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When Subchapter S Meets Subchapter C

MARTIN J. MCMAHON, JR. & DANIEL L. SIMMONS“

ABSTRACT

It is often said that "an S corporation is a corporation that is taxed like a partnership." This statement is incorrect. An S corporation resembles a partnership only in that it generally does not pay income taxes and its income and losses pass through to the shareholders and retain their character as they pass through. Also, like a partnership, basis adjustments to an S corporation shareholder's stock reflect allocations of income, expense, loss, and distributions. However, no other rules of subchapter K governing partnership taxation apply to S corporations. Most of the rules governing the relationship between an S corporation and its shareholders differ significantly from the rules governing the relationship between a partnership and its partners. In fact, an S corporation and its shareholders are subject to the rules of subchapter C, just like a corporation that has not made an S election, with very few exceptions. This Article highlights some of the major differences between taxation of S corporations and taxation of partnerships and explores in greater detail the intersection of subchapter C with subchapter S with respect to transactional issues, such as formation of the corporation, redemptions, liquidations, and mergers and acquisitions of and by S corporations, as well as similar issues regarding qualified subchapter S subsidiaries.

I. Introduction

A. An S Corporation Is a Corporation Taxed Like a Partnership—Not!

“For Federal income tax purposes, however, taxation of S corporations resembles that of partnerships.” — Wikipedia, “S corporation”¹

The above statement from Wikipedia, which is often repeated by tax law neophytes, is incomplete and completely false. An S corporation generally does not pay income taxes and the income and losses pass through to the shareholders and retain their character as they pass though. Basis adjustments to an S corporation shareholder's stock reflect allocations of income, expense, loss, and distributions. Although the pass-through model and basis adjustment rules are modeled in large part on the rules of subchapter K governing

¹James J. Freeland Eminent Scholar in Taxation and Professor of Law, University of Florida Fredric G. Levin College of Law; Rutgers-the State University of New Jersey, B.A., 1971; Boston College, J.D., 1974; Boston University, LL.M. (Taxation), 1979.

²Professor of Law Emeritus, University of California Davis; University of California Davis, B.A., 1968; J.D., 1971.

partnership taxation, no provisions of subchapter K apply to S corporations. In fact, most of the rules governing the relationship between an S corporation and its shareholders differ significantly from the rules governing the relationship between a partnership and its partners. This Article highlights some of the major differences between taxation of S corporations and taxation of partnerships and explores in greater detail the intersection of subchapter C with subchapter S with respect to transactional issues, such as formation of the corporation, redemptions, liquidations, and mergers and acquisitions of and by S corporations, as well as similar issues regarding qualified subchapter S subsidiaries (QSubs).

B. An S Corporation Is a Corporation Subject to Subchapter C with Limited Exceptions

Under section 1371(a), an S corporation and its shareholders are subject to all of the rules of subchapter C, just like a corporation that has not made an S election, with very few exceptions. An S election negates the application of the section 11 corporate tax and the section 301(c) treatment of distributions as dividends to extent of earnings and profits. Correlatively, S corporations do not accumulate earnings and profits. However, an S corporation may acquire earnings and profits from its history as a C corporation before conversion to an S corporation, by acquisition through the acquisition of the assets of a C corporation with earnings and profits in a section 368(a)(1) reorganization (e.g., merger or other asset acquisition reorganization), or the liquidation of a C corporation subsidiary with earnings and profits. The existence of earnings and profits affects the application of the section 1368 distribution rules. In addition, S corporations, like partnerships more than 50% of the interests in which are owned by individual partners, are generally required to report on a calendar year basis. There is, however, an exception if the S corporation can establish a business purpose for a fiscal year. However, shareholder deferral is not a permitted business purpose. Moreover, there are no carrybacks or carryovers of loss or other items from subchapter C years to subchapter S years and

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3 I.R.C. § 1363(a).
4 I.R.C. § 1368(a).
5 I.R.C. § 1371(c).
6 I.R.C. § 381(a).
7 I.R.C. § 1378(b)(1).

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vice versa. With these exceptions, pursuant to section 1371(a), every rule in subchapter C applies equally to subchapter S corporations.

II. General Overview of Subchapter S

A. The Basic Framework of Subchapter S

1. Shareholder Limitation

To be eligible to make a subchapter S election, a corporation must meet a number of requirements, including limitations on the number and identity of its shareholders, none of which apply to partnerships. An S corporation may have no more than 100 shareholders. The 100-shareholder limit is somewhat illusory, however, because section 1361(c)(1) treats as a single shareholder all of the members of a family traced to a common ancestor no more than six generations removed from the youngest family member who is a shareholder.

Qualifying shareholders include individuals, grantor trusts, voting trusts, "qualified subchapter S trusts" (QSSTs), "electing small business trusts" (ESBTs), tax-exempt charitable organizations, and certain retirement pension trusts. An S corporation cannot have a shareholder who is a nonresident alien individual, a corporation (other than a tax-exempt charitable organization), partnership, or an LLC that is taxed as either a partnership or corporation. However, an LLC that is a disregarded entity may be an S corporation shareholder.

Although an S corporation may not be a subsidiary of another corporation, an S corporation may hold stock in a controlled subsidiary corporation. A domestic corporation that is 100% owned by a parent S corporation may, at the parent S corporation's election, be treated as a disregarded entity—

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9§ 1371(b).
10Solely for purposes of employee fringe benefit provisions, however, section 1372 treats an S corporation as a partnership and each shareholder with more than two percent as a partner. I.R.C. § 1372(a). As a result, S corporation shareholders holding more than two percent of the stock are not eligible to receive employee fringe benefits tax-free. See Rev. Rul. 91-26, 1991-1 C.B. 184.
11I.R.C. § 1361(b)(1)(A). The only limitation on the number of members in a partnership is found in section 7704, which, with some exceptions, taxes as corporations partnerships that are publicly traded. I.R.C. § 7704(a).
12§ 1361(c).
13§ 1361(b); Rev. Rul. 2009-15, 2009-1 C.B. 1035 (holding that when an unincorporated entity taxed as a partnership becomes a corporation for federal tax purposes, whether by an election under Regulation section 301.7701-3(c)(1)(i) or through formless conversion under state law, the newly formed corporation is eligible to elect to be taxed as an S corporation effective its first taxable year; thus, the corporation will not be deemed to have an intervening short taxable year in which it was a C corporation).
2. **One Class of Stock Limitation**

An S corporation may issue only one class of stock.\(^{16}\) A corporation has one class of stock if all of the outstanding shares of stock of the corporation confer identical rights to current distributions and liquidation proceeds.\(^{17}\) However, section 1361(c)(4) allows differences in voting rights without violating the one-class-of-stock rule so long as the outstanding shares are identical with respect to the rights of the holders in the profits and in the assets of the corporation.

The existence of debt of an S corporation that might be classified as equity creates a risk that the reclassified equity interests will be treated as a prohibited second class of stock. To reduce this risk, section 1361(c)(5) provides a safe harbor in which certain "straight debt" will not be considered a second class of stock. The regulations further provide that proportionately held debt reclassified as equity will not constitute a second class of stock,\(^{18}\) and that debt reclassified as equity will not be treated as a second class of stock unless a principal purpose of issuing the instrument was to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitations on eligible shareholders.\(^{19}\)

3. **Election and Revocation Procedures**

S corporation status may be elected only with the consent of all shareholders at the time the election is filed.\(^{20}\) An election is effective on the first day of the taxable year following the filing of the election, except that an election filed within the first two and one-half months of the taxable year may be retroactive to the first day of the taxable year.\(^{21}\) In the latter case, the corporation must have satisfied all of the requirements for S corporation status since the first day of the taxable year.\(^{22}\) Once made, an election continues in effect until

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\(^{15}\)§ 1361(b)(3); *see infra* Part VII.

\(^{16}\)§ 1361(b), (c).

\(^{17}\)Reg. § 1.1361-1(d)(1).


\(^{19}\)Reg. § 1.1361-1(d)(4)(ii)(A).

\(^{20}\)I.R.C. § 1362(a)(2). In contrast, an unincorporated business entity with two or more members is treated as a partnership unless it elects to be treated as a corporation. Reg. §§ 301.7701-2(a), -2(b)(1)-(8), -2(c)(1); Reg. §§ 301.7701-3(a), -3(b)(1)(i).

\(^{21}\)§ 1362(b)(1)-(B). Section 1362(b)(5) permits the Service to waive a late election for "reasonable cause." Revenue Procedure 98-55, 1998-2 C.B. 643, provides detailed procedures for seeking relief from a late election under section 1362(b)(5). Revenue Procedure 97-48, 1997-2 C.B. 521, *modified and superseded in part by* Rev. Proc. 2013-30, 2013-36 I.R.B. 173, provides automatic relief for certain late filed elections that are made at least six months after the date on which the corporation filed its tax return for the first year the corporation intended to be treated as an S corporation.

\(^{22}\)§ 1362(b); Reg. § 1.1362-6(a)(2)(ii)(B).
it is revoked by a majority of the shareholders, the corporation ceases to meet the qualifications of an S corporation, or the corporation has accumulated earnings and profits at the close of each of three consecutive tax years and in each of such tax years earns passive investment income in excess of 25% of gross receipts.

