualify for nonrecognition under Section 332.³⁶⁵

Downstream Merger.

As an alternative to liquidating the target corporation, the acquiring S corporation may merge downstream into the target, with the target surviving.³⁶⁶ If the downstream merger is made immediately after the stock acquisition, the target conceivably would not be prevented from making an immediate S election due to the existence of a transitory corporate shareholder (assuming all other requirements under Section 1362 are met). In addition, the acquiring S corporation’s election presumably would not be terminated by the transitory affiliation with target. The target could then freely elect S corporation status without Section 1362(g) applying.³⁶⁷ If the acquiring S corporation’s election terminates, Section 1362(g) will prevent a subsequent election until the close of the prescribed five-year waiting period. This strategy also had potentially adverse tax consequences with respect to the built-in gains tax and LIFO recapture provisions

Direct Asset Purchase and Liquidation.

In some instances there will be liabilities of the target, either contingent, or known or unknown, which were not assumed by the buyer. There may also be other assets that are retained to pay additional claims. In such cases, a liquidating trust may be required. In such instance, it is essential that the trust be treated as such for tax purposes and not be viewed as an association taxable as a corporation.³⁶⁸

Generally, the corporation will recognize gain or loss on the distribution of property in liquidation.³⁶⁹ Under Section 336(d)(1), the corporation is not permitted to recognize loss on the distribution of assets to a related person if the distribution is non-pro rata or the distribution consists of “disqualified property” (i.e., assets acquired in a Section 351 transaction or contribution to capital in the preceding 5 years). A second loss disallowance rule applies where a principal purpose of the transaction in which property was contributed to corporation in advance of liquidation was to recognize loss to offset corporate-level gain.³⁷⁰

³⁶⁵ At the corporate level, for in-kind distributions in liquidation, see Sections 336, 337.

³⁶⁶ See Edwards Motor Transit Co., 64,317 P-H Memo T.C. (1964).

³⁶⁷ See Rev. Rul. 64-94, 1964-1 C.B. 317.

³⁶⁸ See Reg., §301.7701- 4(d).

³⁶⁹ Section 336. Compare Section 311 for distributions of property not in liquidation.

³⁷⁰ Section 336(d)(2).

Reverse Merger of Acquiring Corporation into Target Corporation Treated as Qualified Stock Purchase.

As noted above, when the acquiring corporation (or a wholly owned subsidiary of the acquiring corporation) is merged into the target corporation (a “reverse merger”) and the former shareholders of the target receive cash consideration, the transaction is treated as a qualified stock purchase eligible for treatment as a deemed asset sale under Section 338(h)(10), provide the purchaser is a corporation.³⁷¹ The gain from the asset sale is passed through to the cashed out shareholders of the S corporation.

Forward Merger of Target into Acquiring Corporation Treated as Asset Sale.

The same tax consequences resulting from a Section 338(h)(10) election may be accomplished if the target company is acquired through a *forward merger* of the target into the acquiring corporation, where the selling shareholders receive cash and no stock (a “cash merger”), in which event the transaction is treated as an asset sale.³⁷² Similarly, the forward cash merger of the target corporation into a LLC taxable as a partnership or disregarded as an entity separate from its sole owner is treated as a deemed asset sale, with the buyer obtaining a basis in the assets equal to the purchase price.³⁷³ The transaction is treated as if the assets were sold by the target and the proceeds distributed to the selling shareholders in a liquidating distribution. This may be a preferable method for acquiring the assets of a target subsidiary to avoid technical legal issues generated through the transfer of assets and assignment of leases, contract rights, licenses, etc. In certain instances, a forward merger may qualify as a non-taxable Type A or Type C reorganization.

Forward Triangular Merger.

Same as forward merger but through use of a subsidiary, i.e., newly formed acquisition subsidiary. Where a portion of the consideration consists of stock or debt of the parent, the transaction may qualify for nonrecognition treatment.³⁷⁴ Shareholders of the target corporation may be offered the option of receiving shares of the purchasing corporation (or parent) or cash. Continuity of interest guidelines need to be addressed, i.e., % of consideration in purchasing corporation stock.

Section 338(h)(10) Election: Target C Corporation.

Where a C corporations is the seller of target subsidiary stock and both corporation are members of an affiliated group, the buyer and seller may consent to an (h)(10) election. In such instance the stock sale is treated as an asset sale followed by the (tax-free) complete liquidation of the target. The deemed sale occurs while the target is still a member of the affiliated (seller) group. In contrast, a regular Section 338 election results in the deemed sale taking place after the target stock is sold and is included in a one-day short year

³⁷¹ See Rev. Ruls. 73-247 and 90-95, *supra*.

³⁷² Rev. Rul. 69-6, 1969-1 C.B. 104.

³⁷³ PLR 200628008 (March 28, 2006).

³⁷⁴ See Sections 368(a)(1)(C), 368(a)(2)(D).

return.³⁷⁵ The benefits of the Section 338(h)(10) election include the possible avoidance by the parent (seller) of liquidation gain per Section 332. Target gain, i.e., on the deemed asset sale, can be sheltered by any favorable tax attributes of the rest of the consolidated group.³⁷⁶

Impact of State and Local Taxes.

Some (but not all) states will respect the Section 338(h)(10) election. States also vary on the computation of consolidated tax liability or may deny consolidated or combined reporting.

Section 338(h)(10) Election: Target S Corporation.

Where S corporation shareholders are sellers of target S corporation stock, the corporation and all shareholders, as well as the purchasing corporation, may elect to treat the stock sale as an asset sale for federal income tax purposes. This results in shareholder level gain or loss on the deemed liquidation. Note that the character of the gain may change significantly where the target has ordinary income assets, or recapture items and may be required to accelerate ordinary operating income in the year of the sale. There also is the gross up in the purchase price for liabilities assumed or taken subject to. Thus, in various instances, a straight up sale of stock for the equity value may produce a more favorable result to the seller shareholder(s). Regulations endorse the use of the installment sale method for Section 338(h)(10) elections made by S corporation target shareholders.³⁷⁷

CONVERSION OF TYPE OF ENTITY AND DISREGARDED ENTITIES

Overview

Over the last decade, nearly all states have enacted statutes that allow business entities to convert from one type of entity to another type of entity by merely filing a form (such as articles of conversion) with the state (state law formless conversion statutes). Additionally, during this same time, many states have also enacted statutes allowing one type of business entity to merge into a different type of business entity, such as the merger of a corporation into an LLC (state law cross-entity merger statutes). The effect of such statutes is that title to the assets of the entities is automatically owned by the converted or surviving entity, and correspondingly liabilities automatically become liabilities of the converted or surviving entity.

Additionally, since the issuance of the “check-the-box” regulations in 1997, eligible entities have been able to select their classification for federal income tax purposes by simply “checking the box.”

³⁷⁵ Section 338(h)(9).

³⁷⁶ See PLR 9142013 (parent’s contribution of stock of two wholly-owned subsidiaries to a newly formed subsidiary (Newco) followed by parent’s prearranged sale of Newco stock to a third party (acquiror) constituted a broken Section 351 transaction and a qualified stock purchase of Newco shares such that parent and acquiror could join in making a Section 338(h)(10) election).

³⁷⁷ Reg. §1.338(h)(10)-1(d)(8).

These state law formless conversion statutes, cross-entity merger statutes and the check-the-box regulations can have significant non-tax and state tax law advantages, including:

1. the possible avoidance of non-transferability, acceleration, due on sale, and similar clauses contained in various contracts;
2. avoiding application of transfer fees, sales taxes, documentary stamp taxes, etc.; and
3. simplicity.

However, the ease of converting an entity from one type of entity to another type under state law formless conversion statutes, state law cross-entity merger statutes and the check-the-box regulations can present significant tax pitfalls and a trap for the unwary as a result of the federal tax consequences resulting from changing the tax classification of the entity for federal income tax purposes.

Change of a Sole Proprietorship or Disregarded Entity into an Association Taxable as a Corporation

In General.

One of the simplest types of changes in entity status is the incorporation of a sole proprietorship. This may be achieved by actual incorporation of a sole proprietorship, the filing of a Form 8832, Entity Classification Election, for a disregarded entity (such as a single-member LLC) to be treated as an association taxable as a corporation (or by simply filing a Form 2553, Election by a Small Business Corporation, which is treated as a deemed election for a single-member LLC to be taxed as an association), the conversion of a single-member LLC treated as a DE into a corporation under the applicable state law formless conversion statute, or the merger of a single-member LLC treated as a DE into a corporation under the applicable state law cross-entity merger statute. Whether achieved by actual incorporation of the sole proprietorship, filing an election under Section 8832 for a single-member LLC to be taxed as an association (or the filing of a Form 2553), the conversion of a single-member LLC into a corporation under the applicable state law formless conversion statute or the merger of a single-member LLC treated as a DE into a corporation under the applicable state law cross-entity merger statute, the tax consequences to the individual and the corporation should be the same.

General Incorporation Rules.

Recognition of Gain or Loss to Shareholder.

Under the general rule of Section 351(a), no gain or loss is recognized if *property* is transferred to a corporation by one or more persons *solely in exchange for stock* in such corporation and *immediately after the exchange* such person or persons are in *control* of the corporation.

The general non-recognition rules of Section 351 will not apply if the new corporation constitutes an “investment company” under Section 351(e).

A corporation may be classified as an “investment company” if more than 80% of its assets are held for investment and constitutes stock, securities, money, etc.³⁷⁸

Even if the 80% test is met, the company will not be classified as an “investment company” unless it results in “diversification.” Diversification does not occur if each of the transferors conveys identical assets to the newly organized corporation. Additionally, diversification does not occur if not more than 25% of the portfolio of stock and securities conveyed by each transferor constitutes stock and securities of any one issuer, and not more than 50% of such portfolio is in the stock and/or securities of five or fewer issuers.³⁷⁹

Receipt of Boot.

If any cash or “other property” is received in connection with an incorporation, the transaction will not be disqualified from non-recognition treatment under Section 351(a), however, gain (the excess, if any, of the fair market value of the stock and other consideration received over the basis of the transferred assets) realized in the transaction will be recognized to the extent of any such cash or “other property” (i.e., “boot”) received. Specifically, Section 351(b) provides that if Section 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under Section 351(a), other property or money, then gain to such recipient will be recognized but not in excess of the amount of money received, plus the fair market value of such other property received. Section 351(b)(2) provides that if a transferor receives boot, no loss may be recognized by the recipient.

Rev. Rul. 68-55,³⁸⁰ provides that in determining gain recognized under Section 351(b)(1), where several assets are transferred, each asset must be considered transferred separately in exchange for a portion of each category of consideration received. Each category of consideration received by the transferor is separately allocated to the transferred assets in proportion to their relative fair market values.

If a loss is realized with respect to any particular asset, it will not be recognized under Section 351(b)(2).

Property Requirement.

Section 351(d) provides that for purposes of Section 351, stock issued for: (1) services, (2) indebtedness of the transferee corporation which is not evidenced by a security; or (3) interest on indebtedness of the transferee corporation which is accrued on or after the beginning of the transferor’s holding period for the debt, is *not* considered as issued in return

³⁷⁸ Sections 351(e)(1)(A) and (B), and Reg. §§1.351-1(c)(1)(ii), (iii) and (iv).

³⁷⁹ Section 368(a)(2)(F)(i) and Reg. §§1.351-1(c) (1)(ii)(5), (6) and (7).

³⁸⁰ 1968-1, C.B. 140.

for property. Under such circumstances, ordinary income could be realized to the extent that any stock received in the transaction is not attributable to the contribution of “property.”

Liabilities.

General Rules.

Under the general rule of Section 357(a), if the taxpayer receives property which is permitted to be received under Section 351 without the recognition of gain if it were the sole consideration, and as part of the consideration, another party to the exchange assumes the liability of the taxpayer, then such assumption will *not* be treated as money or other property, and will *not* result in the recognition of gain except as provided below.

Liabilities in Excess of Basis.

Under Section 357(c), to the extent that the aggregate amount of liabilities assumed by the corporation (or liabilities to which the assets received by the corporation in the transaction are subject) exceeds the adjusted basis of the assets transferred to the corporation, gain is recognized.

“Nasty Purpose Liabilities.”

Under Section 357(b), if, taking into consideration the nature of the liability and the circumstances in light of which the arrangement for the assumption was made, it appears that *the* principal purpose of the taxpayer with respect to the assumption of the liability was to avoid federal income tax on the exchange, *or* was not a bona fide business purpose, then such assumption (in the total amount of the liability assumed pursuant to the exchange) will, for purposes of Section 351, be considered as money received by the taxpayer on the exchange.

Control.

Another requirement that must be met for the nonrecognition rules of Section 351 to apply is that the transferors of the property to the corporation must be in “control” after the transaction. Section 368(c) defines the term “control” to mean the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. An example of where this test would not be met is where even though the sole proprietor or individual owner of the disregarded entity receives the requisite ownership “immediately after the exchange,” there is a plan to transfer stock to non-transferors as part of the same transaction. Three tests are primarily used to determine whether the transferors have control of the corporation “immediately after the exchange”:

Binding Commitment Test.

The binding commitment test is relatively straight forward. If, at the time the parties commence the first transaction, they are under a binding commitment to

undertake the subsequent transactions, then all transactions will be integrated into one transaction.

Mutual Interdependence Test.

This test has been articulated as being the question of whether “the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.”

End Results Test.

Under the end results test, the IRS looks to whether the parties intended in the beginning to achieve a particular result, and whether the separate steps were merely entered into as a means of achieving that result.

Basis for Stock.

Under Section 358(a)(1), in the case of an exchange to which Section 351 applies, the basis of the stock received by the transferor is the same as the basis of the property exchanged: (a) decreased by the fair market value of any other property and money received by the taxpayer; (b) decreased by the amount of loss to the taxpayer which was recognized on the exchange; and (c) increased by the amount of gain to the taxpayer which was recognized on such exchange (a “substituted basis”).

Holding Period for Stock.

The holding period for the stock received in the exchange will receive “tacking” of the holding period of any assets transferred to the corporation, provided, however, ordinary income assets (assets other than a capital asset as defined in Section 1221 or property described in Section 1231) are not entitled to tacking and the holding period for the stock begins on the date following the date of the exchange.³⁸¹

Nonrecognition of Gain or Loss to Corporation.