Section 1362(d)(1) allows revocation of an S election by shareholders owning a majority of outstanding stock. A revocation made on or before the fifteenth day of the third month of the taxable year will be retroactively effective as of the first day of the taxable year. Otherwise, a revocation is effective on the first day of the next taxable year. Alternatively, the revocation may specify an effective date as long as the date specified is subsequent to the date of the revocation. A prospective voluntary revocation may be rescinded at any time before the revocation becomes effective. Rescission requires the consent of any person who consented to the revocation and any person who became a shareholder of the corporation after the revocation was filed.

Section 1362(e) requires that in any taxable year in which the S corporation election terminates effective on a date other than the first day of the taxable year, income and deduction items must be allocated between the portion of the year the corporation is qualified as an S corporation and the portion of the year the corporation is treated as a C corporation.

4. Effect of Election

An S corporation is not subject to the section 11 corporate income tax, and section 1363(b) provides that an S corporation must compute its taxable income as an "individual." Thus, for example, the section 243 dividends received deduction, which is available to C corporations, does not apply to S corporations. Nor does the section 170(c)(2) ten percent of taxable income limitation on the amount of deductible charitable contributions by a corporation apply to contributions by an S corporation. Instead, the contribution passes through to the shareholders, and the limitations applicable to individuals apply at the shareholder level.

However, section 1363(b) does not result in the application of all provisions applicable to individuals applying to S corporations. First, section 1363(b), through a cross reference to section 703(a)(2), carves out certain

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23 A corporation will accumulate earnings and profits only in years it is a C corporation. Thus, this restriction does not apply to a corporation that has no tax history as a C corporation. Reg. § 1.1362-2(c)(1).

24 § 1362(c)-(d).

25 The revocation date must be specified in terms of a day, month, and year, rather than in terms of a particular event. Reg. § 1.1362-2(a)(2)(ii).

26 Reg. § 1.1362-2(a)(4).

27 I.R.C. § 1363(b).

exceptions. Furthermore, even if a particular Code section that applies to individuals is not a listed exception, if a section inherently can apply only to an individual, it will not apply to an S corporation. For example, Trugman v. Commissioner held that the first time homebuyer's credit under now-expired section 36, which was available to an "individual" who had no present ownership interest in a principal residence during the three-year period ending on the date of the purchase, was not allowable to an S corporation that purchased a home for its shareholders, notwithstanding that the section 36 credit was not one of the listed exceptions in section 1363(b). The court held that a corporation could not be an "individual" for purposes of section 36 and that the election of subchapter S status did not change that characterization. The court reasoned that only individuals can have a principal residence—a corporation has a principal place of business. Thus, before concluding that a provision that applies to individuals also applies to S corporations, the statutory provision in question must be carefully examined.

Items of income, loss, or deduction of an S corporation are passed through the entity to the shareholders, and retain their character in the shareholders' hands, in the same manner that partnership items are passed through to partners under subchapter K. The character of items, such as capital gain, is based on the character of income at the corporate level. Each item of income or deduction that may affect shareholders differently must be separately stated and reported to the shareholders. For example, tax-exempt interest income retains its exemption under section 103 and interest expense must be categorized under the complex interest allocation rules to determine its deductibility by the individual shareholders. Each shareholder reports the item on the shareholder's return as if the item were derived by the shareholder directly.

The shareholder's basis in S corporation stock is increased for income items and decreased for deduction or loss items passed through to the shareholder from the corporation. As is the case under the partnership model, the shareholder's deductible loss is limited to the shareholder's basis in stock. However, unlike partners in a partnership who include their shares of the partnership's indebtedness in the basis of their partnership interests, S corporation shareholders do not increase the basis of their stock by any portion of the S corporation's indebtedness, even if the shareholders have guaran-

29 Under section 703(a)(2), these include the deduction for personal exemptions, deductions for taxes (except foreign taxes), deductions for charitable contributions, the net operating loss deduction, individual itemized deductions, and the deduction for depletion with respect to oil and gas wells. Where incurred by the S corporation, these items will pass through to the shareholder to be addressed separately in the shareholders' taxable income. I.R.C. § 703(a)(2).
31 § 1366.
32 § 1366(b).
33 I.R.C. § 1367.
34 § 1366(d).
35 I.R.C. § 752(a).
teed the corporation’s debts. Instead, S corporation shareholders who lend money to the corporation may deduct losses up to their basis in the debt of the S corporation after their stock basis has been reduced to zero.

Distributions of the previously taxed income are received by shareholders without additional tax. Distributions reduce the shareholder’s basis in stock of the corporation, and distributions in excess of basis result in recognition of capital gain.

A second tier of distribution rules applies to an S corporation that has accumulated earnings and profits inherited from C corporation taxable years to preserve the “double” tax pattern for earnings originally generated in a C corporation. The corporation must maintain an “accumulated adjustments account” that reflects net corporate income items that have been passed through to shareholders. Distributions to the extent of this accumulated adjustments account are received by the shareholders tax-free to the extent the distributions do not exceed stock basis. Any distributions in excess of the accumulated adjustments account are treated as distributions of earnings and profits, to the extent thereof, and are taxed to the shareholders as dividends. Any distributions that exceed the corporation’s accumulated earnings and profits are received by the shareholders as a reduction of basis, then as capital gain to the extent that a distribution exceeds the recipient shareholder’s basis.

There are two exceptions to the general rule that an S corporation is not subject to corporate tax. Under section 1374, S corporations are taxable at the highest tax rate specified in section 11(b) on “built-in” gain recognized on disposition of appreciated assets or income items generated while the corporation was a C corporation, or acquired from a C corporation in a nonrecognition transaction. In addition, under section 1375, an S corporation with accumulated earnings and profits is taxable at the highest tax rate specified in section 11(b) to the extent that passive investment income exceeds 25% of its gross receipts. Three successive years of passive income in excess of 25% of gross receipts in an S corporation with earnings and profits will cause termination of the S election.

B. Comparison of S Corporations and Partnerships (Including LLCs)

The Code is not neutral as to the choice between taxation as a subchapter S corporation or as a partnership. There are significant differences between

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See, e.g., Goatcher v. United States, 944 F.2d 747, 751 (10th Cir. 1991); Uri v. Commissioner, 949 F.2d 371, 373-74 (10th Cir. 1991); Harris v. United States, 902 F.2d 439, 445 (5th Cir. 1990); Estate of Leavitt v. Commissioner, 875 F.2d 420, 423 (4th Cir. 1989).

§ 1366(d)(1).
§ 1368(b)(1).
§ 1368(b)(2).
§ 1368(c).
§ 1368(c).
§ 1363(a).
§ 1362(d)(3).

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the taxation of S corporations and partnerships that affect a taxpayer’s choice between the two entities. Since an LLC almost always will elect to be taxed as a partnership, the following considerations are applicable to LLCs as well. For example, beneficial ownership of an S corporation is nominally limited to 100 shareholders, while there is no limit on the number of persons who may be partners in a partnership. Nor are there restrictions on the types of entities that may be partners in a partnership.

Partnerships can allocate items of income, deduction, gain and loss among the partners in any manner desired, as long as the allocations have substantial economic effect or are consistent with the partnership interest in the partnership. Extraordinarily detailed regulations expound on these concepts. For S corporations, however, the single class of stock rule prevents S corporations from making special allocations of income, deduction, gain, and loss among an S corporation’s shareholders. All items of income, gain, deduction, and loss must be allocated per share, per day.

The rules of subchapter K governing partnerships treat entity level debt differently than it is treated by the rules governing S corporations. The shareholder’s basis in subchapter S stock or debt is limited to the shareholder’s actual investment in the corporation. In contrast, pursuant to section 752, partners include their shares of partnership debt in the bases of their partnership interests, which in turn allows partners to deduct partnership losses attributable to partnership level debt. Thus, the partnership form provides a significant advantage in the case of leveraged investments if losses are anticipated. This limitation also means that while untaxed entity level cash, for example, from a refinancing, can be distributed by a partnership free of tax, the same distribution by an S corporation may trigger gain recognition. For these reasons, S corporations have not been used for leveraged investments in assets such as real estate.

Subchapter S also differs from subchapter K in its treatment of distributions of appreciated property. An S corporation is required by sections 311(b) and 336 to recognize gain on the distribution of appreciated property to shareholders. The recognized gain is passed through to the shareholders, who increase the basis of their stock accordingly. The distributee shareholder

45One exception is an LLC that elects to be taxed as a corporation and then makes an election to be taxed as an S corporation. This is not a tax strategy but a strategy followed to invoke application of state law LLC governance rules rather than corporate statute governance rules, while obtaining limited liability under state law pass-through taxation. See Stephen R. Looney & Ronald Levitt, Operating an S Corporation Through a State Law Limited Liability Company, 66 N.Y.U. Ann. Inst. Fed. Tax’n §§ 17.01, 17.03 (2008).


47I.R.C. § 704(b).

48Reg. §§ 1.704-1 to -3. Section 704(c), however, prescribes special, less flexible, rules for allocating items of built-in gain or loss. See Reg. § 1.704-4.

49I.R.C. § 1377(a)(1).