Under Section 1032(a), no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation.

Basis of Property Contributed to Corporation.

Under Section 362(a)(1), the basis of property contributed to a corporation in a transaction to which Section 351 applies is equal to the basis of the assets in the hands of the transferor, increased by the amount of gain recognized to the transferor on such transfer (a “carryover” or “transferred” basis).

³⁸¹ Section 1223(1).

Holding Period of Property Contributed to Corporation.

Since the assets will have a “carryover” or “transferred” basis to the transferee corporation, Section 1223(2) allows the transferee corporation to tack on the transferor’s holding period for the contributed assets.

Tax Consequences to the Shareholder.

Recognition of Gain or Loss to Shareholder.

Subject to the rules discussed above regarding the receipt of boot, the “property” requirement, liabilities in excess of basis and “nasty purpose” liabilities and the control requirement, under Section 351(a), no gain or loss is recognized to the shareholder if property is transferred to a corporation solely in exchange for stock in such corporation and immediately after the exchange such person is in control of the corporation.

Basis of Stock to Shareholder.

Under Section 358(a)(1), the shareholder will generally receive a “substituted basis” (i.e., a basis equal to his basis in the property transferred to the corporation) for his stock in the corporation, decreased by the fair market value of any other property or money received by the shareholder, decreased by the amount of loss to the shareholder recognized on the exchange and increased by the amount of any gain to the taxpayer which was recognized on the exchange.

Holding Period of Stock.

The shareholder’s holding period for the stock received will include shareholder’s holding period for any assets transferred to the corporation other than ordinary income assets.

Tax Consequences to the Corporation.

Nonrecognition of Gain or Loss to Corporation.

Under Section 1032(a), no gain or loss will be recognized by the corporation on the receipt of money or other property in exchange for stock of the corporation.

Basis of Property Contributed to the Corporation.

Under Section 362(a)(1), the corporation will generally receive a “carryover” or “transferred” basis in the assets the shareholder transferred to the corporation, increased by the amount of any gain recognized by the shareholder on the transfer.

Holding Period of Property Contributed to Corporation.

Under Section 1223(2), the corporation should be allowed to tack on the shareholder’s holding period for the contributed assets.

Other Considerations.

Employer Identification Number.

In the case of the incorporation of a sole proprietorship, a new employer identification number will need to be obtained for the corporation. In the case of an election by a disregarded entity such as a single-member LLC to be treated as an association taxable as a corporation, the conversion of a disregarded entity into a corporation under the applicable state law formless conversion statute, or the merger of a disregarded entity into a corporation under the applicable state law cross-entity merger statute, if the disregarded entity had an employer identification number prior to the transaction, then the corporation would use that number; otherwise, the corporation must obtain a new employer identification number.

S Corporation.

Election of S Status.

Regardless of whether the transaction involves the incorporation of a sole proprietorship, the election by a disregarded entity under the check-the-box regulations to be treated as an association taxable as a corporation, the conversion of a disregarded entity such as a single-member LLC under the applicable state law formless conversion statute, or the merger of a disregarded entity into a corporation under the applicable state law cross-entity merger statute, if the corporation desires to be taxed as an S corporation, an S election will need to be filed for the corporation within two months and fifteen days of the incorporation, election to be treated as a corporation, conversion or merger, as the case may be.³⁸²

Deemed Election as Association by Filing Form 2553.

An eligible entity that timely elects to be an S corporation under Section 1362(a)(1) is treated as having made an election to be classified as an association, provided that (as of the effective date of the election under Section 1362(a)(1)), the entity meets all other requirements to qualify as a small business corporation under Section 1361(b). Subject to Reg. § 301.7701-3(c)(1)(iv), the deemed election to be classified as an association will apply as of the effective date of the S corporation election and will remain in effect until the entity makes a valid election under Reg. § 301.7701-3(c)(1)(i) to be classified as other than an association.

From QSub to Association Taxable as a Corporation - Termination of QSub Election

³⁸² Sections 1362(a) and (b).

The termination of a QSub election is effective: (a) on the effective date contained in the revocation statement if a QSub election is revoked; (b) at the close of the last day of the parent S corporation’s last taxable year as an S corporation if the parent’s S election terminates; or (c) at the close of the day on which an event occurs that renders the subsidiary ineligible for QSub status.³⁸³

In the event of a termination of the QSub’s election, the corporation is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the S corporation in exchange for stock of the new corporation immediately before the termination.³⁸⁴ Without specifically providing that there is a deemed Section 351 transaction, Reg. §1.1361-5(b)(1) provides that the tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Code and general principles of tax law, including the step transaction doctrine. The sale of 100% of the stock of a QSub is treated as the sale of the assets of the QSub followed by a Section 351 transfer of the assets to a new corporation by the purchaser (or purchasers).³⁸⁵

Prior to the 2007 Act, it was necessary to consider the control requirement (80% transferor group) in Section 368(c) for the termination of a QSub election, for example upon the sale of some or all of the shares, as well as assessing the potential impact of Section 357(c) and the other potential exceptions to tax free treatment. Under the 2007 Act, if a QSub election terminates because some or all of the QSub stock is sold, the sale is treated as a sale of an undivided interest in the assets of the QSub followed by a deemed Section 351 transfer of the assets to the new corporation by the purchaser (and the seller to the extent of any unsold shares).³⁸⁶

If a QSub election terminates because the S corporation distributes its QSub stock to some or all of its shareholders in a transaction which qualifies under Section 368(a)(1)(D) and Section 355, then the Section 351 model will yield to the greater transaction (per step transaction). Reg. §1.1361-5(b)(2) provides that any loss or deduction disallowed under Section 1366(d) with respect to a shareholder of the parent S corporation immediately before the distribution will be allocated between the parent S corporation and the former QSub with respect to each shareholder. The amount allocated to the parent S corporation will bear the same ratio to each item of disallowed loss or deduction as the value of the shareholder’s stock in the parent S corporation bears to the total value of the shareholder’s stock in both the parent S corporation and the former QSub, determined immediately after the distribution.

A termination of QSub status may result through a revocation by the parent or a consequence of transferring a single share of subsidiary stock to a shareholder or third party. More specifically, Section 1361(b)(3)(c) provides that a upon termination, the QSub is

³⁸³ See Reg. §1.1361-5(c).

³⁸⁴ Section 1361(b)(3)(C).

³⁸⁵ Reg. §1.1361-5(b)(1)(i), -5(b)(3)-Example 9.

³⁸⁶ Section 1361(b)(3)(C)(ii), added by Section 8234(a)(1)-(2) of the 2007 Act. This amendment to the Code makes Example 1 of Reg. §1.1361-5(b)(3) obsolete (providing that the sale of 21% of the stock of a QSub does not qualify under Section 351 because immediately after the transfer, the selling S corporation is not in control of the QSub within the meaning of Section 368(c)). The regulations have not been updated to reflect the statutory change.

treated as a new corporation acquiring all of its assets and assuming all of its liabilities from the S corporation parent in exchange for its stock. The former QSub is prohibited from re-electing S status or QSub status for 5 years unless permission is received from the Service.³⁸⁷ The final regulations provide some relief. For S and QSub elections effective after 1996, where a QSub election terminates, the corporation may, without obtaining IRS consent, make an S election or be subject to a new QSub election prior to the end of the five year waiting period provided: (i) immediately following the termination, the corporation (or its successor) is otherwise eligible to make an S election or be subject to a QSub election, and (ii) the relevant election is made effective immediately following the termination of the QSub election.³⁸⁸

Example: Assume X, an S corporation, owns 100% of Y, a QSub and distributes all of its Y stock to X shareholders. The distribution terminates the corporation’s QSub election.³⁸⁹ Assuming Y is otherwise eligible to elect S, Y’s shareholders may elect S status without IRS consent within the 5 year period. The same result applies were X to instead sell 100% of its Y stock to an unrelated S corporation, Z, where Z intends to make a QSub election effective on the date of the acquisition.

Rev. Rul. 2004-85³⁹⁰ addresses whether a QSub election terminates when the QSub is transferred pursuant to a reorganization under Section 368. In a Section 368(a)(1)(F) transaction where an S corporation merges into a sister S corporation (having identical stock ownership), the QSub election for a QSub owned by the merging S corporation does not terminate. However, in transactions qualifying as reorganizations under Sections 368(a)(1)(A), (C) or (D), a QSub election for a subsidiary that is transferred as part of the transaction to an acquirer S corporation will terminate as of the date of transfer unless the acquirer S corporation makes a QSub election for the subsidiary effective immediately following the termination. If this new election is not made effective immediately following the termination, the subsidiary will not be eligible to be treated as a QSub or as an S corporation before the expiration of the waiting period under Section 1361(b)(3)(D).³⁹¹

The final regulations provide that the effective date of a QSub termination is: (i) on the effective date contained in the revocation statement if a QSub election is revoked under Reg. §1.1361-3(b); (ii) at the close of the last day of the parent’s last taxable year as an S corporation if the parent’s S election terminates under Reg. §1.1362-2; or (iii) at the close of the day on which a disqualification event occurs that results in the QSub not being described under Section 1361(b)(3)(B).³⁹²

Example: A terminates its S election effective on January 1, 2006. A wholly owned QSub B no longer qualifies as a QSub at the close of December 31, 2006.

³⁸⁷ Section 1361(b)(3)(D). See Reg. §1.1361-5.

³⁸⁸ Reg. §1.1361-5(c)(2).

³⁸⁹ See also Sections 368(a)(1)(D), 355, 311.

³⁹⁰ 2004-33 I.R.B. 189.

³⁹¹ See also Rev. Proc. 2004-49, 2004-33 I.R.B. 210, for certain relief for late elections in this context.

³⁹² Reg. §§1.1361-5(a)(1),-5(a)(2)(information required to be filed upon failure to qualify as QSub).

Example: A sells 1 share of its QSub B on December 10, 2006. B is no longer a QSub at the close of December 10, 2006.

Example: A has a QSub election for B and C while B owns 100% of C. B transfers all of its C stock to A. No termination occurs since A is already treated as owning all of the C stock through B.

Example: A, an S corporation owns 100% of B a QSub. Z, the common parent of a consolidated group purchases 80% of the stock of A on June 1, 2006. Z does not make a Section 338 election. A’s S election terminates its election as of the close of the preceding date, May 31, 2006. The QSub election for B is also terminated as of the close of May 31, 2006. Pursuant to Reg. §1.1502-76(b)(1)-(ii)(A)(2), A and B become members of Z’s consolidated group as of the start of June 1, 2006. If instead of purchasing 80% of A, Z purchased 80% of B, A’s QSub election terminates as of the close of June 1, 2006 and B becomes a member of the consolidated group at such time.

Under the final regulations, where a tier of QSubs have their elections terminated on the same day, the formation of any higher tier subsidiary is deemed to have occurred prior to the formation of a lower tier subsidiary, a so-called “top to bottom” approach.³⁹³

From QRS to Association Taxable as a Corporation; TRS Election.

If a QRS ceases to meet the requirements to be a QRS, or upon an election to be treated as a taxable REIT subsidiary (“TRS”), the former QRS will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the REIT parent in exchange for stock.³⁹⁴ The deemed transfer of assets to a new corporation will qualify for nonrecognition if the requirements of Section 351 are satisfied, similar to the termination of a QSub election.

Changing a Corporation into a Sole Proprietorship or a Disregarded Entity (Single-Member Limited Liability Company)

In General.

As opposed to an “incorporation” transaction such as the incorporation or conversion of a sole proprietorship or partnership into a corporation, the changing of a corporation or association taxed as a corporation into a sole proprietorship (or a partnership as will be discussed below), constitutes a “de-incorporation” transaction, which will *result in a taxable liquidation of the corporation*. One of the simplest types of de-incorporation transactions is the changing of a corporation into a sole proprietorship or single-member LLC treated as a disregarded entity for tax purposes.

As with the incorporation transactions discussed above, the change in entity status can be achieved by the actual liquidation of the corporation or the actual liquidation of an

³⁹³ Reg. §1.1361-5(b)(1)(ii).

³⁹⁴ Section 856(i)(3).

LLC which elected to be treated as an association taxable as a corporation, the conversion of a corporation into a single-member LLC (which does not elect to be treated as an association taxable as a corporation) under the applicable state law formless conversion statute, the merger of the existing corporation into a single-member LLC (which does not elect to be treated as an association taxable as a corporation) under the applicable state law merger statute, or for an eligible entity such as an LLC which has previously elected to be treated as an association taxable as a corporation, the filing of a Form 8832, Entity Classification Election, to change the status of the entity from an association taxable as a corporation to a disregarded entity.

Whether achieved by a simple liquidation of the corporation to the sole shareholder who will operate the business as a sole proprietorship or form a new single-member LLC to operate the business, the conversion of a corporation into a single-member LLC under the applicable state law formless conversion statute for which an election is *not* made to treat the single-member LLC as an association taxable as a corporation, the merger of a corporation into a single-member LLC under the applicable state law merger statute where no election is made to treat the single-member LLC as an association taxable as a corporation, or the filing of a Form 8832 election for a change in classification of an eligible entity such as a single-member LLC which previously elected to be treated as an association taxable as a corporation to be treated as a disregarded entity, the tax consequences to the corporation and the shareholder should be the same.

Tax Consequences to the Corporation.

Recognition of Gain or Loss.

Under the general rule of Section 336, the corporation will be treated as distributing all of its assets and liabilities to its sole shareholder in complete liquidation of the corporation. Specifically, Section 336(a) provides that the corporation will be treated as if its property were sold to the distributee at its fair market value.

Treatment of C Corporation Versus S Corporation.

Any gain or loss realized under Section 336 will be recognized at the corporate level if the corporation is taxed as a C corporation, but generally will not be subject to taxation at the corporate level if the corporation is an S corporation. Rather, such gain or loss will be passed through to the shareholders of the S corporation under Section 1366, and in turn increase their bases in the S corporation under Section 1367. However, if the S corporation is subject to the built-in gain tax imposed under Section 1374, the deemed sale of the property could trigger built-in gain tax at the corporate level.

Beware of Section 1239.