50See Estate of Leavitt v. Commissioner, 875 F.2d 420, 422 (4th Cir. 1989) (holding that a bank loan to an S corporation guaranteed by shareholders is not included in the shareholders’ basis).
obtains a fair market value basis in the distributed property and decreases the basis of the S corporation stock by the same amount. In contrast, under subchapter K, section 731 (subject to some exceptions) provides that the distribution of appreciated property by a partnership generally does not trigger recognition of gain or loss to either the partnership or the partner. Instead, the distributee partner takes either a transferred or exchanged basis in the distributed property, depending on the particular facts, and recognition of gain is deferred until the distributee disposes of the property.

The sale by a shareholder of stock of an S corporation results in capital gain or loss, all of which is taxed at the most preferential rate that applies to capital gains if the stock has been held long-term. In contrast, the sale of a partnership interest, while first categorized as the sale of a capital asset, is subject to a "look-through" rule that results in ordinary income to the selling partner with respect to "unrealized receivables" and inventory (which together include the selling partner's share of all partnership ordinary income assets), as well as a look-through that subjects "unrecaptured section 1250 gain" (i.e., gain on depreciable real estate to the extent of prior depreciation deductions) and collectibles gain to the less preferential section 1(h) rates applicable to those categories of long-term capital gain.

In addition, an S corporation can avail itself of the corporate reorganization provisions of subchapter C. In contrast, while the merger of partnerships does not generally give rise to a taxable event, the merger of a partnership into a corporation, like the sale of an interest in a partnership, triggers the recognition of gain or loss under section 741. Finally, as a corporation, an S corporation can terminate its election and offer shares to the public without tax consequences. The termination of an S election is not a taxable event. In contrast, a public offering of partnership interests converts the partnership to a corporation pursuant to section 7704, which can have tax consequences even though it is generally a tax-free transaction.

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51 I.R.C. § 301(d).
52 I.R.C. §§ 1367(a)(2)(A), 301(b).
53 In some instances, section 751(b) requires recognition of gain (or loss) by either or both the partnership and the partner.
54 See I.R.C. § 732.
55 Long-term capital gains are generally taxed at zero percent if they would have been taxed as ordinary income in the 10% and 15% brackets, 15% if they would have been taxed in tax brackets higher than 15% (but below the 39.6% bracket if they would have been taxed at ordinary income rates), and 20% if they would have been taxed in the 39.6% bracket at ordinary income rates. I.R.C. § 1(h)(11).
56 I.R.C. § 741.
57 I.R.C. § 751(a).
58 See §§ 1.1(h)-1(b)(2), -1(b)(3).
59 Reg. § 1.708-1(c).
III. Formation of an S Corporation

A. Generally

Notwithstanding the heading of this Part III, there is no such thing as "forming an S corporation." There are no special rules for forming a corporation that subsequently will make an S election, even if that election is made retroactive to the corporation's formation. Moreover, and most importantly, under section 1371, S corporations are subject to all subchapter C rules, including, among others, sections 302, 304, 306, 331, 336, 351, 357, 368, 381, and 382 of the Code.

The rule of section 351(a), which provides nonrecognition of gain and loss to shareholders contributing property upon the formation of a corporation, whether or not that corporation will make an S election, applies only if the persons transferring property to the corporation pursuant to the plan to incorporate receive, in the aggregate, 80% of the voting common stock and 80% of each class of nonvoting common stock, if the corporation issues nonvoting common stock. The exchanged basis rule of section 358 applies to determine the shareholder's basis in the stock, and the transferred basis rule of section 362(a) applies to determine the S corporation's basis in its assets. Furthermore, notwithstanding the making of a retroactive S election for the corporation's first year, the basis limitation rule of section 362(e)(2) applies if any shareholder has transferred property to the corporation with an aggregate built-in loss. However, the corporate-level basis limitation rule can be avoided through a joint election by the contributing shareholder and the corporation to have the shareholder reduce the basis of the shareholder's stock by the required basis reduction amount in lieu of the corporate-level basis reduction. Subchapter K, dealing with partnerships, has no basis limitation rule analogous to section 362(e)(2), although section 704(c) requires that only the contributing partner enjoys the tax benefit of the excess of the basis of contributed property over its fair market value.

Unlike in the case of a partnership, new owners cannot be admitted to a preexisting S corporation in exchange for contributions of property without gain recognition by the incoming shareholder unless section 351 applies to the transfer of property. Once an S corporation is in existence, a subsequent contribution of property in exchange for additional shares is a recognition event unless the contributing shareholder (or group of contributing shareholders in the aggregate) holds more than 80% of the voting common stock (and 80% of each class of nonvoting common stock, if the corporation issues nonvoting common stock). In the case of partnerships (including LLCs taxed as partnerships) subsequent property contributions in exchange for an increased interest in the entity are automatically accorded nonrecognition under section 721.

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601.R.C. § 362(e)(2)(C). For details on making the section 362(e)(2)(C) election see Regulation section 1.362-4(d).
The applicability of section 351 to S corporations also means that if a transferor of property to an S corporation receives not only stock as the consideration for the transfer of property, but also receives other property (boot), including the corporation's promissory note, then pursuant to section 351(b) the transferor shareholder's realized gain must be recognized to the extent of money and the fair market value of property received as boot.61

After formation, the corporation can then elect S corporation status, which may be retroactive to the first day of the corporation's taxable year if the election is made on or before the fifteenth day of the third month of the taxable year.62 The taxable year of a new corporation begins on the date the corporation has shareholders, acquires assets, or begins doing business, whichever occurs first.63

B. Assumption of Shareholder's Debts in Connection with Formation—Beware of Section 357(c)

Pursuant to section 357(c), a shareholder transferring property to a corporation in a section 351 transaction must recognize gain equal to the amount of the excess of the shareholder's debts assumed by the corporation over the shareholder's basis in property contributed to the corporation.64 Section 357(c) applies to an S corporation and its shareholders in the same manner as if no S election had been made. Section 357(c) requires gain recognition when the liabilities assumed by the corporation exceed the transferor shareholder's basis in the property even if the transferor remains liable as a guarantor.65 The corporation increases its transferred basis in the contributed property by the amount of gain recognized to the contributing shareholder under section 357(c).66 These rules differ significantly from the rules of section 752, applicable to partnerships, under which the partner's share of all of the partnership's debts is taken into account in determining whether a contributing partner's net debt relief exceeds the partner's basis in the partnership interest (which upon formation is derived from the basis in the contributed property). Furthermore, a partnership does not automatically increase its section 723 transferred basis in contributed property by virtue of a contributing partner's gain recognition.

In Peracchi v. Commissioner, the Ninth Circuit Court of Appeals held that a promissory note contributed by a shareholder to a C corporation had a basis

61 The fair market value of a promissory note that bears interest of at least the applicable federal rate is the stated principal amount. See Reg. § 1.1001-1(g).
63 Reg. § 1.1362-6(a)(2)(ii)(C). See Bone v. Commissioner, 52 T.C. 913, 918-20 (1969) (holding first taxable year had begun when the corporation acquired assets and engaged in business even though no stock had been issued to shareholders; under state law the issuance of stock was not a prerequisite to corporate existence).
64 Debts that will be deductible only when paid, that is, cash method accounts receivable or accrual method liabilities the deduction for which is deferred under section 461(h), are not taken into account for this purpose. I.R.C. § 357(c)(3); see Rev. Rul. 95-74, 1995-2 C.B. 36.
65 Seggerman Farms, Inc. v. Commissioner, 308 F.3d 803, 808 (7th Cir. 2002).
66 I.R.C. § 362(a).
equal to its principal amount for purposes of applying section 357(c). Thus, where a shareholder contributes property and a promissory note and the sum of the basis of the property and the principal amount of the note (assuming that the note is genuine and bears interest at the applicable federal rate (AFR)) equals or exceeds the shareholder's debts assumed by the corporation in connection with the contribution, no gain must be recognized. In *Lessinger v. Commissioner*, the Second Circuit Court of Appeals reached the same result on somewhat different reasoning. The Service and Tax Court take a different view, treating the basis of a promissory note contributed by a shareholder as zero and requiring gain recognition. In Revenue Ruling 68-629, the Service held that for purposes of applying section 357(c), a shareholder's note contributed to the corporation had a zero basis. The Tax Court first followed Revenue Ruling 68-629 in *Alderman v. Commissioner*.