Because Section 336(a) provides that the property is treated as sold to the distributee at its fair market value, any gain attributable to depreciable property distributed to a shareholder owning more than 50% of the stock of the corporation may be subject to ordinary income, rather than capital/Section 1231 gain. Although this may not be important in the C corporation context since C corporations do not enjoy special capital gain rates,

Section 1239 can have a significant impact on S corporations since the gain would flow through to the shareholders as ordinary income rather than as capital gain, and could cause a mismatching of ordinary income against capital loss. This poses a significant trap for the unwary.

Deductibility of Loss on Liquidation.

The corporation, whether a C or S corporation, will be allowed to deduct any losses on the deemed sale (to the extent the adjusted tax basis to the corporation of its assets exceeds the fair market value of such assets at the time of the distribution), with the following exceptions:

(i) Under Section 336(d)(1), no loss will be allowed on distributions to a more than 50% shareholder, unless the distribution is pro rata and the property was not acquired in a tax-free contribution transaction during the preceding 5-year period.

(ii) Under Section 336(d)(2), the IRS could disallow a loss on previously contributed property if “a” principal purpose of the contribution of that property was to recognize loss in connection with the liquidation.

Tax Consequences to the Shareholder.

Recognition of Gain or Loss.

In addition to corporate-level gain or loss, under Section 331(a), the shareholder will recognize gain or loss to the extent the fair market value of the assets distributed to the shareholder exceeds such shareholder’s basis in the stock of the corporation or loss to the extent the shareholder’s adjusted tax basis in the stock of the corporation exceeds the fair market value of the property distributed to the shareholder. Any shareholder-level gain will constitute capital gain or loss if the shareholder has held his stock for more than one year.³⁹⁵

C Corporation Versus S Corporation.

Although both C corporation and S corporation shareholders will recognize gain or loss at the shareholder level, there should generally only be one level of tax in the event the corporation is an S corporation because any gain recognized at the corporate level under Section 336 will pass through to the shareholder under Section 1366(a) and increase such shareholder’s basis in his stock under Section 1367(a). Note, however, if ordinary income is triggered at the corporate level, by reason of gain from inventory, depreciation recapture or the application of Section 1239, as discussed above, any capital loss recognized at the shareholder level may not offset the ordinary income passed through to the shareholder under Section 1366. Under Section 1211(b), in the case of a taxpayer other than a

³⁹⁵ Section 1222.

corporation, losses from the sale or exchange of capital assets are allowed only to the extent of the taxpayer’s capital gains plus up to \$3,000 of ordinary income per year.

Qualified Subchapter S Trusts.

Another possible mismatching of gain and loss could occur in the case of the sale of S corporation stock by a qualified subchapter S trust (QSST), if the gain passing through from the S corporation is taxable to the current income beneficiary, whereas the loss on liquidation is taxable to the trust itself. However, the IRS has made it clear that both the loss and the corresponding gain in such situations should be reported by the QSST.³⁹⁶

From Corporation to QSub Status – the QSub Election.

Once effective, the QSub election requires that the assets, liabilities, tax items, tax history, etc., of the QSub are treated as directly owned and realized by the S corporation parent for federal income tax purposes. All intercompany transactions presumably will be eliminated for federal tax purposes.³⁹⁷ A similar rule is contained in Section 856(i), permitting a REIT’s ownership of a 100% subsidiary. As to the QSub, it would no longer add/subtract to its tax history, e.g., earnings and profits, AAA, etc., during the applicable period. There is a carryover of tax basis, which in turn triggers application of Section 1374 with respect to transferred basis assets.³⁹⁸ Where the subsidiary uses the LIFO method of inventory accounting, the making of the QSub election triggers the four year LIFO recapture rule. For state law purposes, the QSub is still recognized as a separate legal entity.³⁹⁹

Final regulations to the QSub rules were issued on January 25, 2000.⁴⁰⁰ The final regulations generally apply to taxable years that begin on or after January 20, 2000; however, taxpayers previously could have elected to apply the regulations in whole, but not in part (aside from those Sections with special dates of applicability), for taxable years beginning on or after January 1, 2000, provided the corporation and all affected taxpayers apply the regulations in a consistent manner. To make the election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. The rules relating to the treatment of banks apply to all taxable years beginning after December 31, 1996.⁴⁰¹

Ownership of QSub Through Disregarded Entities. A corporation may be a QSub even if all its stock is not actually owned by an S corporation, as long as all of its stock is treated as owned by an S corporation for federal income tax purposes. Therefore, an S corporation can make a QSub election for a subsidiary which it owns through other entities that are “disregarded” for federal income tax purposes.

³⁹⁶ See PLR 9721020 (Feb. 20, 1997), which provides that if an S corporation liquidates, the trust should report both (a) the Section 331 gain or loss on the stock; and (b) the Section 336 gain or loss that passes through from the corporation. See also PLR 201232003 (Aug. 10, 2012) and PLR 19992007.

³⁹⁷ See S. Rept. No. 104-281, 104th Cong., 2d Sess. 54-55 (1996).

³⁹⁸ Section 1374(d)(8).

³⁹⁹ See IRS Notice 97-4, Reg. §1.1361-4.

⁴⁰⁰ 65 FR 3843.

⁴⁰¹ Reg. §1.1361-4(a)(3)(iii).

Debt, Options and Other Instrument and Arrangements Involving QSubs. While the parent electing QSub must own all of the stock of the subsidiary, the question is whether there is any disguised equity floating around the QSub orbit through the issuance of debt, options or other arrangements held by third parties which would violate the QSub rules.⁴⁰² The Proposed Regulations did not provide any bright line rules or safe harbors. Instead, general federal tax principles are to be applied, including the safe harbors for options and straight debt instruments under Subchapter S. Instead, the amorphous set of 14 factors would be used to make this determination.⁴⁰³

In response to criticism of the rule applying general tax principles for determining if the parent owns all of the QSub stock, the final regulations adopt the position that arrangements that are not considered to be stock under the one class of stock rules set forth in Reg. §1.1361-1(l) will be disregarded. Commentators recommended that, for purposes of determining whether a subsidiary is wholly owned by the parent S corporation, arrangements that are not considered to be stock under the one-class-of-stock rules of Reg. §1.1361-1(l) should be disregarded. The final regulations provide a straight debt safe harbor if the obligation would meet the requirements under Reg. §1.1361-1(l)(5).⁴⁰⁴ The commentators noted that applying the principles of these regulations would provide certainty with respect to the subsidiary’s eligibility to be a QSub and avoid difficult debt/equity determinations. Similar relief is provided for deemed exercise of an option under Reg. §1.1504-4.⁴⁰⁵ An example of the use of straight debt to maintain QSub status is provided in Reg. §1.1361-2(d).

Election of QSub Status. Section 1361(b)(3) requires that an S corporation must file a QSub election for each applicable subsidiary otherwise the subsidiary will be treated as a C corporation. The election mechanics are set forth in Reg. §1.1361-3 which generally follows the rules set forth in the proposed regulations including the provision that a QSub election may be made by the S corporation parent at any time during the taxable year. The election form, which is still to be prescribed by the IRS, must be signed by the appropriate officer of the corporation under Section 6037. The election is filed with the Service center where the subsidiary filed its most recent tax return, or if a newly organized subsidiary, where the S corporation parent filed its most recent return.⁴⁰⁶ The QSub election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. For this purpose, the definition of the term “month” found in Reg. §1.1362-6(a)(2)(ii)(C) applies. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the

⁴⁰² See Reg. §1.1361-1(l)(4)(ii)(B), (iii)(B), (iii)(C)(safe harbor rules for certain debt and option arrangements).

⁴⁰³ See Plumb, “The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal,” 26 Tax L. Rev. 369 (1971).

⁴⁰⁴ Reg. §1.1361-2(b)(2), -2(c).

⁴⁰⁵ See Reg. §1.361-4(a)(2)(v).

⁴⁰⁶ Reg. §1.1361-3(a)(2).

date it is filed. The final regulations further acknowledge that relief is available under the 9100 regulations for a late filing.⁴⁰⁷

An S corporation may revoke a QSub election under Section 1361 by filing the appropriate statement with the service center where the S corporation’s most recent tax return was properly filed. The revocation of a QSub election, provided the QSub election has not otherwise terminated for eligibility reasons, is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified.⁴⁰⁸ The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

Reg. §1.1361-5 provides that an extension of time to make a QSub election may be available under the late election relief rule in Reg. § 301.9100 by filing a request with the National Office explaining the reason for the failure.⁴⁰⁹ The final regulations acknowledge that 9100 relief is available for late QSub elections.⁴¹⁰

Rev. Proc. 98-55⁴¹¹ contains relief provisions for late-filed QSub elections. The Revenue Procedure applies only to a corporation (i) for which a timely QSub election under Section 1361(b)(3)(B) was not filed for the desired effective date, (ii) for which a QSub election is filed within 12 months of the date that an election for the desired effective date should have been filed, and (iii) for which the due date for the S corporation’s tax return (excluding extensions) for the first taxable year for which the S corporation desired QSub status for the subsidiary has not passed. The procedural requirements for this relief are as follows. Within 12 months of the due date for filing a QSub election to be effective on the desired effective date (but in no event later than the due date for the S corporation’s tax return (excluding extensions)) for the first taxable year of the S corporation for which the S corporation intended to treat the subsidiary as a QSub), the corporation must file with the applicable service center a completed QSub election. The QSub election must state at the top the form “FILED PURSUANT TO REV. PROC. 98-55.” Attached to the form must be a statement explaining the reason for the failure to file a QSub election within the time period required for the desired effective date.⁴¹²

Rev. Proc. 2003-43,⁴¹³ in superseding the earlier Rev. Proc. 98-55, *supra*, provides for making a late QSub election within 2 years of its original due date by filing the form with the service center in the normal manner, but with a statement of reasonable cause attached.

⁴⁰⁷ Reg. §1.1361-3(a)(6).

⁴⁰⁸ Reg. §1.1361-2(b)(2).

⁴⁰⁹ See PLRs 9834010, 9828025, 9827029 (granting late filed QSub elections).

⁴¹⁰ Reg. §1.1361-1(a)(6).

⁴¹¹ 1998-46 I.R.B. 27.

⁴¹² See also Rev. Proc. 97-48, 1997-43 I.R.B. 19, 97-40, 1997-33 I.R.B. 50.

⁴¹³ 2003-1 C.B. 998.

If the two-year period has passed, an S corporation may seek 9100 relief by filing a private letter ruling request with the National Office of the Service.⁴¹⁴

While an S corporation can obtain relief for a defective election under Subchapter S in Section 1362(f), neither the QSub provision, nor the regulations had set forth a specific rule providing relief in this area. The proposed regulations indicated that the Service would allow for an inadvertent termination of QSub status.

Example: A, the S corporation parent of B, inadvertently transfers one share of B stock to another person causing the QSub election to terminate. B is not eligible to have a QSub election in effect for the period during which the parent does not own 100 percent of its stock. If the QSub election terminates because of the inadvertent termination of the parent’s S election, however, relief may be available under Section 1362(f). A favorable determination under that Section causes the subsidiary to continue to satisfy the requirements of Section 1361(b)(3)(B)(ii) during the period when the parent is accorded relief for inadvertent termination of its S election. The final regulations do not include the provision relating to the inadvertent termination of a QSub election. Despite its refusal to provide relief, the Treasury indicated that the provision is not intended to suggest that relief under Section 1362(f) is not available in appropriate circumstances.

As a result of the amendment to Section 1362(f) under the 2004 Act, relief is now provided for defective QSub elections provided there are adequate grounds for establishing relief.

The 2005 Act provides that a QSub is a separate entity for purposes of making information returns, except to the extent otherwise provided by the Secretary. In other words, Treasury and the IRS have the authority to treat a QSub as a disregarded entity for purposes of information returns; the 2004 Act had mandated separate entity treatment for information return purposes.

The final regulations confirm the rule set forth in the proposed regulations which provide that a QSub election can be effective at any time during its tax year as long as the QSub eligibility requirements are satisfied at the time that the election is made and for all periods for which the election is to be effective.⁴¹⁵

Tax Treatment Of QSub Election. Although the relevant statutory language does not specifically provide, the QSub election is treated as a deemed liquidation of a wholly owned subsidiary into its electing S corporation parent.⁴¹⁶ Under Section 337, no gain or loss is generally recognized by the liquidating subsidiary. Similarly, no gain or loss is recognized by the parent.⁴¹⁷ In accordance with Section 381, the S corporation parent will succeed to the QSub’s entire tax history as well as the adjusted basis in its assets. Where the subsidiary

⁴¹⁴ Reg. §1.1361-3(a)(6).

⁴¹⁵ Reg. §1.1361-3(a)(3); Reg. §§1.1361-3(a)(2), -3(a)(3).

⁴¹⁶ See Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted by the 100th Cong., *supra*.

⁴¹⁷ Section 332.

has been a C corporation, the liquidation will cause the parent S corporation to become subject to the built-in gains tax under Section 1374 with respect to the target’s assets. If the target C corporation used the LIFO method of inventory accounting, the special recapture rule in Section 1363(d) comes into play. Post-QSub election problems may also be attributable to inheriting the target’s C earnings and profits. Obviously, such will have an impact on characterizing post-QSub election distributions by a parent S corporation to its shareholders.⁴¹⁸ Where there is a significant amount of passive investment income, the carryover of the target’s earnings and profits may result in an entity level tax under Section 1375 and/or eventually pose a termination risk under Section 1362(d)(3).

Although Section 1361(b)(3) allows the Service to issue regulations to make exceptions to the general rule disregarding a QSub’s separate status for federal tax purposes, the proposed regulations provided only one exception for banks described in Section 581. Final Reg. §1.1361-4(a)(3)(i) provides that for any QSub that is a bank, all of its assets, liabilities and items of income, deduction and credit, determined in accordance with the special bank rules, are treated as being the assets, liabilities, etc., of the S corporation parent.

Debt instruments issued by a QSub to a shareholder of the S corporation-parent are also treated as debts of the parent under Section 1366(d)(1)(B). This rule permits the flow through of losses up the S tier to the ultimate shareholder. However, it would appear that the at-risk rules apply at the shareholder level and require a determination of the extent to which each shareholder is “at-risk” with respect to the QSub’s operations. There will also be instances where shareholders of the parent hold debt of both the parent S corporation and the QSub. The legislative history indicates that the Treasury may issue regulations regarding the order that the losses pass through.

For states which have “piggyback” statutes which borrow from federal definitions of Subchapter S, it would appear that the QSub rules will be respected for state income tax purposes. Uncertainty is present however for those states which have separate definitions or modifiers, or, for states which do not recognize or otherwise tax S corporations,

Section 332(b) requires that the parent must adopt a plan of liquidation when it owns 80% or more of the stock of the liquidating subsidiary. A QSub election is, by design, a constructive liquidation. Since the subsidiary will not liquidate under state law, the question arises as to whether the adoption of a plan of liquidation is necessary. The timing of the deemed liquidation may also affect its tax consequences. The deemed liquidation is effective at the close of the date prior to the QSub election becoming effective.⁴¹⁹ For the conversion of a consolidated group (and its parent corporation), the S corporation/QSub election deemed liquidation of the QSubs will be deemed to occur in the last consolidated return year. This means that ELA will be eliminated.⁴²⁰

Generally the ordering of the QSub elections is from the “bottom up” in order to avoid ELA recapture unless the election form designates a QSub election sequence.⁴²¹ However,

⁴¹⁸ Section 1368(c).

⁴¹⁹ Reg. §1.1361-4(b)(1).

⁴²⁰ Reg. §1.1502-19(b)(2)(i).

⁴²¹ Reg. §1.1361-4(b)(2).

an election may be made to change the ordering of the QSub election from top to bottom. For example, if A, an S corporation, owns all of the stock of B and C, and B and C each own 50% of the stock of D, A should specify that the B and C liquidations occur first, in order to qualify the entire set of deemed liquidations.⁴²²

Where the QSub election is made after the acquisition of another corporation, the liquidation is deemed to occur immediately after the stock ownership requirement is met.⁴²³

The deemed liquidation occurs immediately after the deemed asset purchase.⁴²⁴ The regulations provide that, for purposes of satisfying the requirement of Section 332(b) that the parent corporation own stock in the subsidiary meeting the requirements of Section 1504(a)(2) on the date of adoption of the plan of liquidation of the subsidiary, the plan of liquidation is deemed adopted immediately before the deemed liquidation incident to a QSub election unless a formal plan of liquidation that contemplates the filing of the QSub election is adopted on an earlier date.⁴²⁵ Still if as a result of the application of general tax principles the transactions that include the QSub election are treated as an asset acquisition, and as further subject to transitional relief, Section 332 is not applicable and this rule has no relevance.

Application of Step Transaction Doctrine. Applying step transaction to the acquisition of stock that precedes a QSub election can cause the transaction to be recast as an asset acquisition under Section 368 with unfortunate results for the unwary or unsophisticated, which again, is inconsistent with the legislative history to QSub.⁴²⁶

The final regulations provide that general principles of tax law, including the step transaction doctrine, will apply to determine the tax consequences of the transactions that include a QSub election. The final regulations provide examples illustrating the results of applying step transaction in the context of a QSub election.

In *Bausch & Lomb Optical Co. v. Commissioner*,⁴²⁷ the taxpayer owned 79 percent of the stock of a subsidiary corporation. In order to acquire its assets, the taxpayer issued its stock in exchange for all the assets; the subsidiary then liquidated, distributing the parent’s stock pro rata to all of its shareholders. The outside shareholders of the subsidiary thus became minority shareholders of the parent. The various steps were held to constitute a single plan having the effect of a taxable liquidation (to the extent of the assets received in exchange for the parent’s 79 percent stock interest), rather than a tax-free Type C reorganization, on the theory that the assets were acquired by the taxpayer in consideration

⁴²² See Form 8869.

⁴²³ Reg. §1.1361-4(b)(3)(i).

⁴²⁴ Reg. §1.1361-4(b) and (d), Example 3.

⁴²⁵ Reg. §1.1361-4(a)(2)(iii), (iv).

⁴²⁶ See generally, Rev. Rul. 67-274 (1967-2 C.B. 141) (which treats as a Type C reorganization an acquisition of the stock of one corporation by another corporation, solely in exchange for voting stock of the acquiring corporation, followed by a liquidation of the target corporation pursuant to a plan). For a defense of the Service’s application of the step transaction doctrine to the deemed liquidation resulting from the making of a QSub election see Anderson, “Reexamining the Qualified Subchapter S Subsidiary—Years Later,” 40 Tax Mgt. Mem., No. 24 (Nov. 22, 1999).

⁴²⁷ 267 F.2d 75 (2d Cir. 1959) cert denied 361 U.S. 835 (1959).

for its stock of the subsidiary rather than in exchange for its own voting stock, as required by Section 368(a)(1)(C).

Similarly, where an S corporation forms a subsidiary and makes a valid QSub election for the subsidiary effective as of the date of the formation of the subsidiary, no deemed liquidation should be treated as having occurred since the subsidiary will never have been a separate corporation.

Example: X is an S corporation which operates retail and manufacturing divisions. In January, 2005, X contributes the retail operations, subject to liabilities, which liabilities exceed the adjusted basis of the retail assets, to a newly formed corporation Y in exchange for all of Y’s stock and makes a QSub election effective as of the date of formation of Y. If Section 332 applied, the liquidation would be taxable since Y is insolvent. Similarly, Section 357(c) should not apply since there is no Section 351 transaction. Reg. §1.1361-1(a)(2) applies step transaction analysis to ignore the deemed liquidation under Sections 337 and 332 and treat the transaction simply as the formation of a newly organized subsidiary.

Another example of the application of the step transaction doctrine in the context of a QSub election is a qualified stock purchase followed by a QSub election.⁴²⁸ In the first example of the Regulations, a C corporation acquires all of a solvent, target corporation from an unrelated individual for cash and short-term notes. As part of the same plan, the acquiring corporation immediately makes an S election for itself and a QSub election for the target. The example provides that since the stock purchase is “qualified” per Section 338(d)(3), the deemed liquidation is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under Sections 332 and 337.⁴²⁹ Other examples are discussed under Disregarded Entities in Corporate Reorganizations.

Timing of Deemed Liquidation. Under Reg. §1.1361-4(b), rules are set forth for the date on which the deemed liquidation resulting from a QSub election occurs. Where the S corporation parent owns all of the subsidiary stock prior to the effective date of the QSub election, the proposed regulations provide that the deemed liquidation occurs at the close of the day prior to the effective date of the QSub election. This was the same rule previously contained in the proposed regulations. Thus, if a C corporation elects to be treated as an S corporation and makes a QSub election effective on the same date, the liquidation occurs immediately prior to the S election becomes effective, while the S electing parent is still a C corporation. This timing rule has significant implications for consolidated groups which convert to S corporation and QSub status.

A second rule pertains to acquisitions of target corporations, i.e., where an S corporation does not own all of the subsidiary’s stock on the day before the QSub election is to be effective. In this situation, the regulations provide that the deemed liquidation occurs

⁴²⁸ Reg. §1.1362-4(a)(2)(ii).

⁴²⁹ See Rev. Rul. 90-95; Reg. §1.338.

immediately after the time at which the S corporation’s owns 100% of the subsidiary’s stock.⁴³⁰

The QSub election is not effective for the target until the day after the acquisition date. The deemed liquidation resulting from the QSub election occurs immediately after the date of the deemed asset purchase by the new target corporation under Section 338.⁴³¹ Where the S corporation makes an election under Section 338 (without a Section 338(h)(10) election) with respect to a target, the target must file a final or deemed sale return as a C corporation for the deemed sale.⁴³²

Effect of QSub Election on S Corporation’s Basis in Subsidiary Stock. Aside from the tax history issues generated by a deemed liquidation, perhaps the most immediate drawback to the QSub is the disappearing basis problem. Suppose, for example, that an S corporation purchases all of the stock of a target C corporation (in a non-Section 338 transaction) at a purchase price of \$2,000x. Assume the target’s basis in its assets is \$500x. By purchasing all of the target’s stock and making the QSub election (or, alternatively, by immediately liquidating the target into the purchaser), the parent’s cost basis in the subsidiary stock, i.e., \$2,000x, disappears. The only relevant basis to the parent is the adjusted basis of the subsidiary’s assets. The \$2,000x basis is not reinstated if there is a termination of the QSub election because the subsidiary is treated as a newly-formed corporation at that time under Section 1361(b)(3)(C). Again, the inside versus outside value differential will present built-in gains tax problems to the purchaser with respect to the QSub’s assets. The total net unrealized built-in gain is allocated on an asset-by-asset basis including goodwill and going concern value.⁴³³

Acquisitions of S Corporations—AAA and Suspended Losses. The Regulations acknowledge that the AAA of a target S corporation which is acquired in a tax-free reorganization or liquidation described in Sections 337/332 will be inherited by the acquiring corporation.⁴³⁴ Reg. §1.1361-4(c) further provides that suspended losses also carry over where one S corporation acquires the stock of another S corporation referencing Reg. §1.1366-2(c)(1).

Application of Built-In Gains Tax to QSub Elections. Section 1374 imposes a corporate level tax on the built in gains of an S corporation after it has converted from C corporation status. The tax is imposed on net recognized built-in gains for the subsequent 5-year period following the effective date of a C to S conversion. Section 1374(d)(8) provides the Section 1374 tax carries over with respect to an S corporation’s receipt of transferred basis property from another C corporation or S corporation having an unexpired recognition period under Section 1374 from a prior conversion event. Therefore, Section 1374(d)(8) will apply with respect to the purchase of all of the stock of a target corporation and subsequent QSub election under the deemed liquidation rule. In such case, a separate determination of

⁴³⁰ Reg. §1.1361-4(b)(2).

⁴³¹ Section 338(h)(2). Reg. §1.1361-4(b)(2).

⁴³² Reg. §1.338-10T(a). Reg. §1.1361-4(d), Ex. 3.

⁴³³ Sections 334(b)(1), 1374(d)(8), 1374(d)(1). Regs. §§1.334-1(b), 1.1361-4(a)(4)(except for purposes of Section 1361(b)(3)(B)(i) and Reg. §1.1361-2(a)(1), the stock of a QSub is disregarded for federal tax purposes).

⁴³⁴ Reg. §1.1368-2(d)(2).

tax is made with respect to the assets acquired by each particular target corporation. Regulations under Section 1374 provide that the tax attributes of the target, e.g., net operating loss and capital loss carryovers, may only be used against the target’s subsequent recognized built-in gains.⁴³⁵ Furthermore, Section 1374 attributes acquired in one Section 1374(d)(8) transaction may only be used to reduce the tax on the disposition of assets acquired in that transaction. This results in a “Libson Shops” type separate pooling approach.

Conversions of a Disregarded Entity into a Partnership and a Partnership into a Disregarded Entity

1. In General.

The acquisition of a disregarded entity by a single buyer is treated for federal income tax purposes as the sale of assets by the owner of the disregarded entity which neither elected or converted to association status. The check-the-box regulations do not address a change in tax status caused by a change in number of members, but this subject has been addressed by the IRS in two well-known rulings.⁴³⁶

2. Conversion of a Disregarded Entity into a Partnership: Increase From One Member to Two (or More) Members.

In Rev. Rul. 99-5, *supra*, two scenarios involving the conversion of a disregarded entity into a partnership are discussed. In both cases, A owns 100% of the interests in an LLC valued at \$10,000 and B purchases a 50% interest from A.

(a) In situation one, B acquires the interest from A for \$5,000. The transaction is treated as a sale of one-half of each asset to B, followed by a contribution of all of the assets by A and B to a new partnership. A recognizes gain or loss on the sale of each asset held by the LLC.

(b) In situation two, B acquires a new 50% interest in the LLC from the LLC for \$10,000 and the proceeds of the sale are retained in the business of the LLC. The transaction is treated as a transfer of all of the assets by A to a new partnership for an interest in the partnership, and a transfer of cash by B to the new partnership. No gain or loss, in general, is recognized by either party under Section 721.

(c) What if A transfers an interest in the LLC to B, but A contributes the cash to the business, so that their interests were 2/3 to A and 1/3 to B? Would the form of the transaction be followed, resulting in gain to A on an asset sale to B, or would the transaction be treated as a subscription by B to a 1/3 interest in the resulting partnership, resulting in nontaxable Section 721 treatment to A?⁴³⁷

⁴³⁵ Reg. §1.1374-8(b).

⁴³⁶ Rev. Rul. 99-5, 1999-1 C.B. 434 (increase in number of owners of disregarded entity from one to two or more), and Rev. Rul. 99-6, 1999-1 C.B. 432 (sale of membership interest in a partnership to a single purchaser resulting in the conversion to a disregarded entity).

⁴³⁷ See Monte A. Jackel, “New Rulings Address One-to-Two and Two-to-One Entity Conversions”, 82 Tax Notes 1167 (Feb. 22, 1999).

(d) What if B purchases his interest directly from the LLC but cash is distributed to A? Presumably the disguised sales rules under Section 707(a)(2)(B) would apply. This result could also occur if A caused new liabilities to be assumed by the new entity.

(e) Other Consequences. Each scenario will have a varying outcome with respect to: (i) basis; (ii) holding period; (iii) Section 704(c) attributes and possibly with respect to Section 197.

3. Conversion of a Partnership into A Disregarded Entity: Purchase of All of the Interests in an LLC Taxable as a Partnership by One Buyer.

In Rev. Rul. 99-6, the IRS addressed the purchase of all of the interests in an LLC taxed as a partnership by a single purchaser, resulting in a conversion to an single-member LLC.

(a) In situation one, A and B are each equal 50% owners of an LLC. B purchases A’s interest in the LLC for 10X and continues to operate the business as a single-member LLC. The ruling concludes that: (i) the partnership terminates under Section 708(b)(1)(A); (ii) A, under Section 741, is treated as selling his partnership interest to B; and (iii) B, however, is treated as if the LLC first made a liquidating distribution of all of its assets to A and B and then B acquired the assets deemed distributed to A for full monetary consideration paid. B would therefore have a carryover basis in 1/2 of the assets (his pre-purchase share and tacking of holding period for his interest) and a fair market value purchase price basis in 1/2 of the assets deemed purchased from A with a new holding period.