Assuming that *Peracchi* is the controlling law (which, except in the Ninth Circuit, might be a big assumption), it is not clear whether *Peracchi* supports treating a shareholder's note to an S corporation as having basis equal to principal amount for purposes of applying section 357(c). Indicating that an entity with

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67Peracchi v. Commissioner, 143 F.3d 487, 496 (9th Cir. 1998).
68Lessinger v. Commissioner, 872 F.2d 519, 528 (2d Cir. 1989).
71The courts' reasoning in both *Peracchi* and *Lessinger*, as well as the Tax Court's reasoning in *Alderman* and the Service's reasoning in Revenue Ruling 68-629, are misguided, but ultimately the court in *Peracchi* reached the correct conclusion, at least where the debt obligation is genuine. All of these authorities focus on determining whether the transferor shareholder's basis in the shareholder's own note is zero or its principal (face) amount in applying section 357(c). The court decisions, including *Peracchi*, as well as the Service's reasoning, miss the point that the statutory rule in section 357(c) is inadequate to deal with the issue because the statute focuses on the transferor's basis in property "transferred." To transfer property the transferor must own the property prior to the transfer. However, the transferor never owned the transferor's own promissory note. The note did not come into existence as "property" until it was owned by the corporation. The shareholder "issued" the note to the corporation: the shareholder did not "transfer" it; rather, the note was created by its issuance. *Alderman* and the Service attempt to follow the statutory pattern of subchapter C quite literally, without resort to general principles of taxation. *Peracchi*, on the other hand, superimposes on subchapter C the general principle that payment with a promissory note is treated the same as payment in cash. For basis purposes, the acquisition of property for a note is the same as the acquisition of property for cash. See Rev. Rul. 2004-37, 2004-1 C.B. 583. Revenue Ruling 2004-37 held that under general principles of taxation, stock in a corporation acquired in exchange for the shareholder's promissory note takes a section 1012 cost basis equal to the principal amount of the note, just as it would if cash had been paid. From this perspective, it should not matter whether a taxpayer, on the one hand, transfers property and cash to a corporation in exchange for stock, or, on the other hand, transfers property and a promissory note in exchange for stock. If the exchange were a taxable transaction, the tax consequences to both the shareholder and corporation would be identical in each case. Thus, the issuance of the shareholder's promissory note to the corporation in addition to the transfer of property in connection with which the corporation assumes debts of the shareholder should be treated in the same manner as a contribution of cash equal to the principal amount of the debt. Perhaps this is the reason that no case, Revenue Ruling, or any informal Service guidance has applied or cited either *Alderman* or Revenue Ruling 68-629 since *Peracchi* was decided.
pass-through losses presents a different problem, footnote 16 of Peracchi states, 
"Our holding therefore does not extend to the partnership or S Corp context."\(^7\)
This statement simply cannot be correct if under section 1371(a) all subchapter C rules apply to an S corporation. There are no special rules for "forming an S corporation." If it is meaningful, perhaps the limitation in footnote 16 of Peracchi applies only in the case of contributions to a preexisting corporation, which was the factual context of Peracchi. Further, the retroactive election of S corporation status does not have to date all the way back to the date on which the assets were contributed; rather, the election can be retroactive to the day following the date on which the assets were contributed.

C. Section 362(e) Asset Basis Reduction

When property is transferred to a corporation in exchange for stock in a transaction governed by section 351, section 362(a) generally provides the corporation with a basis in the property equal to the transferor's basis (plus any gain recognized by the transferor under section 351(b)). However, when the aggregate basis of the transferred property exceeds its aggregate fair market value, section 362(e) limits the aggregate basis of all property transferred to the corporation by any particular transferor to the aggregate fair market value of the transferred property. Section 362(e)(2) was enacted to prevent taxpayers from transmuting a single economic loss into two (or more) tax losses by taking advantage of the dual application of the substituted basis rules in section 358 for stock received in a section 351 transaction and in section 362 for assets transferred to a corporation in a section 351 transaction. Although it might be thought that because S corporation income and losses are passed through to the shareholders under section 1366 and the basis of their stock is adjusted under section 1367, the double deduction problem is not present in the S corporation regime because the greater deductions (or lower income) recognized at the corporate level as a result of a basis in excess of fair market value would be reflected in adjustment to the basis of the stock, this is not necessarily true.\(^7\) If the excess of basis over fair market value is recouped by the corporation before the stock is sold, the double deduction is eliminated; but if the stock is sold before the corporation recoups the excess basis, the double deduction problem remains because the corporation's basis in its assets is not affected by the stock sale.\(^7\)

Section 362(e)(2) does not necessarily result in the basis of every item of loss property being reduced to its fair market value. When some appreciated property also is transferred to the corporation, section 362(e)(2)(A) requires

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\(^7\)Peracchi, 143 F.3d at 494.

\(^7\)For the application of section 362(e)(2) to transfers to an S corporation generally, see Regulation section 1.362-4(h), Ex. (9)(i).

\(^7\)This is in contrast to the adjustment to the basis of a partnership's assets under section 743(b) that can, and sometimes must, result from a sale of partnership interest. See I.R.C. § 743(b).
that the aggregate basis of the transferred property be reduced by the excess of
the aggregate basis over the aggregate fair market value, and section 362(e)(2)
(B) requires that the aggregate basis reduction be allocated among the trans-
ferred properties in proportion to the built-in losses in the properties before
taking into account section 362(e)(2). Assume, for example, that B trans-
ferred three properties to newly formed Y Corporation in exchange for all of
the stock: a building, with a fair market value $7,000 and a basis $9,000; land
with a fair market value $4,500 and a basis $3,000; and a machine, with a
fair market value $4,000 and a basis $5,000. The aggregate fair market value
of the three properties is $15,500 and their aggregate basis is $17,000, thus
requiring a basis reduction of $1,500 ($17,000 - $15,500) with respect to the
building and the machine, the two properties with a basis that exceeds fair
market value. The building has a built-in loss of $2,000 and the machine has
a built-in loss of $1,000. The $1,500 basis reduction is allocated two thirds
to the building ($2,000/($2,000 + $1,000)), and one third to the machine
($1,000/($2,000 + $1,000)). Thus, the basis of the building is reduced by
$1,000 (2/3 x $1,500), from $9,000 to $8,000, leaving an unrealized loss
of $1,000 ($8,000 basis - $7,000 fair market value) inherent in the build-
ing and the basis of the machine is reduced by $500 (1/3 x $1,500), from
$5,000 to $4,500, leaving an unrealized loss of $500 ($4,500 basis - $4,000
fair market value) inherent in the machine. Alternatively, B and Y Corpora-
tion could elect under section 362(e)(2)(C) to have B reduce the basis of the
stock received in exchange for the three assets by $1,500—from $17,000 to
$15,500.

Section 362(e)(2) applies transferor-by-transferor. Thus, if the building,
land, and machine described above were transferred to the corporation by C,
D, and E, respectively, the $2,000 built-in loss with respect to the building

75 No stock basis reduction is required under section 1367(a)(2)(D) by reason of a reduction
to the S corporation’s basis in acquired assets if a section 362(e)(2)(C) election is not made. Reg. § 1.362-4(f).

76 Regulation section 1.362-4(d) provides details on how to make the section 362(h)(2)(C)
election to reduce the transferor’s stock basis in lieu of the corporation reducing asset basis. For
an election to be effective: (1) prior to filing “a Section 362(e)(2)(C) Statement,” the transferor
and transferee must enter into a written, binding agreement to elect to apply section 362(e)(2)
(C), and (2) detailed requirements for filing the “Section 362(e)(2)(C) Statement,” which is
required to contain extraordinarily detailed information about the transfer, must be followed.
The transferor must include the “Section 362(e)(2)(C) Statement” on or with its timely filed
(including extensions) original return for the taxable year in which the transfer occurred. A
section 362(e)(2)(C) election is irrevocable. It may be made protectively and will have no effect
to the extent it is determined that section 362(e)(2) does not apply.

For the application of section 362(e)(2) to transfers by one S corporation to another cor-
poration in exchange for stock generally, see Reg. § 1.362-4(h), Ex. (9)(ii). If an S corporation
is the transferor, any reduction under section 362(e)(2)(C) to the basis in stock received by an
S corporation in a transaction subject to section 362(e)(2) is an expenditure or expense of the
transferor partnership or S corporation. As a result, pursuant to section 1367(a)(2)(D), the sec-
tion 362(e)(2)(C) stock basis reduction results in a reduction to the basis of the S corporation
shareholder’s basis in the stock of the S corporation. Reg. § 1.362-4(e)(2).

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and the $1,000 built-in loss with respect to the machine would be taken into account separately, and would not be offset by the $1,500 built-in gain with respect to the land. As a result, the basis of the building would be reduced from $9,000 to $7,000 and the basis of the machine would be reduced from $5,000 to $4,000. Alternatively, C could elect (jointly with the corporation) to reduce the basis of the stock received in exchange for the building from $9,000 to $7,000, leaving the corporation with a $9,000 basis in the building; and E could separately elect (jointly with the corporation) to reduce the basis of the stock received in exchange for the machine from $5,000 to $4,000, leaving the corporation with a $5,000 basis in the machine.

The election provided by section 362(e)(2)(C) to reduce the contributing shareholder's basis in the stock received for the property in lieu of reducing the corporation's basis in the assets otherwise subject to a basis reduction pursuant to section 362(e)(2) can be quite beneficial, particularly in the case of an S corporation. The basis in the contributed assets, particularly if the assets are inventory or depreciable property, likely will be relevant to the contributing shareholder's tax consequences long before the basis of the stock becomes relevant. While it is true that the basis of the stock determines the ceiling on passed-through losses that can be currently deducted under section 1366(d), retaining a higher corporate basis in inventory and depreciable property will reduce the net taxable income (or increase the net loss) passed through to the shareholder(s) under section 1366 in all cases. However, the reduction of the shareholder's stock basis pursuant to a section 362(e)(2)(C) election will be relevant only if cumulative net passed-through losses exceed the aggregate basis of all of the shareholder's stock, and even then, the result is merely deferral, rather than loss of the deductions. Suffering the section 362(e)(2) basis reduction in the corporation's assets, in contrast, has a more permanent effect.

On the other hand, under some circumstances, an S corporation shareholder who elects to reduce the basis of the S corporation stock under section 362(e)(2)(C) may inadvertently eliminate the loss completely when the transferred asset is sold. The regulations illustrate this possibility with an example involving an election to reduce the basis of the shareholder's stock followed by the sale in the same year of the corporation's assets, resulting in a passed-through loss that further reduced basis of the stock, and the sale of the stock, which resulted in an offsetting gain in an equal amount.