(b) In situation two, C and D are equal partners in CD, an LLC. C and D sell their entire interests in CD to E, an unrelated person, for \$10X each. The business is continued by the LLC, which is owned solely by E. The IRS concluded: (i) the CD partnership terminates under Section 708(b)(1)(A); (ii) C and D must report gain or loss under Section 741; (iii) the CD partnership is deemed to make a liquidating distribution of its assets to C and D; and (iv) immediately thereafter, E is deemed to acquire, by purchase, all of the former partnership’s assets. E has a cost basis of \$20X in the assets and a new holding period. Compare Rev. Rul. 84-111,438 which determines the tax consequences to a corporate transferee of all interests in a partnership in a manner consistent with *McCauslen v. Comm’r*,⁴³⁹ and holds that the transferee’s basis in the assets received equals the basis of the partnership interests, allocated among the assets in accordance with Section 732(c).

4. AICPA Proposes that Rev. Rul. 99-6 be Revoked or Clarified.

In a letter dated October 1, 2013, the American Institute of CPAs (AICPA) provided comments on Rev. Rul. 99-6 relating to the conversion of partnerships to disregarded entities. In the letter, the AICPA proposes that Rev. Rul. 99-6 be revoked, and that a sale which results

⁴³⁸ 1984-2 C.B. 88 (Situation 3).

⁴³⁹ 45 TC 588 (1966).

in a partnership being converted into a disregarded entity be treated as the sale of a partnership interest by the selling partner or partners, and likewise that the purchaser be treated as acquiring the seller’s partnership interest followed by a liquidating distribution of all of the assets of the partnership to the purchaser.

The letter goes on to provide that if Rev. Rul. 99-6 is not revoked, the following clarifications should be made to Rev. Rul. 99-6:

1. Limit the amount of liabilities assumed by the buyer from the seller to the seller’s share of liabilities immediately before the transaction.
2. Determine the partnership’s distribution of gross assets to the seller and buyer by adding each partner’s share of liabilities under Section 752 immediately before the transaction to the value of their equity.
3. Clarify that neither the purchasing partner nor the partnership will recognize gain or loss as a result of the extinguishment of the partnership’s debt to the purchasing partner resulting from the deemed liquidation of the partnership in Situation 1 of Rev. Rul. 99-6.
4. Clarify that Sections 704(c)(1)(B) and 737 will not apply to the purchasing partner in the constructive distribution of partnership assets in Situation 1 of Rev. Rul. 99-6.
5. Clarify that Section 751(b) does not apply to the purchasing partner in Situation 1 of Rev. Rul. 99-6.
6. Provide that the tax consequences of nontaxable and partially taxable transfers not described in Rev. Rul. 99-6 that result in a partnership having a single owner and, therefore, becoming a disregarded entity for tax purposes (e.g., transfers to corporations, gifts, and bequests), have the same construct for basis and holding period as is adopted for Situation 1 of Rev. Rul. 99-6, except for those transfers resulting in a partnership merger.
7. Provide that the tax consequences of the conversion of two or more partnerships into one partnership should be determined under the partnership merger rules of Reg. § 1.708-1(c) rather than Rev. Rul. 99-6.

USE OF DISREGARDED ENTITIES IN M&A TRANSACTIONS

Disregarded Entities in Corporate Reorganizations

1. Proposed and Final Regulations on Mergers involving Disregarded Entities.

On May 17, 2000, the Service issued a proposed rulemaking⁴⁴⁰ on mergers involving disregarded entities. The proposed regulations revised paragraph (b)(1) of Reg. §1.368-2(b)(1) and adopted the view that a merger involving a corporation and a disregarded entity is not a statutory merger for purposes of qualifying as a tax-free reorganization under Section 368(a)(1)(A).⁴⁴¹ The proposed regulations would have extended to a qualified subchapter S subsidiary or QSub, a limited liability company (LLC) with a single corporate owner which does not elect to be treated as a separate corporation, or a qualified REIT subsidiary. Section 368(a)(1)(A), discussed below, requires that a qualifying reorganization constitute a “statutory merger or consolidation.”⁴⁴² Under the Proposed Regulations, the merger of a disregarded entity (“DRE”) (including a QSub or qualified REIT subsidiary) into a tax corporation would not be a Type A reorganization because the merging entity is not a tax corporation. In Rev. Rul. 2000-5, the Service held that a Type A merger must involve the transfer of the assets of a target corporation to a single transferee corporation ceasing to exist as a result of the “merger” Rev. Rul. 2000-5 implies that a merger of a DRE (single member) owned by a corporation (including a QSub), cannot be a Type A reorganization because it will be divisive and will not necessarily result in the termination or liquidation of the member. Due to the additional requirements for a Type C (“substantially all of the transferor’s assets,” no more than 20% boot, including liability assumptions, and “solely for voting stock” requirements) and Type D (“substantially all”/liabilities in excess of basis) reorganization, many of the DRE mergers would constitute taxable transactions under the 2000 proposed regulations.⁴⁴³

The final regulations, issued in 2003, retain much of the conceptual background to the proposed regulations, including the definition of a disregarded entity.⁴⁴⁴ Examples are set forth in the regulations which apply to disregarded entities, such as a domestic, single member LLC which does not elect to be treated as a corporation for federal income tax purposes, a qualified REIT subsidiary per Section 856(i)(2) and a QSub per Section 1361(b)(3)(B).⁴⁴⁵ Defined terms included the following:

- (i) Disregarded Entity; a business entity that is disregarded as an entity separate from its owner for Federal tax purposes;
- (ii) Combining Entity; a business entity that is a corporation that is not a disregarded entity;

⁴⁴⁰ REG-106186-98, 65 FR 31115-01.

⁴⁴¹ See also Rev. Rul. 2000-5, 2000-5 IRB 1.

⁴⁴² Reg. §1.368-2(b)(1) provides that a statutory merger or consolidation must be effectuated in accordance with the “corporation laws” of the United States or a state, territory, or the District of Columbia.

⁴⁴³ See Rev. Rul. 70-107, 1970-1 C.B. 78 (assumption of target liabilities by wrong corporation in an attempted triangular acquisition resulted in invalid Type C reorganization treatment).

⁴⁴⁴ Reg. §301.7701-2(b)(5).

⁴⁴⁵ These proposals were adopted as Temporary Reg. §1.368-2T(b)(1) by TD 9038 on Jan. 24, 2003; and became final in TD 9242 (Jan. 23, 2006).

- (iii) Combining Unit; is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such entity for Federal tax purposes;
- (iv) Transferor Unit; and
- (v) Transferee Unit.⁴⁴⁶

With an A reorganization involving a disregarded entity, i.e., a statutory merger or consolidation effected pursuant to the statute or statutes necessary to effect the merger or consolidation, the following events occur simultaneously at the effective time of the transaction; (i) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and (ii) the combining entity of each transferor unit ceases its separate legal existence for all purposes; provided, however, that this requirement will be satisfied even if, under applicable law, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents) may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the requirements of Reg. §1.368-2(b)(1)-(ii)(A).

The final regulations can be viewed as consistent with rulings previously issued by the Service. In Situation 1 of Rev. Rul. 2001-46,⁴⁴⁷ an acquirer purchased a target corporation by means of two consecutive mergers. First, all of the target’s outstanding stock was acquired in a reverse triangular merger (the “Acquisition Merger”), in which the merger consideration consisted of 30% cash and 70% stock. Next, the target, a wholly owned subsidiary of the acquirer, was merged upstream into the acquirer (the “Upstream Merger”). The Service held that the two steps should be integrated and treated as an asset acquisition under Rev. Rul. 67-274. Because Section 338 policies do not dictate otherwise, this transaction is treated as an A reorganization.⁴⁴⁸

In Situation 2 of the Ruling, the facts are the same as in Situation 1 except that in the Acquisition Merger the target shareholders receive solely voting stock in the acquirer in exchange for their target stock, so that the Acquisition Merger, if viewed independently of the Upstream Merger, would qualify as a reorganization under 368(a)(1)(A). The Service held that the difference in consideration (all stock, no cash) does not change the result in Situation 1.

⁴⁴⁶ Reg. §1.368-2(b)(1)(i)(C).

⁴⁴⁷ 2001-42 I.R.B. 1(September 25, 2001).

⁴⁴⁸ See *King Enterprises, Inc. v. U.S.*, 418 F.2d 511 (CT. CL. 1969); Rev. Rul. 67-274.

Because Section 368(a)(1)(A) does not contain a 20% boot limitation (or a “substantially all” requirement), Rev. Rul. 2001-46 sanctions the use of a second step upstream merger to avoid the limitations of a reverse triangular merger under Section 368(a)(2)(E). The same consequences would apply if the target was converted or merged into a disregarded entity owned 100% by the acquirer, treated as an A reorganization under the final regulations dealing with mergers involving disregarded entities.

2. Reorganizations Involving QSubs.

QSubs can be part of a tax-free reorganization, such as a Section 368(a)(1)(A) merger or consolidation.⁴⁴⁹ Provision is made that if a target S corporation that has a QSub merges into a disregarded entity, the termination of the QSub election followed by the deemed contribution of the former QSub’s assets to a new C corporation immediately prior to the merger does not disqualify the merger under Section 368(a)(1)(A).⁴⁵⁰ These regulations generally apply to transactions occurring on or after January 23, 2006.⁴⁵¹

As discussed further above, the Service and Treasury proposed regulations in January 2005 containing a revised definition of statutory merger or consolidation that allows transactions effected pursuant to the statutes of a foreign jurisdiction or of a United States possession to qualify as a statutory merger or consolidation. Simultaneously with the publication of the 2005 proposed regulations, the IRS and Treasury Department published a notice of proposed rulemaking proposing amendments to the regulations under Sections 358, 367, and 884 to reflect that, under the 2005 proposed regulations, a transaction involving a foreign entity and a transaction effected pursuant to the laws of a foreign jurisdiction may qualify as a statutory merger or consolidation (the foreign regulations). The regulations were finalized in January, 2006.⁴⁵²

Acquisition of Stock Through Type C Reorganization Followed by QSub Election for Target Corporation. In this example, target corporation is acquired by acquiring corporation solely for voting stock of acquiring corporation as part of a transaction intended to meet the requirements under Section 368(a)(1)(C). Immediately upon making the acquisition, acquiring corporation makes an S election and files a QSub election for target. The example concludes that the transaction will be a type C reorganization, assuming that the other conditions for reorganization treatment are satisfied.

Deemed Liquidation Recharacterized as Type D Reorganization. Another example in the final regulations raises the potential problem under Section 357(c) in connection with a QSub election. Of course, this problem was removed temporarily under a transactions rule contained in Reg. §1.1361-4(a)(5)(i) and was removed permanently by the 2004 Act which

⁴⁴⁹ Reg. §1.368-2(b)(iv) ex. 2.

⁴⁵⁰ See Reg. §1.368-2(b)(1)(iii) Ex. 3 (providing that the deemed formation by the target S corporation of a C corporation subsidiary as a result of the termination of its subsidiary’s QSub status is disregarded for federal income tax purposes; the target S corporation is viewed as transferring the assets of its subsidiary to the acquirer followed by the acquirer contributing those assets to a new C corporation subsidiary in exchange for stock); see also Reg. §1.1361-5(b)(3) Ex. 9.

⁴⁵¹ Reg. §1.368-2(b)(1)(v).

⁴⁵² 71 FR 4259-01, 2006-7 I.R.B. 422, 2006 WL 173491 (F.R.).

amended Section 357(c) so that it is only applicable to *divisive* D reorganizations involving Section 355. Prior to the 2004 amendment to Section 357(c), assume Individual A contributes all of the outstanding stock of Y to his wholly owned S corporation, X, and immediately causes X to make a QSub election for Y. The example concludes that the transaction will be a Type D reorganization, assuming the other conditions for reorganization treatment are satisfied, and consequently, that if the sum of the Y liabilities treated as assumed by X exceeds the total of the adjusted basis of Y’s property, Section 357(c) will apply to the transaction and the excess will be gain from the sale of the contributed assets as allocated under relative FMVs.⁴⁵³

QSub Election Involving Insolvent Subsidiary. Despite receiving comments that insolvent subsidiaries should qualify for a deemed 332 liquidation, the final regulations treat insolvent subsidiary liquidations, even as part of a QSub election, as outside of Section 332. In general, Section 332 does not apply to the liquidation of an insolvent corporation, because the parent corporation does not receive at least partial payment for the stock of its subsidiary. An example is provided in the final regulations.⁴⁵⁴ In such instance the tax attributes and adjusted basis of the assets of the subsidiary will not carry over to the parent. As far as transitional relief is concerned, the final regulations provide that for related party acquisitions followed by a QSub election, the step transaction will not apply provided the QSub election is made prior to January 1, 2001.⁴⁵⁵ Examples are provided in the regulations as to the application of transitional relief.

“F” Reorganizations. While the step transaction was adopted in the proposed and final regulations to the QSub rules, some argued that during the transition period where the step transaction is not applicable, per se, the formation of a new shell S corporation (Newco) by the shareholders of an existing S corporation in a mid-year formation, qualify as a Type F reorganization if all of the other requirements of the Section are met. As a Type F reorganization, the taxable year of the existing S corporation does not close. The preamble to the final regulations provides that during the extended transition period set forth in the final regulations, the Service will not challenge taxpayers who, through use of the step transaction doctrine to an acquisition of stock followed by a QSub election, employ the tax treatment applicable to a Type F reorganization.

In Ltr. Rul. 201007043, the IRS ruled that an S corporation’s merger into its wholly owned QSub constituted a tax-free reorganization under Section 368(a)(1)(F) without adversely affecting S corporation status. In the ruling, the S corporation and one of its two wholly owned QSubs desired to combine their assets and operations into a single corporation in order to take advantage of planned efficiencies and to reduce expenses and redundancies. Because certain legal agreements of the QSub prohibited the QSub from merging upstream into the S corporation, it was decided that the S corporation should merge downstream into the QSub.

⁴⁵³ This example has not been updated to reflect the 2004 amendment to Section 357(c).

⁴⁵⁴ Reg. §1.332-4(d), Ex. 5.