Furthermore, it must be recognized that where an S corporation has two or more shareholders, particularly if the shareholders are unrelated, a shareholder who contributed depreciated property and joins in a section 362(e)(2)(C) election suffers a basis reduction in the stock that is greater in amount than the cumulative reduction in the amount of passed-through income that will result from the corporation's higher basis. Some of the benefit of the corporation's

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78 Reg. § 1.362-4(h), Ex. (9).
higher basis is shifted to the other shareholders. If for example, F contributes $800 of cash and G contributes a depreciable asset with a fair market value of $800 and a basis of $1,000, each receives the same number of shares, and when the election is made, G suffers a $200 reduction in the basis of the stock received (from $1,000 to $800) while gaining only $100 in cumulative additional depreciation deductions—one-half of $500 instead of one-half of $400. However, taking into account the time value of money (as well as the possibility that if the stock appreciates and is held until death, section 1014 in effect reverses the effect of the election on the basis of the stock), the election still could be very beneficial to G.

IV. Election of S Corporation Status

A subchapter S election is made by the corporation, but the election is valid only if all of the shareholders file consents to this election. After an election has been made, new shareholders are not required to consent. A shareholder cannot individually directly revoke or terminate an election, but undertaking a transaction that causes the corporation no longer to qualify for S corporation status, such as transferring shares to an ineligible shareholder, may have that effect. 

An election made any time during the taxable year will be effective for the corporation’s next succeeding taxable year. Section 1362(b)(1)(B) provides for an election retroactive to the first day of the taxable year if the election is made on or before the fifteenth day of the third month of the taxable year. A retroactive election is effective for the taxable year in which it is made only if the corporation meets all of the requirements for S corporation status during the portion of the taxable year preceding the filing of the election and all of the shareholders consent to the election, including shareholders who were shareholders before the election was filed but who are no longer shareholders at the time of the election. This requirement is intended to “prevent any allocation of income and loss to pre-election stockholders who were either ineligible to hold subchapter S corporation stock or did not consent to the election.” If the corporation and its shareholders were not qualified to elect S corporation status during each day of the portion of the taxable year preceding a retroactive election, the election will be effective on the first day of the next taxable year.

81. § 1362(b)(1)(A).
82. § 1362(b)(2); Reg. § 1.1362-6(a)(2)(ii)(B).
84. § 1362(b)(3).
V. Corporate Level Taxes: Issues for an S Corporation with a C Corporation History

Several special problems arise when a corporation makes an S election after operating for some period of time as a C corporation or if an S corporation acquires earnings and profits through a tax-free acquisition of a C corporation's assets in a section 368(a)(1) reorganization or a section 332 liquidation of a C corporation subsidiary.

A. LIFO Recapture

Section 1363(d) requires a C corporation that makes a subchapter S election and which has used the last-in, first-out (LIFO) method of inventory accounting to include in gross income for its last year as a C corporation the "LIFO recapture amount." The LIFO recapture amount is the amount by which the S corporation's "inventory amount" (i.e., the corporation's basis in its inventory) of its inventory assets under the first-in, first-out (FIFO) method exceeds the inventory of such assets under the LIFO accounting method, determined as of the close of the last taxable year in which the S corporation was a C corporation. Because the FIFO inventory amount often significantly exceeds the LIFO inventory amount, section 1363(d) frequently imposes a significant impediment to an existing corporation that maintains inventory from making an S election. LIFO recapture also occurs when a corporation that conducts business through an interest in a partnership makes a subchapter S election.

B. Section 1374 Built-in Gains Tax

1. Generally

Except for the recapture of the benefits of LIFO inventory accounting under section 1363(d), described above, there are no other immediate income tax consequences attendant to a C corporation making an S election. However, section 1374 imposes deferred taxation at the corporate level of appreciation that occurred while assets were held by a C corporation that subsequently makes an S election if the corporation does not continue to hold the assets for...
a 120-month period—the recognition period—after making the S election. Section 1374 can, and often will, result in a corporate level tax on sales of inventory in the ordinary course of business after a C corporation makes the S election.

Double taxation is achieved by imposing a corporate level tax on recognized built-in gain with respect to assets held by the corporation at the time of conversion from C corporation to S corporation status in addition to taxing the shareholders on the gain under section 1366. The tax also applies to built-in gain recognized on the disposition of an asset that was acquired from a C corporation in a nonrecognition transaction with a transferred basis to the acquiring S corporation, that is, assets acquired in subsidiary liquidations and tax-free reorganizations. Section 1374 is not applicable to an S corporation that never was a C corporation and which has no assets that it acquired from a C corporation in a nonrecognition transaction. Section 1374 is also not applicable to assets purchased by the corporation or contributed to it during the period an S election is in effect.

Built-in gain recognized by an S corporation during the ten-year recognition period is subject to tax at the highest corporate tax rate under section 11(b), currently 35%. Recognized built-in gain is then subject to a second tax at the shareholder level as the recognized gain is passed through to shareholders under section 1366. Each shareholder's proportionate share of recognized built-in gain is reduced by the shareholder's proportionate share of the section 1374 tax. For example, if an S corporation sells a built-in gain long-term capital asset with a basis of $10 for $110, the corporation's recognized gain of $100 is subject to a corporate tax of 35%. Shareholders are allocated their proportionate share of the $100 of gain, less the tax of $35, for a net taxable gain of $65. Then the shareholders pay a tax on the passed-through $65 at the appropriate rate under section 1, which varies depending on the

Regulation section 1.1374-1(d) provides that the “recognition period” during which the section 1374 tax applies is the 120-month period beginning on the first day that the corporation is an S corporation (or acquires an asset from a C corporation in a transferred basis transaction), and provides rules for determining taxable recognized built-in gain when the recognition period ends within the corporation’s taxable year. The Small Business Jobs Act of 2010 shortened the holding period under section 1374 for recognizing unrealized built-in gain on conversion from a C corporation to an S corporation to five years preceding the corporation’s tax year beginning in 2011. Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2014, 124 Stat. 2504, 2556. Before the change, the holding period was ten years for sales or exchanges in tax years beginning before 2009, and seven years for tax years beginning in 2009 or 2010. The American Taxpayer Relief Act of 2012 extended the holding period reduction to five years for recognized built-in gain in 2012 and 2013. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 326, 126 Stat. 2313, 2334 (2013).

I.R.C. § 1374(a).

I.R.C. § 1374(c)(1).

I.R.C. § 1366(f)(2).
shareholders' marginal tax rate and whether or not the asset was an ordinary income asset, capital asset, or section 1231 asset.\(^2\)

Before the introduction in 2003 of the preferential rates for dividends, the total taxes would have been the same as would have been imposed on a C corporation selling the assets and distributing the after-tax proceeds as a dividend, thus preserving the effects of the double tax regime. After 2003, when an S corporation that formerly was a C corporation sells assets with a built-in gain, section 1374 tax can impose a higher total tax burden than is imposed on a C corporation selling ordinary gain assets and distributing the after-tax proceeds as a dividend.

Section 1374(e) grants to the Treasury Department broad authority to promulgate regulations to ensure that the double tax on assets that were appreciated at the time the corporation converted from C to S corporation status is not circumvented. Regulations sections 1.1374-1 through 1.1374-10 provide detailed rules governing the application of section 1374.

2. Amount of Gain Subject to the Built-in Gain Tax

The technical operation of section 1374 is somewhat convoluted. Section 1374(a) imposes the tax on the corporation's "net recognized built-in gain." The term "net recognized built-in gain" is, in turn, defined in section 1374(d) (2)(A) as the amount that would be the corporation's taxable income for the year if only "recognized built-in gains" and "recognized built-in losses" were taken into account (but not more than the corporation's actual taxable income for the year).

"Recognized built-in gain" is defined in section 1374(d)(3) as the amount of the gain recognized with respect to any asset disposed of during the year that was held by the corporation on the first day of its first taxable year as an S corporation to the extent the property's fair market value exceeded its basis on that day. Similarly, "recognized built-in loss" is defined in section 1374(d)
(4) as the loss recognized with respect to any asset disposed of during the year that was held by the corporation on the first day of its first taxable year as an S corporation to the extent the fair market value of the property was less than its basis on that day. Section 1374(c)(2) then limits the net recognized built-in gain taxable under section 1374(a) for the year to the excess of the corporation's "net unrealized built-in gain" over the net recognized built-in gain for previous years. "Net unrealized built-in gain" is defined in section 1374(d)(1) as the excess of the fair market value of the corporation's assets on the first day of its first taxable year as an S corporation over the aggregate basis of those assets on that day.

The purpose of this maze of statutory rules is to assure that the aggregate amount taxed under section 1374, if assets held on the day the S election was made are sold over a number of years, does not exceed the gain that would have been recognized if the corporation had sold all of its assets immediately before making the S election. The wording of sections 1374(d)(3) and (4) create rebuttable presumptions that all recognized gain on any asset sold during the ten-year recognition period is built-in gain and that no loss recognized during the period is built-in loss. Therefore, it is incumbent on the corporation to appraise all of its assets as of the effective date of an S election.