⁴⁵⁵ Reg. §1.1361-4(a)(5)(i).

Citing Rev. Rul. 64-250,⁴⁵⁶ the IRS concluded that pursuant to the F reorganization, the S corporation election would continue in effect with respect to the surviving QSub following the merger. Additionally, citing Rev. Rul. 2004-85,⁴⁵⁷ the IRS found that the status of the S corporation’s other QSub would not terminate as a result of the F reorganization.

Interestingly, the ruling does not address whether the surviving entity should continue to use the federal identification number previously used by the S corporation or the federal identification number of the QSub into which it was merged. In Rev. Rul. 73-526,⁴⁵⁸ the IRS ruled that where an S corporation merges into another corporation in a transaction qualifying as an F reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation. However, more recently in Rev. Rul. 2008-18,⁴⁵⁹ the IRS ruled that in the two situations presented in the ruling, which both qualified as F reorganizations within the meaning of Section 368(a)(1)(F), the newly formed corporations would be required to obtain new employer identification numbers and that the existing corporation which became a QSub would retain its same employer identification number.

Like-Kind Exchanges Using Disregarded Entities

Section 1031(a) provides that no gain or loss is recognized on the disposition of property (“relinquished property”) which was held for productive use in a trade or business or for investment if the relinquished property is exchanged solely for like kind property (“replacement property”) which is to be held either for productive use in a trade or business or for investment. Section 1031(a)(2) provides that stocks and partnership interests do not qualify for like kind exchange treatment.

With the availability of disregarded entities, taxpayers can structure like kind exchanges with disregarded entities as special purpose holding companies.

Example: Taxpayer A has transferred some real estate and wishes to structure a like-kind exchange. B would like to acquire all of the interests in Swap LLC, an entity that owns like-kind property. Swap LLC is wholly-owned by B. The acquisition of all of the interests in Swap LLC by A would be treated as an acquisition of the like-kind property owned by Swap LLC. From B’s perspective, the transaction would be treated as a sale of the Swap LLC assets.

Example: Assume the same facts as in the previous Example, except that Swap LLC is owned by B, C and D. The moment before A acquires all of the LLC interests, Swap LLC was an entity treated as a partnership for tax purposes. Immediately after the transaction, Swap LLC is a disregarded entity. Partnership interests are not good like-kind exchange property.⁴⁶⁰ However, the transaction is treated as a sale of partnership interests by B, C and

⁴⁵⁶ 1964-2 CB 333.

⁴⁵⁷ 2004-2 CB 189.

⁴⁵⁸ 1973-2 CB 404.

⁴⁵⁹ 2008-1 CB 674.

⁴⁶⁰ Section 1031(a)(2)(D).

D, but it is treated as a purchase of assets by A.⁴⁶¹ Consequently, the transaction is a good like-kind exchange for A. Of course, if A only acquired the interests owned by B and C but not D, A would not have a good like-kind exchange because Swap LLC would not be a disregarded entity immediately after the purchase.

Example: Assume that A held his relinquished real estate in a single member LLC. A transferred all of the interests in LLC to B, C and D. The transaction is treated as a transfer of assets by A to B, C and D.⁴⁶² B, C and D are treated as contributing their fictional undivided interests in the assets to the LLC immediately thereafter. Thus, A would be entitled to structure a like-kind exchange. Note that if B, C or D were attempting to use the purchase as replacement property in their exchanges, they would have to contend with the “holding” requirement of Section 1031.⁴⁶³

Suppose that A transferred only a portion of his interest in his single member LLC. Rev. Rul. 99-5⁴⁶⁴ would still treat A as having transferred an undivided interest in the real estate owned by the single member LLC. Thus, A would still be entitled to 1031 treatment (assuming all requirements of Section 1031 are otherwise satisfied) because he did not sell a partnership interest.

Example: S Corp’s only asset is 100% of the stock of QSub, a qualified S subsidiary. QSub owns investment real estate. Stock is not good like-kind exchange property.⁴⁶⁵ The sale of all of the QSub stock will be treated as if S Corp sold, and the purchaser bought, all of the assets of QSub.⁴⁶⁶ The purchaser is then deemed to have contributed the assets to QSub in exchange for QSub stock. S Corp may close the like-kind exchange by buying all of the stock of an unrelated QSub that owns investment real estate if the QSub remains a QSub in the hands of S Corp. However, a transfer of less than all of the stock would not qualify for like kind treatment.⁴⁶⁷

Alternatively, S Corp can form Newco LLC as a wholly-owned subsidiary of S Corp. QSub merges into Newco LLC with Newco LLC surviving. Because the merger is between two disregarded entities, this transaction will be disregarded for federal income tax purposes. S Corp can then sell the interests in Newco LLC and qualify for like-kind exchange treatment.⁴⁶⁸

Example: Assume that A has transferred some investment real estate and wishes to do a like-kind exchange. A is a 10% member in Real Estate LLC and B is the unrelated 90% member. Real Estate LLC owns real estate that would qualify as good replacement property for A if A acquired the real estate from Real Estate LLC. What if A instead acquires B’s 90% membership interest? Generally, an LLC membership interest is not good exchange

⁴⁶¹ Rev. Rul. 99-6, 1999-1 C.B. 432.

⁴⁶² Rev. Rul. 99-5, 1999-1 C.B. 434.

⁴⁶³ See e.g., Magneson v. Commissioner, 81 TC 767 (1983), *aff’d*, 753 F.2d 1490 (9th Cir. 1985); Bolker v. Commissioner, 81 TC 782 (1983), *aff’d*, 760 F.2d 1039 (9th Cir. 1985).

⁴⁶⁴ 1999-1 C.B. 434.

⁴⁶⁵ Section 1031(a)(2)(B).

⁴⁶⁶ Reg. §1.1361-5(b)(3), Ex. 9.

⁴⁶⁷ *But see* Section 503 of the Subchapter S Modernization Act of 2003 (H.R. 2576 and S. 1201).

⁴⁶⁸ See Reg. §1.1361-5(b)(3), Ex. 2.

property under Section 1031. However, under Rev. Rul. 99-6⁴⁶⁹ B is treated as having sold an interest in an LLC. However, because A will own 100% of the membership interests in Real Estate LLC after the purchase, Rev. Rul. 99-6 treats A as having acquired the underlying assets of the LLC.

Example: Assume that each of A and B owns a 50% membership interest in LLCI. LLCI owns real property held for investment. A and B would like to convey their membership interests in LLCI (to avoid state transfer taxes) and treat this as the disposition of relinquished property under Section 1031. However, the sale of membership interests in an LLC treated as a partnership for tax purposes will not qualify under Section 1031.⁴⁷⁰ A and B contribute their membership interests in LLCI to a newly formed entity, LLCII, in exchange for membership interests in LLCII. LLCI becomes a wholly owned subsidiary of LLCII and a disregarded entity. LLCII then conveys 100% of the membership interests in LLCI.

This structure achieves the objectives of avoiding state transfer taxes and qualifying the disposition for Section 1031 treatment. Under the Section 708 partnership merger rules, LLCII is deemed to be a continuation of LLCI.⁴⁷¹ Thus, LLCII is treated as “holding” the LLCI real property for investment to the same extent as LLCI, qualifying for like-kind exchange treatment.⁴⁷²

STRUCTURING PRIVATE EQUITY INVESTMENT TRANSACTIONS

In General

Private equity, as referred to in this Section, includes venture capital investments in entrepreneurial start-ups, investments in and the financing of growth businesses, leveraged buyouts, management buyouts, and recapitalizations of existing businesses and companies in financial trouble.

Private equity investors and private equity funds actively acquire portfolio investments through the buyout of operating companies from the founder shareholders, as well as from purchases of businesses from diversified companies operating many businesses and subsidiaries and divisions, wishing to divest a non-core business or a business that it is unable to make profitable. These middle market businesses may have been historically operated as C corporations, S corporations, or limited liability companies.

The private equity investor hopes that additional capital for expansion, synergy through additional acquisitions, properly incentivized management, and close supervision by sophisticated management, or a combination of these circumstances, will cause the enterprise value of the portfolio company’s business and operations to increase geometrically.

⁴⁶⁹ 1999-1 C.B. 432.

⁴⁷⁰ See Section 1031(a)(2)(D).

⁴⁷¹ Reg. §1.708-1(c).

⁴⁷² See Rev. Rul. 75-292, 1975-2 C.B. 333; Rev. Rul. 77-337, 1977-2 C.B. 305. See also Magneson & Bolker, supra.

Private equity investors are generally willing to expose capital to risk in order to achieve higher rates of return. There are cheaper sources of capital than private equity capital, such as traditional bank loans and private placements of senior debt securities. However, such sources may not be available to an early stage entrepreneur with no proven business plan or collateral or an operating company producing cash flow deficits. Even if traditional financing is available for a portion of the capital required, private equity financing may be necessary to provide the equity base for a business plan to succeed.

Federal law has encouraged private equity investments through various tax and other incentives for over 50 years. The Small Business Investment Act of 1958 permitted banks and bank holding companies to invest in Small Business Investment Corporations (SBICs) subject to certain restrictions.⁴⁷³ The involvement of banks in private equity investments through the 1960s and 1970s provided the basis for the development of a professional private equity industry in the United States.

Today, participants in private equity transactions include high net worth individuals, merchant banking subsidiaries or divisions of bank holding companies, insurance companies, investment banks, and other large corporations, publicly held and privately held funds formed for the purpose of making private equity investments, and employee pension plans, university endowment funds, and other investors looking for a greater than normal investment return which generally require a high level of risk. Special private equity funds have been formed to permit private investors to diversify their risk among a portfolio of investments, while achieving professional management and oversight of the investments.

An operating company may be reasonably successful, but it may require equity capital from nontraditional private equity sources if traditional financing is not available from bank lenders, or the bank lenders condition credit on the infusion of additional equity capital. The founders may not be ready to sell out to a third party, as they may still have confidence in the original business plan and their ability to execute it. However, without additional private equity, the company may not realize its true potential.

Structuring Private Equity Investments in an Operating Company

Private equity investors often find profit opportunities in “growth-equity” investments in existing operating companies. The investment capital may be used to fuel expansion, to provide an equity base to support cost effective borrowing from traditional bank lenders, to purchase the stock formerly held by senior founders or their estates, or to recapitalize the current equity and debt structure of the company to provide the foundation for future growth and expansion. The best use of the capital raised from mezzanine and private equity investors is the direct funding of growth and expansion initiatives or strategic

⁴⁷³ An SBIC may invest in a business or “portfolio company” if it meets one of two “size standards” (i) the portfolio company has tangible book net worth (exclusive of intangible assets such as “goodwill”) that do not exceed \$18 million and the prior two fiscal years’ average net income does not exceed \$6 million, or (ii) the portfolio copay meets certain employee or revenue standards published by the SBA for the industry in which it is principally engaged. While an SBIC may continue to invest in a portfolio company after it exceeds the size standards, it must divest itself of control after 7 years (subject to extension with the SBA’s approval to complete divestiture of control or to ensure the company’s financial stability).

acquisitions. In the alternative, mezzanine debt and equity and private equity capital may be raised to buyout original shareholders who no longer contribute to the business plan, or in the case of deceased shareholder, where money is needed to pay estate taxes.

Capital Structure of Operating Company.

If a cheaper source of capital were available to the operating company, such as bank financing, asset based lending, or equipment leasing, the founders would take advantage of such sources. However, such sources may have “maxed out” and the founders may be required to seek either (a) subordinated debt, in the form of debt mezzanine capital, or (b) equity, in the form of equity mezzanine capital or pure private equity, from private equity investors.

Debt mezzanine capital may be structured to provide the mezzanine lender with a preferred position through the issuance of subordinated debt, behind senior lenders but ahead of the founders’ equity. In addition, equity may be provided through the issuance of preferred stock by a C corporation (multiple classes of stock are not permitted for an S corporation), preferred LLC or partnership interests, or through the issuance of warrants and convertible debt, discussed further below.

A concern of the mezzanine or private equity investor that must be addressed in the capital structure is maintaining a position that is senior to the equity holders, although junior to the senior lenders, putting them “second in line” to realize any value left in the event of the liquidation of the business. Generally, the private equity investment may be structured through a tax free recapitalization of the operating company. Since the private equity investor does not have control of the company, as in the case of a buy-out, the potential for a successful investment will continue to depend on the business acumen and ability of the existing founders or management group to execute the business plan. The private equity investors will seek to ensure that the management group IS properly incentivized to ensure the success of the portfolio company.

There are several ways to recapitalize an existing company to accommodate private equity investments, usually ensuring that the private equity investor has some liquidation preference over the founders. A recapitalization may be accomplished by the transfer of shares in the operating company to a holding company, qualifying as a tax free Section 351 transaction, or the tax free recapitalization of the operating company under Section 368(a)(1)(E) (an “E recap”).

In either a Section 351 transaction or an E recap, there is risk that preferred stock, issued on a non pro rata basis to the passive shareholders in exchange for a substantial block of common stock, will subject the preferred stock to Section “306 stock” treatment. Since the proceeds of the disposition of Section 306 stock is subject to the tax rate of 20% applicable to “qualified dividends,” without reduction for basis, or subject to the dividends received exclusion for a corporate taxpayer, the consequences of the Section 306 taint may not be particularly objectionable.

Avoiding Nonqualified Preferred Stock Treatment for Portfolio Companies
Operated as C Corporations.

The 1997 Tax Act imposed additional barriers to achieving favorable tax consequences through the use of preferred stock in the capital structure of a C corporation, by defining a new category of preferred stock called “nonqualified preferred stock.” Nonqualified preferred stock is preferred stock that meets any one of four tests:

1. The holder has the right to require the issuer (or a related person) to redeem or purchase the stock within 20 years after the issuance date.
2. The issuer (or a related person) is required to redeem or purchase the stock within 20 years after the issuance date.
3. The issuer (or a related person) has the right to redeem or purchase the stock, and as of the issuance date, it is more likely than not that the right will be exercised within 20 years after the issuance date.
4. The dividend rate on the stock varies in whole or in part with reference to an indexed interest rate, commodity price, or other similar indices, regardless of whether varying the rate is an express term of the stock, or results from other aspects of the stock.

Even if stock qualifies under one of the foregoing tests, it is treated as nonqualified preferred stock only if it is “limited and preferred as to dividends and does not participate in corporate growth to any significant extent.” A shareholder who receives nonqualified preferred stock in an otherwise tax free recapitalization is required to recognize gain (generally long-term capital gain) even where the redemption would have been “essentially equivalent to a dividend” under Section 302 or otherwise subject to treatment as a dividend under Section 301 and eligible for the 20% tax rate for qualified dividends, or the dividend received exclusion in the case of a corporate recipient.

Nonqualified preferred stock is, by definition, not tainted by Section 306 since nonqualified preferred stock is not received by the passive shareholder tax free. A subsequent sale or redemption of the nonqualified preferred stock would not produce Section 306 dividend income to the passive shareholders, although a redemption of nonqualified preferred stock might result in dividend income under Section 302.

Preferred Interest in Portfolio Company Operated as Partnership or LLC.

While a preferred interest in an S corporation cannot be obtained by a private equity investor as a result of a single class of stock rules, the investment may be structured to avoid the double tax by issuing the private equity investor a preferred interest in a limited liability company, which may be the historic operating company, or a newly formed LLC or partnership with an S corporation as a member or partner.

While a preferred membership interest in an LLC is not secured and would be lower on the pecking order than subordinated debt, a preferred interest may be one

component of the capitalization structure to ensure the private equity investor that it will “get its money back” with some level of return commensurate with its minimum expectations, while at the same time being ahead of the founder equity investors. Preferred returns and special allocation provisions, common to private equity and venture capital investment transactions, may be drafted into the partnership agreement or the LLC operating agreement.⁴⁷⁴

Unrelated Business Taxable Income for Tax-Exempt Entities.

If a portfolio company is organized as a pass-through entity, income tax is avoided at the entity level and passed-through to the private equity investors. Taxable investors pay federal income taxes at the marginal rate applicable after considering all other items of income, loss, deduction, and credit.

Tax-exempt entities, including employee pension plans, are exempt from federal income tax on many items of income. Section 511 imposes tax on the “unrelated business taxable income” or “UBTI” of a tax-exempt entity at regular graduated rates, computed under the same rules applied to domestic corporations.⁴⁷⁵ This would include the tax-exempt partner’s share of the UBTI of a partnership or limited liability company.

In addition, Section 514 may cause otherwise exempt interest, dividends or capital gains to be taxed as UBTI if the underlying investment is “debt financed” either as a result of borrowing by the tax-exempt entity, or borrowing by a partnership of which the tax-exempt entity is a partner.⁴⁷⁶ While private equity funds seldom borrow or incur acquisition debt, as in the case of a hedge fund, acquisition debt commonly is incurred by a portfolio company. If the portfolio company is a pass-through entity, the debt may “taint” all or portion of any gain on the sale allocable to the tax-exempt investors.

Effectively Connected Income for Foreign Investors.

Foreign persons are subject to federal income tax on income effectively connected with the conduct of a U.S. trade or business (“ECI”). If a treaty applies⁴⁷⁷ the IRS must establish that the income in question is “attributable to” a U.S. permanent establishment of the foreign person, in which event the income is subject to tax at the maximum rate of 35%. Absent treaty protection, foreign corporations are subject to the “branch profits tax” on the repatriation of ECI from the United States to the foreign jurisdiction, at a rate of 30%.

⁴⁷⁴ Section 704(a) provides that a partnership’s share of income, gain, loss, deduction or credit shall, unless otherwise provided, be determined by the partnership agreement. Under Section 704(b), the Service will respect allocations of partnership income or loss provided (i) the allocations have “substantial economic effect,” as further defined in the Regulations, or (ii) taking into account all facts and circumstances, the allocations are in accordance with the “partner’s interest in the partnership.”

⁴⁷⁵ Section 511(a)(i).

⁴⁷⁶ Reg. §1.514(c-1)(a), example 4.

⁴⁷⁷ U.S. Model Income Tax Convention of September 20, 1996, Article 5.

In effect, foreign corporations are subject to federal tax on ECI at a rate of 54.5%, without regard to state and local taxes.⁴⁷⁸

Like tax-exempt organizations, which are subject to UBTI on business activities of a partnership, foreign persons are subject to tax on ECI attributable to a partnership engaged in U.S. trade or business and allocable to the foreign person. A foreign person or a partnership in which the foreign person is a partner is subject to tax on ECI upon the sale of an interest in a partnership engaged in a U.S. trade or business.⁴⁷⁹ The ECI tax regime is backstopped by the requirement that a partnership that generates ECI must withhold the foreign partner’s “applicable percentage” determined under Section 704.⁴⁸⁰

Use of “Blocker” Entities to Avoid UBTI/ECI.

Tax-exempt and foreign investors, and funds in which tax-exempt and foreign investors invest, often interpose a corporate “blocker” entity between the investors and the portfolio investment to “trap” the operating profits of the portfolio company within a separate taxable entity. The blocker structure prevents the trade or business activities of the entity from passing through the tiers to the tax-exempt or foreign shareholders. While not resulting in any significant tax savings, the use of a blocker entity avoids the need to report the UBTI and ECI at the investor level.⁴⁸¹ The tax-exempt or foreign investor may avoid the need to file a U.S. tax return otherwise triggered by the EBTI or ECI from a portfolio company investment shielded by the blocker.

Unlike hedge funds, which often structure investments by tax-exempt and foreign investors through offshore entities, private equity funds must deal with the fact that income generated by U.S. based portfolio companies is subject to tax as U.S. source income.

Blocker entities may reside in parallel fund structures, in which the fund invests all capital earmarked for pass-through entities and invested by foreign and tax-exempt investors through a blocker entity, and all other funds directly in the portfolio company. This prevents the other investors (not tax-exempt and foreign investors) from being subject to an additional level of tax at the blocker level. If the fund (or a direct investment in a portfolio company by a foreign or tax-exempt investor) does not involve a blocker in its structure, the tax-exempt or foreign investor may choose to interpose a blocker between the investor and the fund or portfolio investment as a “feeder” organization. If the tax-exempt or foreign investor forms its own blocker, it may domicile the entity in a tax haven jurisdiction to avoid U.S. taxes on income that is not ECI and to avoid U.S. withholding taxes from distributions to the investor by the blocker. The use of a blocker domiciled in a tax haven jurisdiction will permit a tax-exempt investor from being subject to tax on UBTI sourced in a foreign jurisdiction.

⁴⁷⁸ Section 11 and Section 884 (35% plus $(1 - 35\%) \times 30\% = 54.5\%$).

⁴⁷⁹ See Rev. Rul. 91-32, 1991-1 C.B.107.

⁴⁸⁰ Section 1446(a).

⁴⁸¹ The indirect tax burden incurred by the investors at the blocker level will roughly approximate the tax that the tax-exempt or foreign investor would have paid on the UBTI or ECI.

The transfer of investments or the structuring of investments to utilize blocker entities by tax-exempt and foreign investors should be respected for federal tax purposes. A corporation should be recognized as a corporation for tax purposes if it is either formed for a substantial business purpose or engaged in substantial business activity.⁴⁸² Even if an explicit shareholder purpose is to avoid taxes by the use of the blocker, the blocker corporation should be perceived as carrying out substantive business functions and therefore the corporation should not be ignored as a viable business entity. Similarly, the IRS should not be able to assert that the shareholders formed or acquired control of the blocker for “tax avoidance” purposes under Section 269 of the Code. In a parallel fund structure, shareholder use of the blocker may be sufficiently dispersed to avoid the “control” test of Section 269. In addition, the blocker structure may achieve only marginal tax savings for the shareholders, serving primarily to downstream the tax return filing requirements or to facilitate the later sale of stock in the blocker entity. As a separate corporation, the blocker will always bear full corporate tax on its ECI, and in the case of a domestically formed blocker, on its worldwide income.

Limitations on the Use of Debt to Minimize Corporate Tax (“Earnings Stripping”).

The use of senior and subordinated acquisition debt on favorable terms may provide the private equity investor with the opportunity to generate tax deductions at the entity level and increase the overall return on capital deployed in a portfolio company acquisition. The senior financing may be provided by a traditional lender. Subordinated debt financing may be used by the private equity investor to create interest deductions and “strip” corporate earnings from a C corporation. Earnings stripping is subject to numerous limitations, including: (i) the proposed debt/equity regulations under Section 385 (discussed further below), (ii) the original interest discount (“OID”) rules requiring the amortization of the debt holder’s interest income over the life of a debt obligation on a constant yield to maturity basis,⁴⁸³ (iii) the Section 279 limitations on interest on convertible and nonconvertible debentures accompanied by warrants to acquire equity, (iv) the Section 163(e)(5) limitations applicable high yield discount obligations (“AHYDO”) involving debt instruments issued by C corporations with a maturity of more than 5 years after issuance and OID and payment in kind (“PIK”) features with a yield equal or in excess of 5 percentage points over the applicable federal rate (“AFR”), (v) the Section 163(j) limitations on interest payable to or guaranteed by a related lender, and (vi) the Section 163(l) limitation on equity linked debt where there is a substantial certainty that an option to convert the debt into equity will be exercised.

Each of these limitations and the proposed Section 385 Regulations must be carefully navigated where debt is used in the capital structure of a private equity investment through a C corporation, regardless of whether the use of debt is tax motivated.

⁴⁸² Moline Properties v Commissioner, 319 U.S. 436 (1943).

⁴⁸³ Sections 1272 and 1273.

On April 4, 2016, Treasury and the Service released proposed regulations under Section 385.⁴⁸⁴ If finalized in their current form, the Proposed Regulations would make sweeping changes to the characterization of instruments issued by a corporation to a related party that were previously treated as indebtedness under current law.

The Proposed Regulations consist of three sets of rules. First, the Bifurcation Rule provides that the Service may treat certain instruments that are in the form of debt as in part indebtedness and in part stock to the extent they are properly treated as such under general debt/equity testing principles.⁴⁸⁵ In particular, the Bifurcation Rule can potentially apply to any expanded group instrument (“EGI”), as modified by Proposed Regulation Section 1.385-1(d)(1). The term “expanded group” generally refers to an affiliated group as defined in Section 1504(a), with certain modifications to expand its scope, including by counting indirect stock ownership under the rules of Section 304(c)(3). The term “modified expanded group” is defined in the same manner as the expanded group, but adopting a 50% ownership threshold, and adding further potential noncorporate members. A n EGI is an instrument that is in form a debt instrument issued by a member of an expanded group and held by a member of the same expanded group.⁴⁸⁶ Proposed Regulation Section 1.385-1(d)(2) modifies the definition of EGI to apply to instruments issued and held by members of a modified expanded group.⁴⁸⁷

Second, the Documentation Rule provides that an EGI is treated as stock for U.S. federal income tax purposes if certain documentation and information requirements are not satisfied.⁴⁸⁸

Third, the Proposed Regulations provide a regime whereby certain instruments that would otherwise be treated as indebtedness for U.S. federal income tax purposes are instead treated as stock of the issuer to the extent such instruments are issued in certain specified transactions or issued with a principal purpose of funding, or are treated by the Proposed Regulations as being issued with a principal purpose of funding, such specified transactions.⁴⁸⁹

NEGOTIATION AND DOCUMENTING THE ACQUISITION TRANSACTION

Corporate acquisitions of any size, even straightforward ones, involve considerable legal documentation and negotiation. The purchase of a lower middle market business operated by an S corporation target may require the same level of sophisticated documentation as a \$500 million upper middle market business.

The major tasks for the seller, its lawyers and its accountants are: (i) reaching agreement with a financial adviser, if one is to be used; (ii) negotiating the basic terms of the acquisition and formalizing them in a letter of intent; (iii) responding to the due diligence

⁴⁸⁴ See Notice of Proposed Rulemaking, 81 Fed. Reg. 20,914.

⁴⁸⁵ See generally Prop. Reg. §1.385-1(d), 81 Fed. Reg. 20,912, 20,931 (2016).

⁴⁸⁶ Prop. Reg. §§1.385-1(d)(2), 1.385-2(a)(4), 81 Fed. Reg. at 20,931.

⁴⁸⁷ Prop. Reg. §§1.385-1(d)(2), 1.385-2(a)(4), 81 Fed. Reg. at 20,931.

⁴⁸⁸ See generally Prop. Reg. §1.385-2, 81 Fed. Reg. at 20,931.

⁴⁸⁹ See generally Prop. Reg. §1.385-3, 81 Fed. Reg. at 20,934.

investigation by the purchaser; (iv) negotiating and drafting the definitive purchase agreement; and (v) negotiating and drafting supporting documents.

A. *Agreement with Financial Adviser*

In reaching agreement with a financial advisor, the issues most commonly subject to negotiation are compensation and indemnification. Typically, the investment banker receives an initial and/or periodic financial advisory fee as well as a more significant success fee if the transaction is completed. The investment banker also typically receives “all events” indemnification, except for liabilities caused by the investment banker’s bad faith or negligence.

The engagement of an investment bank is a particularly good idea if the acquirer is pursuing an acquisition for the first time, the available targets are not known, the acquirer needs advice on price, or the target itself is represented by an investment bank. In a competitive situation, the acquirer should be careful not to side-step the target’s investment bank. This will only encourage the target’s bank to find other acquirers or exact a higher price.

B. *Letter of Intent*

Once a target company has been identified and approached and the parties have agreed in principle to the essential terms of the transaction, they typically execute a letter of intent. The letter of intent is usually not binding as to the ultimate consummation of the acquisition, but customarily sets forth the parties’ binding agreement to negotiate in good faith and to maintain confidentiality. The letter can contain a binding exclusivity provision restricting the seller from soliciting or negotiating a similar deal with another acquirer for an agreed period of time. A letter of intent will typically set out the parties’ agreement with respect to cooperation and the ability of acquirer to perform its purchase investigation and the seller’s agreement to assist the acquirer with such investigation.

A letter of intent is not an essential step in a business acquisition, and, unless exclusivity is important to the acquirer, letters of intent are often skipped in favor of moving directly to the definitive documentation. In such a case, the parties typically sign a separate confidentiality agreement at this stage to allow the acquirer’s purchase investigation to begin. While nonbinding, the letter of intent gives both parties the comfort of knowing that the time and expense of the due diligence process will not be incurred unless the essential terms of the transaction (primarily the price) have been agreed upon.