For example, assume that X Corporation made an S election on July 1, 2012. At that time X Corporation had the following assets:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>Fair Market Value</th>
<th>Built-in Gain/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Blackacre</td>
<td>$150</td>
<td>$225</td>
<td>$75</td>
</tr>
<tr>
<td>Whiteacre</td>
<td>$300</td>
<td>$550</td>
<td>$250</td>
</tr>
<tr>
<td>Greenacre</td>
<td>$450</td>
<td>$350</td>
<td>($100)</td>
</tr>
<tr>
<td>Net Built-in gain</td>
<td></td>
<td></td>
<td>$225</td>
</tr>
</tbody>
</table>

In 2014, when it has operating profits of $500, X Corporation sells Whiteacre for $650 and Greenacre for $300. The corporation recognizes a gain of $350 on Whiteacre and a loss of $150 on Greenacre. Assuming that X Corporation satisfies its burden of proof as to the properties' fair market values on July 1, 2012, the recognized built-in gain on Whiteacre is $250 and the recognized built-in loss on Greenacre is $100. The net recognized built-in gain for the year is $150. Since the corporation's net unrealized built-in gain with respect to all of its assets is $225, the entire net recognized built-in gain is taxed under section 1374(a) in 2014. If Blackacre is sold the following year for $225, the entire gain is net recognized built-in gain, and since the ceiling in section 1374(c)(2) is $75 ($225 net unrealized built-in gain minus $150 net recognized built-in gain from 2011), the entire $75 gain is taxed at the corporate level under section 1374(a).
Now assume alternatively that, in 2014, X Corporation sells Blackacre for $225 and Greenacre for $300. X Corporation recognizes a gain of $75 on Blackacre and a loss of $150 on Greenacre. Assuming that X Corporation satisfies its burden of proof as to the properties' fair market values on July 1, 2012, the recognized built-in gain on Blackacre is $75 and the recognized built-in loss on Greenacre is $100. Its net recognized built-in loss for the year is $25, and no tax is due under section 1374(a). If Whiteacre is sold the following year for $650, the corporation recognizes a gain of $350, of which $250 is net recognized built-in gain. But since the corporation's net unrealized built-in gain is only $225, only $225 of that gain is subject to corporate level tax under section 1374(a).

Although section 1371(b) generally proscribes the use by an S corporation of net operating loss carryovers from years when it was a C corporation, there is an exception if built-in gains are required to be recognized and taxed to the S corporation under section 1374. Section 1374(b) permits subchapter C net operating loss carryovers to offset net recognized built-in gain for a subchapter S year solely for the purpose of computing the section 1374 tax.93

3. Effect of Accounting Method

The inventory method maintained by a corporation will be used to determine whether goods required to be included in inventory were on hand with built-in gain at the time of conversion to S corporation status.94 The Tax Court held in Reliable Steel Fabricators, Inc. v. Commissioner that the valuation of inventory work in progress on the effective date of an S election must include some profit margin for completed work, but not for raw materials.95

The section 1374 tax applies to all gains from an installment sale under section 453 recognized during or after the 120-month recognition period if the sale occurred prior to or during the 120-month recognition period.96 Tax is imposed under this provision only to the extent that the gain would have been included in net recognized built-in gain if the entire gain had been recognized in the year of sale, taking into account the taxable income limitation of section 1374(d)(2)(A). In determining the limitation, if the sale occurred before commencement of the recognition period (generally speaking, while the corporation was still a C Corporation), the sale is deemed to have occurred in the first year of the recognition period.

4. Other Income Items Subject to Section 1374

Sections 1374(d)(3) and (4) define built-in gain and loss as gain or loss recognized during the recognition period “on the disposition of any asset”

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93Regulation sections 1.1374-9 and 1.1374-10(b)(3) provide anti-abuse rules directed to the acquisition of property for the purpose of avoiding the section 1374 tax.
94Reg. § 1.1374-7.
96Reg. § 1.1374-4(h).
held at the beginning of the first taxable year of an S corporation. Income from the sale of oil under a working interest in oil and gas property held by a corporation at the time of its conversion to S corporation status is not recognized built-in gain. The example reasons that at the time of conversion to S corporation status, the corporation held a working interest in oil in place, and not the oil itself.

By analogy to the example in the regulations, Revenue Ruling 2001-50 held that income from the sale of standing timber, or from the sale of coal or iron ore, owned by a corporation at the time of its S corporation election likewise is not recognized built-in gain under section 1374. (The Ruling applies both to gains that are treated as capital gains under the special rules of section 631, and gains that are not subject to section 631.) The Ruling indicates that timber cut and sold during the recognition period is sold as inventory that “did not constitute separate assets held by the S corporation on the conversion date.” The Ruling also states that even though some income from the disposition of timber or coal and iron ore receives capital gains treatment under section 631, “the income received from the sale of the resulting wood product, produced coal, or produced iron ore involves the receipt of normal operating business income in the nature of rent or royalties” that is not subject to tax under section 1374. Both the example in the Regulation and the Revenue Ruling avoid the very difficult valuation problem that would exist in attempting to determine built-in gain or loss of natural resources at the time of conversion to S corporation status.

Items of income and deduction attributable to prior periods that are taken into account as built-in gain items under section 1374(d)(5) include items that would have been taken into account before the beginning of the recognition period if the corporation had used the accrual method of accounting. For example, accounts receivable accrued before conversion to S corporation status, but collected by a cash method S corporation after conversion, are treated as built-in gain items.

Cancellation of debt income or bad debt deductions attributable to indebtedness that exists prior to the beginning of the recognition period are treated as built-in gain or loss. Built-in gain or loss also includes adjustments to income required under section 481 as a result of a change in accounting method effective before the beginning of the second year of the recognition period.

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97 Reg. § 1.1374-4(a)(3), Ex. (1).
100 See Reg. § 1.1374-4(b)(3), Ex. (1); Leou v. Commissioner, 68 T.C.M. (CCH) 404, 1994 T.C.M. (RIA) § 94,393, at 2 (finding section 1374 built-in gains tax applied to collection of cash method accounts receivable of a corporation that elected S corporation status in 1988 and previously had been a C corporation).
101 Reg. § 1.1374-4(f).
102 Reg. § 1.1374-4(d).
Section 1374 has implications for an S corporation that is the owner of a partnership interest. An S corporation's distributive share of income or loss from a partnership interest owned by the S corporation will be treated as built-in gain or loss to the extent that the item would have been so treated if it had been taken into account directly by the corporation. Among other limitations, the amount of built-in gain or loss recognized by an S corporation as its distributive share of partnership items will be limited to the corporation's built-in gain or loss in the partnership interest itself. Subject to an anti-abuse rule, these partnership rules do not apply if the fair market value of an S corporation's partnership interest is less than $100,000 and represents less than ten percent of the partnership capital and profits.

5. Built-in Gains Attributable to a C Corporation Subsidiary of an S Corporation

Built-in gain or loss attributable to the stock of a subsidiary subchapter C corporation owned at the time a parent corporation elects subchapter S status will be reflected in the S corporation's net unrealized built-in gain or loss. If the subsidiary is subsequently liquidated in a transaction for which sections 332 and 337 provide nonrecognition of gain to the parent and liquidated subsidiary corporations, net unrealized built-in gain or loss attributable to the subsidiary's assets will be added to the net unrealized built-in gain or loss of the parent. To avoid double-counting unrealized appreciation or depreciation attributable to the subsidiary stock and assets, net unrealized built-in gain is adjusted to eliminate the effect of any built-in gain or loss attributable to redeemed or cancelled stock on the initial computation of unrealized built-in gain on assets held at the time a corporation becomes an S corporation or acquired from a C corporation. The adjustment reflects only net unrealized built-in gain or loss attributable to the subsidiary stock at the time the parent corporation first became subject to the tax of section 1374 that has not resulted in recognized built-in gain or loss. The regulations also disallow an adjustment that is duplicative of an adjustment that has been made to the pool of assets reflected in the subsidiary and its stock.

C. Passive Investment Income of an S Corporation with Accumulated Earnings and Profits

1. Tax on Passive Investment Income

There are no limitations on the type of income, for example, passive versus active, that can be earned by an S corporation with no C corporation.