C. *Due Diligence Investigation*

Once a letter of intent or confidentiality agreement is signed, the acquirer often conducts a legal and financial investigation (a so-called “due-diligence” investigation) of the target’s business. A purchase investigation is less important if the target is an audited company with recent financial statements certified by reputable accountants, and the purchase investigation, may be accelerated.

In connection with such an investigation, the acquirer asks the seller to provide it with information about the target’s business (including detailed information about its operations, real property, personal property (including patents, trademarks and other intellectual property), environmental matters, employee benefit plans, financial condition, litigation, and tax filings) and to provide it with copies of the relevant material documents (including corporate and organizational records, insurance policies, supply contracts, employment and labor contracts, employee benefit plans, leases, debt agreements, licenses, tax returns and informational filings and, if applicable, SEC filings). The acquirer, its lawyers and its accountants review these documents and information, as well as any other information they can obtain about the company or business, to determine if there are any legal, financial or other problems with the company or business and to learn as much about the target company as possible. In certain environmentally sensitive industries, specialist environmental consultants may be retained to conduct at least a Phase I audit (review of environmental records) and, in certain situations, a Phase II audit (soil and ground water testing).

The purchase investigation may, but need not, precede the execution of a definitive purchase agreement. Rather, the satisfactory completion of the purchase investigation could be a condition to the acquirer’s obligations under the purchase agreement. The seller often resists such a condition since it provides the acquirer with a one-sided and somewhat subjective option to terminate the deal or renegotiate the price. The seller might instead offer the acquirer an opportunity to conduct its investigation before the agreement is signed or within a specified period of time thereafter.

If the seller offers neither a due diligence condition nor an opportunity for a meaningful purchase investigation before the agreement is signed, the acquirer should insist on comprehensive warranties.

The buyer’s ability to conduct a purchase investigation and/or to obtain detailed warranties will depend, at least in part, on whether there is competition for the target. If the seller or its investment bankers are auctioning the business, a “document room” is typically set up by the seller and a buyer’s opportunity to conduct its investigation of the target may be limited in practice.

For an S corporation target, certain information will be requested with respect to the S corporation history and various tax matters.

D. *Purchase Agreement*

The purchase agreement sets forth the basic terms of the transaction (i.e., what is to be sold and the price to be paid). Particularly in an asset sale, it should specifically and carefully describe the assets to be transferred and the liabilities to be assumed and should also set forth how the purchase price will be allocated among the assets. This allocation will determine, in part, both the taxation of the seller in the transaction and the taxation of the buyer after the transaction.

The following discussion is a general overview of the standard terms and provisions included in a purchase agreement for the acquisition of all of the stock of the target company

or the acquisition of substantially all of the assets of the target business. In drafting such agreements or reviewing drafts of such agreements prepared by counsel for the other party, the practitioner may refer to provisions designed as “neutral,” “pro-seller,” and “pro-buyer,” in the monographs entitled “*Model Asset Purchase Agreement with Commentary*” and “*Model Stock Purchase Agreement with Commentary*,” published by the Committee on Negotiated Transactions of the Section of Business Law of the American Bar Association. Similar standard form provisions and sophisticated variations thereof are set forth in Volume 4 of Ginsburg and Levine, *Mergers, Acquisitions and Buyouts – Sample Acquisition Agreements with Tax and Legal Analysis*.⁴⁹⁰

1. Representations and Warranties.

Typically, the seller makes extensive representations and warranties to the acquirer, including with respect to (i) the due incorporation and valid existence of the target company, (ii) the seller’s authority to enter into the transaction, (iii) the capitalization of the target company, (iv) the accuracy and completeness of the financial statements and other documents given to the acquirer by the seller, (v) contingent and other liabilities, (vi) the target company’s title to its assets, (vii) tax matters, (viii) absence of litigation and governmental investigations, (ix) environmental matters, (x) compliance with ERISA and related employee benefit matters, (xi) necessity for consents to the transaction, (xii) absence of defaults under existing agreements, (xiii) intellectual property matters, and (xiv) absence of burdensome provisions in existing agreements. Other warranties may be required, depending on the nature of the target’s business and other facts unique to the transaction. The parent company or principal shareholders of the target company also may be asked to make or stand behind at least some of these representations and warranties.

The tax matters representations are important for any transaction, but special considerations arise when the target is an S corporation. On the one hand, the fact that the target is a pass through entity leaves the selling shareholders with the tax liabilities resulting from the audit of periods prior to the closing. On the other hand, the validity of the S election and the qualification of the target for S status at all times prior the closing is critical to the eligibility of the target for the Section 338(h)(10) election and deemed asset sale treatment with a full basis step up for the assets. Therefore, the selling shareholders will be expected to make significant representations with respect to the S election and the qualification of the target for the S election, including satisfaction of all the requirements of S status for periods prior to the closing.

If the buyer is paying for the acquired business with its own shares, it may make representations and warranties as to its financial condition comparable to those of the seller; otherwise, its representations and warranties are minimal.

2. Covenants.

The purchase agreement sets forth various covenants of the seller and the buyer. One of the most important covenants made by the seller concerns the operation of the acquired

⁴⁹⁰ Wolters Kluwer Law & Business, February, 2014.

business during the period between the signing of the purchase agreement and the closing. The seller generally agrees to conduct the target company’s operations in the usual course and to maintain the assets of the company. It also typically agrees not to take any action that would have a material adverse effect on the business or engage in any other material transaction without the buyer’s approval. For an S corporation target, the sellers would be expected to maintain the S election through the closing.

3. Conditions.

The purchase agreement sets forth conditions to the obligations of the parties to complete the transaction. Buyers customarily make their obligation to proceed with the acquisition contingent on the truth and accuracy of the seller’s representations and warranties, the performance of the seller’s covenants, the absence of litigation and other material proceedings, and the absence of material adverse changes in the seller’s financial condition.

The acquirer often seeks to make its obligation contingent upon satisfactory completion of its purchase investigation, but, as noted above, this condition is often resisted. While retaining flexibility for itself, the acquirer seeks to commit the seller to the transaction as firmly as possible. Because the parties’ obligations to complete the transaction are contingent on obtaining necessary approvals and consents, it may be difficult or impossible to commit the seller completely. For example, if the transaction requires the approval of the seller’s shareholders, as will be the case in acquisitions of public companies, an intervening, better offer can thwart the acquirer’s offer regardless of whether the board of directors of the target had previously approved the acquirer’s deal. In such a circumstance, a buyer must decide whether to revise its offer or drop out of the bidding. A buyer may be able to recover some of its losses if it is forced to drop out by obtaining lock-ups or break-up or topping fees.

Significant transactions involving public companies are often completed with great speed to minimize the risk of competing offers. In the case of acquisitions of private companies, haste makes waste, especially if confidentiality and exclusivity provisions are in place.

4. Purchase Price Adjustments for Tax Costs of Section 338 Election.

In some cases, the value of a Section 338(h)(10) election to the buyer may require a sharing of the cost of the election to the selling shareholders as an adjustment to the purchase price. This is especially true in the case of unsophisticated sellers who may be overwhelmed by the complexities of the transaction and the tax costs of a deemed asset sale as opposed to a straight stock sale. The more sophisticated sellers appreciate that the goal is to get the best price for the business, period.

In these cases, consideration may be given to language to the effect sellers will be “made whole” (including a tax gross up) to the extent the tax cost of the asset sale or deemed asset sale (under a Section 338(h)(10) election) to the sellers would exceed the tax cost of a stock sale (without a Section 338(h)(10) election) to the sellers. The sources of differences in the after-tax effects of the Section 338(h)(10) election on the sellers, as opposed to a straight stock sale, include the (a) character of gain as ordinary income, long term capital

gain or Section 1250 gain, as compared with all capital gain on a straight stock sale, (b) additional inside gain attributable to corporate level liabilities included in the calculation of the Aggregate Deemed Selling Price (“ADSP”) under Section 338,⁴⁹¹ (c) for a shareholder with a high tax basis in the stock as a result of a step up basis for the stock of a deceased shareholder or the purchase of the stock at a higher price, the shareholder may recognize ordinary income and capital loss without any current tax benefit for the latter, (d) where the target is doing business in states where income is apportioned subject to higher tax rates than the states of the shareholders’ residences, additional state tax will be payable by the selling shareholders, (e) exposure for entity level taxes under Section 1374 or entity level state taxes, and (f) the potential for the reallocation of purchase price by the Service, and (g) the timing of gain recognition (i.e. consequences of an installment sale).

A Section 338(h)(10) tax gross up provision may be useful when the parties have not already negotiated and priced the transaction with full knowledge of the tax consequences. For example, when a stock sale is agreed upon between the parties, with the assumption that there will be no step-up in the basis of the underlying assets, the buyer may be willing to agree to gross up the purchase price to reimburse the seller for the additional taxes due as a result of a deemed asset sale should it be determined, after the closing, that a Section 338(h)(10) election is more advantageous to the buyer than the straight stock sale. Such provisions would not be appropriate, for example, where the transaction is priced as an asset purchase, and the buyer has already agreed to pay for the business with the expectation of a basis step up and the opportunity to amortize the goodwill component.

5. Remedies for Breach of Agreement; Indemnification.

A purchase agreement will generally include provisions providing the buyer with some form of security to ensure that the seller’s pre-closing representations and warranties are correct. The purchase agreement will generally provide that all of the representations and warranties of both parties contained in the agreement shall survive the closing and continue in full force and effect subject to any applicable statute of limitations and subject to any other periods specified in the agreement.

The purchase agreement may also contain alternative provisions for (a) full indemnification, where there is no deductible, threshold or ceiling on indemnifications against breaches, and (b) limited indemnification, where the representations and warranties for the transaction itself and tax, environmental, and capitalization matters and certain other fundamental representations and warranties survive indefinitely, but the other representations and warranties survive only for a specified period, and there is a threshold, or a deductible, or a ceiling, on the indemnification obligation. A pro-seller approach to the purchase agreement may involve only minimal indemnification, where only the representations and warranties concerning the transaction itself survive the closing. Provisions may also specify

⁴⁹¹ The gain on the deemed asset sale is based on the difference between the Aggregate Deemed Selling Price (“ADSP”) and Adjusted Grossed-Up Basis (“AGUB”) of the assets determined under Reg. §1.338-4, et seq. The ADSP includes any liabilities taken or assumed as a part of the transaction.

that if the damaged party knew or had reason to know of the misrepresentation or breach of warranty at the time of closing, then a claim of breach would not survive the closing.

The buyer may also seek some form of additional security to ensure that the seller’s obligation to indemnify the buyer may be satisfied after the closing, including (a) an escrow deposit of a portion of the purchase price with a third party escrow agent, (b) a “hold back” by the buyer of a portion of the purchase price, to be paid later with interest, or (c) the buyer retaining a lien on certain assets of the sellers. Finally, where there are multiple sellers, including shareholders, the agreement may provide for severable liability, where each seller is responsible for a proportionate share of a claim for a breach of representations and warranties, or joint and severable liability, where all of the sellers are responsible for the full amount of the claim for indemnification, subject to a right of contribution against each other.

The assistance of the practitioner with experience in drafting indemnification provisions and a library of alternative indemnification provisions is invaluable to both the buyer and seller’s efforts to negotiate reasonable and fair indemnification provisions.

The experienced tax counselor can be especially useful in drafting and negotiating tax indemnification provisions, provisions allocating responsibilities for pre-closing and post-closing tax liabilities, and tax sharing agreements.

E. *Sandbagging and Anti-Sandbagging Provisions*

A “sandbagger” is a golfer who pretends to have a higher handicap and play a worse game of golf than his or her true playing skills deserve. By gaining additional strokes over opponents, the chances of winning a match are improved.

In connection with an asset purchase agreement, stock purchase agreement, or merger agreement, a “pro-sandbagging” provision states that a buyer’s remedies against the seller for indemnification based on representations, warranties, and covenants in the agreement will not be impacted by whether or not the buyer has knowledge, prior to the closing, of facts or circumstances giving rise to the indemnification claim, and closes anyway.⁴⁹² An “anti-sandbagging” provision prohibits the buyer from “sandbagging” the seller by limiting the buyer’s ability to seek recourse against the seller if the buyer has knowledge of the facts prior to closing and closes with such knowledge.⁴⁹³

Counsel for sellers will seek to include “anti-sandbagging” language and resist “pro-sandbagging” language. Counsel for buyers will seek to include “pro-sandbagging” language and resist “anti-sandbagging” language. Where the agreement is silent, state law will control

⁴⁹² An example of pro-sandbagging language: “*The rights of the Purchaser under this Agreement for indemnification or any other remedy under this Agreement shall not be impacted or limited by any knowledge that the Purchaser may have acquired, or could have acquired, on or before the Closing Date, nor by any investigation or diligence by the Purchaser.*”

⁴⁹³ An example of anti-sandbagging language: “*In no event shall the Seller have any liability to the Purchaser with respect to a breach of representation, warranty, or covenant under this Agreement to the extent that the Purchaser knew of such breach as of the Closing Date.*”

whether or not the buyer believed it was “purchasing the promise as the truth of the relevant warranties,” as in *CBS, Inc. V. Ziff-Davis Publishing Co., et. al.*⁴⁹⁴

F. *Additional Documentation*

Other documents required to complete an acquisition can be extensive, and may include employment agreements with key employees; non-competition agreements with principals leaving the business; a merger agreement if the purchase of shares will be followed by a merger of the acquired corporation with the acquirer or a subsidiary of the acquirer; deeds, assignments and other transfer documents in the case of an asset sale; certificates of the seller regarding important representations and warranties; consents of major suppliers, governmental agencies, major creditors, landlords and others; resolutions of the boards of directors of the corporations and their shareholders; a “cold comfort” letter from the accountants of the seller regarding their investigation of the target business; an escrow agreement if any of the purchase price is placed in escrow; an opinion of counsel to the seller concerning certain representations and warranties made by the seller in the purchase agreement; receipts for money paid at the closing; and promissory notes representing a portion of the purchase price.

⁴⁹⁴ 75 N.Y.2d 496 (1990).