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103 Reg. § 1.1374-4(i)(1).
104 Reg. § 1.1374-4(i)(4).
105 Reg. § 1.1374-4(i)(5).
106 Reg. § 1.1374-3(b).
107 Reg. § 1.1374-3(b)(2).
Section 1375 imposes a tax on an S corporation with accumulated subchapter C earnings and profits in any year in which the corporation has passive investment income in excess of 25% of gross receipts. The tax is imposed at the highest rate under section 11(b) on "excess net passive income," which is defined in section 1375(b)(1) as an amount that bears the same ratio to net passive income as the passive investment income in excess of 25% of gross receipts bears to the passive investment income for the taxable year. In other words, the taxable amount is determined from the formula:

\[
\text{Net Passive Investment Income} \times \frac{\text{Passive Investment Income} \text{ minus } 0.25 \times (\text{Passive Investment Income} + \text{Gross Receipts})}{\text{Gross Receipts}}
\]

"Net passive investment income" is defined in section 1375(b)(2) as passive income less deductible expenses incurred to produce the passive investment income. By virtue of this definition, the apportionment formula allocates expenses between the passive investment income in excess of 25% of gross receipts, which is subject to the tax, and the passive investment income that is less than 25% of gross receipts, which is not taxed. Finally, the amount subject to tax as net passive investment income is limited to the corporation's regular taxable income for the year.109

Suppose that an S corporation with earnings and profits from its C corporation history had gross receipts from an active business of $600,000, dividend income of $360,000, and expenses to earn the dividend income of $60,000. The formula in section 1375(b) would be calculated as follows:

\[
($360,000 - $60,000) \times \frac{($360,000 - 0.25 \times ($600,000 + $360,000))}{$360,000} = $100,000
\]

The section 1375(a) tax is levied on the amount of $100,000, which under the formula is the corporation's "excess net passive income." Applying the highest rate under section 11, 35%, the tax is $35,000. Pursuant to section 1366(f)(3), the amount of dividend income passed through to the shareholders will be reduced by the tax imposed on the corporation with respect to that income. The Service may waive imposition of the passive investment income tax if the corporation establishes that it determined in good faith that it had

108 Before 1982, former section 1375(e)(5) provided for termination of an S election for any corporation if more than 20% of its gross receipts constituted passive investment income, without regard to whether the corporation also had subchapter C earnings and profits. The definition of passive investment income under this now-repealed provision raised interpretable issues that continue to be important under current law.

no subchapter C earnings and profits at the close of a taxable year and within a reasonable period of time after the corporation determined that it actually did have accumulated earnings and profits at the close of such taxable year, it distributed such earnings and profits to shareholders.\textsuperscript{110}

2. Passive Investment Income Defined

For purposes of section 1375 and section 1362(d) (discussed below), passive investment income is defined as income from royalties, rents, dividends, interest, and annuities.\textsuperscript{111} Passive investment income does not include interest on notes acquired in the ordinary course of business on the sale of inventory, or gross receipts from the regular conduct of a lending or finance business.\textsuperscript{112}

Section 1362(d)(3)(C)(iv) excludes from passive investment income dividends that are attributable to the active conduct of a trade or business of a C corporation in which the S corporation has an 80% or greater ownership interest (as defined in section 1504(a)(2)). The Regulations provide rules for determining whether the earnings and profits of the C corporation subsidiary are "active" or "passive."\textsuperscript{113} The term "rents" does not include rents derived in an active trade or business of renting property if the corporation provides significant services or incurs substantial costs in the rental business.\textsuperscript{114} For example, the income from hotel and motel operations is not rent because the corporation is "active" and provides "significant services."\textsuperscript{115} However, there is no relief for rental income derived in the ordinary course of a business that is not "active." Consequently, a corporation with subchapter C earnings and profits still cannot conduct rental operations yielding rents in excess of 25% of its gross receipts for more than three years and retain S corporation status.

Although several rulings have found services to be significant thereby removing rental income from "rents" under the regulations,\textsuperscript{116} the "significant services" requirement of Regulation section 1.1362-2(c)(5)(ii)(B)(2) for excluding from the definition of rents any rents derived in an active trade or business has been strictly interpreted by the courts. In \textit{Feingold v. Commissioner}, the Tax Court held under the predecessor regulations that rental income from summer bungalows did not fall within the "significant services" exception and constituted disqualifying income.\textsuperscript{117} In \textit{City Markets, Inc. v. Commissioner}, the corporation owned a "farmers' market" and maintained buildings paralleling streets occupied primarily by vendors of farm produce

\textsuperscript{110}§ 1375(d).

\textsuperscript{111}I.R.C. §§ 1375(b)(3), 1362(d)(3)(C).

\textsuperscript{112}§ 1362(d)(3)(C)(ii), (iii).

\textsuperscript{113}Reg. § 1.1362-8.

\textsuperscript{114}Reg. § 1.1362-2(c)(5)(ii)(B)(2).

\textsuperscript{115}Id.


\textsuperscript{117}Feingold v. Commissioner, 49 T.C. 461, 467 (1968).
and flowers. The taxpayer's income consisted entirely of amounts paid to it by various tenants who occupied the facilities, and significant work performed by two employees of the taxpayer in the facilities was of the nature of services normally provided by landlords. On these facts, the Sixth Circuit Court of Appeals held that the taxpayer's gross receipts were "rent" and its S election was terminated. In Lillis v. Commissioner, the Tax Court held that "[p]ayments for the use or occupancy of entire private residences constitute 'rents' for purposes of [the statutory predecessor of section 1362(d)(3)(c)(i)], even though the taxpayer advertised the properties for rent, cleaned them when tenants moved out, leased them to new tenants, and maintained and repaired them, because the court did not consider these activities "significant services." The Tax Court in Howell v. Commissioner held that the list of passive interest income items in the predecessor to section 1362(d)(3)(C)(i) was exclusive, and therefore gains from the sale of unimproved real estate did not constitute passive investment income for purposes of the limitation.

3. "Gross Receipts" Defined

Gross receipts are not the same as gross income. A corporation operating at a loss because its cost of goods sold exceeds its receipts will still have gross receipts. In contrast, proceeds from the sale or exchange of capital assets (except for stocks or securities) are taken into account in computing gross receipts only to the extent that gains from the sale or exchange of capital assets exceed losses from the sale or exchange of capital assets. Similarly, gross receipts from the sale of stock or securities are taken into account only to the extent of gains. However, losses from the sale of stock or securities do not offset the gains for this purpose. This rule prevents the corporation from acquiring and selling stocks to artificially enhance the amount of its gross receipts. Receipts that are not included in gross income, because the corporation is a mere conduit, are not included in gross receipts.

D. Termination of S Election for Excessive Passive Income

Pursuant to section 1362(d)(3), an S election is terminated if the corporation has subchapter C earnings and profits at the close of each of three

119 Lillis v. Commissioner, 45 T.C.M. (CCH) 1000, T.C.M. (P-H) § 83-142 (1983), aff'd by order, 740 F.2d 974 (9th Cir. 1984).
121 Reg. § 1.1362-2(c)(4)(i).
124 See Reg. § 1.1362-2(c)(4)(ii)(B).
125 See Estate of Kaiser v. Commissioner, 73 T.C.M. (CCH) 2072, T.C.M. (RIA) § 97,088 (Finding an insurance agency's gross receipts from its insurance business included only commissions received with respect to policies written by it; gross receipts did not include premiums collected from customers on behalf of the insurance company and remitted to the company).
consecutive taxable years following the election and during each of the three years in which more than 25% of the corporation’s gross receipts are passive investment income. This provision is intended to prevent an S corporation from utilizing accumulated C corporation earnings and profits for passive investment purposes.

A termination because of excess passive investment income is effective on the first day of the taxable year following the third consecutive year in which the corporation has disqualifying earnings and profits and investment income. Termination may be avoided if the Service determines that the termination is inadvertent under the standards of section 1362(f).

Both the tax on passive investment income and termination of S corporation status can be avoided either by distributing accumulated earnings and profits to shareholders as a taxable dividend prior to making the S election or by making a deemed dividend and recontribution election under section 1368(e)(3).127

VI. Distributions from an S Corporation

A. Generally

Section 1368, rather than section 301(c), is the default rule governing distributions from S corporations. Other than section 301(c), all of the other subsections of section 301 apply with equal force to distributions by an S corporation to its shareholders. Pursuant to section 301(b), the amount of any distribution of property is reduced by any corporate debt assumed by the shareholder, within the meaning of section 357(d), in connection with the distribution. This treatment differs significantly from the deemed contribution rule of section 752(b) that applies when a partner assumes a partnership debt in connection with a distribution of property.

The shareholder’s basis in property distributed by an S corporation to the shareholder equals the fair market value of the property received in the distribution. In contrast, pursuant to section 732, a partner who receives a non-liquidating distribution from a partnership generally takes a transferred basis from the partnership in the distributed property.

B. Distributions from an S Corporation That Has No Earnings and Profits

Pursuant to section 1368(b), distributions to S corporation shareholders from an S corporation that has no earnings and profits are tax-free to the extent of the shareholder’s stock basis, and a distribution in excess of the shareholder’s basis is recognized as capital gain. The shareholder’s stock basis is increased by positive adjustments under section 1367(a) before taking into

126 The termination rule does not apply with respect to earnings and profits accumulated before the effective date of the 1982 Act. Prior to 1983, it was possible for an S corporation to accumulate earnings and profits because earnings and profits could exceed pass-through taxable income.

127 See Reg. § 1.1368-1(f)(3).
account the distributions against basis under section 1368(b).\textsuperscript{128} However, distributions are taken into account before making negative adjustments to basis under section 1367(a)(2).\textsuperscript{129}

Gain from a distribution in excess of basis is computed differently under section 1368(b) than it is computed under section 301(c). With respect to distributions by a C corporation, a section 301(c) distribution that is not a dividend (either because there are no earnings and profits or because total distributions exceed available earnings and profits) is applied on a share-by-share basis, first to reduce the shareholder's basis for the stock to zero under section 301(c)(2), and any excess results in capital gain under section 301(c)(3).\textsuperscript{130} As a consequence, the distribution may require recognition of gain under section 301(c)(3) with respect to some shares while the distributee shareholder retains basis in other shares. But with respect to distributions by an S corporation subject to section 1368, if the distribution with respect to any share exceeds the basis of that share, the excess distribution can be applied against the basis of other shares, distributions on which have not exceeded basis, before gain is recognized. Thus, no gain is recognized under section 1368(b)(2) unless the aggregate distribution exceeds the aggregate basis in all of the shares.\textsuperscript{131} This is often referred to as the "spillover rule."

C. Distributions from an S Corporation with Earnings and Profits

Under section 1368(c)(1), distributions by an S corporation that has accumulated earnings and profits are tax-free to shareholders only to the extent of the "accumulated adjustments account." Although S corporations do not accumulate earnings and profits,\textsuperscript{132} an S corporation that had a prior history as

\textsuperscript{128}See I.R.C. § 1368(d) (especially the last sentence).
\textsuperscript{129}Reg. § 1.1367-1(f).
\textsuperscript{130}Johnson v. United States, 435 F.2d 1257, 1259 (4th Cir. 1971) (holding that a taxpayer who had several blocks of stock with different bases was required to treat a distribution on the stock not out of earnings and profits as made pro rata among the blocks of stock in order to determine the gain realized by the taxpayer on the distribution; the taxpayer was not allowed to aggregate the total basis in the stock and offset that total against the amount of the distribution). Proposed Regulation section 1.301-2 would adopt the rule of Johnson to provide that the portion of a distribution that is not a dividend will be applied to reduce the basis of each share within the class of stock on which the distribution is made pro rata on a share-by-share basis. Notice of Proposed Rulemaking: The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities, 2009-8 I.R.B. 579.
\textsuperscript{131}Reg. § 1.1367-1(c)(3); see T.D. 8508, 1994-1 C.B. 219, 220 ("The proposed regulations also provided a spillover rule that allowed a shareholder to apply losses and deductions in excess of the basis of a share of stock to which such items are attributable against the remaining bases of all other shares of stock owned by a shareholder . . . . [T]he final regulations clarify that the spillover rule applies to basis adjustments for distributions to shareholders as well as to adjustments for pro rata shares of pass-through items of losses or deductions."). This rule resembles the partnership rule under which a partner has a unitary basis in the partnership interest, even if the partner holds partnership interests that differ for state law purposes, such as both a general and limited partnership interest. See Rev. Rul. 84-53, 1984-1 C.B. 159.
\textsuperscript{132}I.R.C. § 1371(c).
a C corporation might have accumulated earnings and profits. Furthermore, an S corporation may acquire earnings and profits through the acquisition of the assets of a C corporation with earnings and profits in a section 368(a)(1) reorganization (e.g., merger or other asset acquisition reorganization) or the liquidation of a C corporation subsidiary with earnings and profits. Thus, if an S corporation without earnings and profits engages in a tax-free reorganization, such as a section 368(a)(1)(A) merger into an S corporation with earnings and profits, the target S corporation must be able to calculate its accumulated adjustments account at the time of the merger for purposes of determining the tax effect of post-merger distributions. The liquidation of a C corporation subsidiary of the S corporation includes making a qualified subchapter S subsidiary (QSub) election under section 1361(b)(3) for a theretofore C corporation subsidiary, whether preexisting or newly acquired. An S corporation's acquisition of a C corporation that remains a subsidiary of the S corporation, whether through stock purchase or a tax-free section 368 reorganization, does not result in the S corporation acquiring any earnings and profits.

The accumulated adjustments account, as defined in section 1368(e)(1), reflects the S corporation's taxable income that has been passed through and taxed to shareholders under section 1368 while the corporation has been subject to subchapter S treatment. The accumulated adjustments account is basically a running total of the corporation's net taxable income while operating as an S corporation. The account is based on adjustments to shareholders' bases under section 1367, except that the accumulated adjustments account does not include tax-exempt income, nor is it reduced by deductions not allowed in computing the corporation's taxable income. The exclusion of tax-exempt items from the accumulated adjustments account means that tax-exempt income of the S corporation may not be distributed tax-free to shareholders until after the taxable distributions of accumulated earnings and profits from the subchapter C period have been made.

Distributions in excess of the accumulated adjustments account are treated as taxable dividends to the shareholders to the extent of the corporation's accumulated earnings and profits. Distributions in excess of both the accumulated adjustments account and the accumulated earnings and profits are treated the same as distributions from a corporation with no earnings and profits: such distributions are not included in the shareholder's gross income to the extent of the shareholder's basis in the S corporation's stock and any excess distribution is treated as a capital gain.

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133 I.R.C. § 381(a).
134 See Section IV of the preamble to final regulations under section 1368. T.D. 8508, 1994-1 C.B. 219, 220.
135 For the effect of a QSub election for an existing C corporation subsidiary, see infra Part VII.A.2, beginning at note 203.
137 § 1368(c)(2).
The accumulated adjustments account is a corporate account that is not apportioned among the shareholders.\textsuperscript{138} The accumulated adjustments account, as determined as of the end of the year without regard to distributions during the year, is allocated pro rata among two or more distributions during the year.\textsuperscript{139} Application of this rule is illustrated by the following example, derived from Regulation section 1.1368-3, Ex. (5).

Assume that the stock of X Corporation, which as of December 31, 2014, had earnings and profits of $1,000 and an accumulated adjustments account of $400, is owned 40\% by A and 60\% by B. For 2015, X Corp. has taxable income of $120, which increases its accumulated adjustments account to $520. On January 31, 2015, X Corp. distributes $240 to A and $360 to B. On October 31, 2015, X Corp. distributes $80 to A and $120 to B. During the year, X Corporation distributed a total of $800, which exceeded its $520 accumulated adjustments account by $280. A's January distribution was 30\% of the total distributions (240/800), so 30\% of the accumulated adjustments account as of December 31, 2015, or $156 is allocated to A's January distribution. B's January distribution was 45\% of the total distributions for the year, so $234 of the accumulated adjustments account is allocated to that distribution. A's October distribution was ten percent of the total distributions, so $52 of the accumulated adjustments account is allocated to that distribution; likewise 15\% of the accumulated adjustments account, or $78 is allocated to B's October distribution. A has received a total of $208 ($156 + $52) tax-free under section 1368(c)(1) and $112 taxed as a dividend; B has received $312 ($234 + $78) tax-free and $168 taxed as a dividend. Earnings and profits are reduced to $720 to reflect the $280 of dividends. Section 1371(c)(3) provides for an adjustment to an S corporation's earnings and profits in the case of distributions treated as dividends under section 1368(c)(2).\textsuperscript{140}

D. Distributions of Property by an S Corporation

1. Generally

Section 311(b) requires recognition of gain at the corporate level on the distribution of appreciated property by an S corporation to its shareholders. This is significantly different from the partnership provisions on which treatment of S corporation distributions is generally based. In the corresponding partnership situation, under section 731(b) the partnership does not recognize gain or loss on the distribution, and gain recognition is postponed through the basis rules in sections 705 and 732. Compared to a partnership, the distribution of appreciated property by an S corporation accelerates the payment of tax, although there generally is still only one level of tax.

\textsuperscript{138}Reg. § 1.1368-2(a)(1).
\textsuperscript{139}Reg. § 1.1368-2(b).
\textsuperscript{140}I.R.C. § 1371(c)(3); see Reg. § 1.1368-2(d)(iii).
The gain recognized pursuant to section 311(b) is passed through to the shareholders, who report the gain as income under section 1366. The character of the gain is determined as if the property had been sold to the shareholder. If the property is depreciable in the shareholder's hands and the shareholder owns 50% or more of the value of the stock of the S corporation, the gain is ordinary. The passed-through gain is taken into account with all of the other passed-through income and loss for the year in making the section 1367 stock basis adjustments, in this case an increase for the gain. Section 1368(d) requires that positive adjustments to a shareholder's stock basis under section 1367(a)(1), reflecting the shareholder's share of corporate income, be taken into account before applying the distribution rules of section 1368(b).\(^{141}\)

Under section 1368, the S corporation's distribution of the property is tax-free to the shareholder to the extent of the shareholder's basis in the stock. Pursuant to section 1367(a)(2)(A), the shareholder reduces the basis of the stock with respect to which the distribution was made by the amount of the distribution, which under section 301(b) is the fair market value of the property less any corporate debt assumed (within the meaning of section 357(d))\(^{142}\) in connection with the distribution. If the fair market value of the property (net of any debt assumed) exceeds the shareholder's stock basis, the shareholder recognizes capital gain.\(^{143}\) The shareholder's basis in the property received is its fair market value.\(^{144}\) There is no adjustment to the shareholder's basis in the property for any of the corporation's debts assumed by the shareholder in connection with the distribution.

The provisions relating to distributions of property by an S corporation are illustrated by the following example. Assume that individual B owns all of the stock of X Corporation which has an S election in effect. B's basis in B's stock is $300. X Corporation distributes Blackacre, with a fair market value of $1,000 and a basis of $600, to B. X corporation recognizes a gain of $400 under section 311(b), as it would have recognized that gain had it sold Blackacre to B for its fair market value. The character of the gain is determined in the same manner as if X Corporation had sold Blackacre to B. The $400 gain passes through to B under section 1366 and retains its character when reported by B. B increases the basis of B's S corporation stock from $300

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\(^{141}\)§ 1368. On the other hand, section 1368(d) requires distributions to be taken into account before negative adjustments to a shareholder's stock basis reflecting the shareholder's share of corporate loss are made under § 1367(a)(2). See Reg. §§ 1.1367-1(f), -1(h), Ex. (2).

\(^{142}\)I.R.C. §§ 301(b), 1367(a)(2)(A); see Reg. § 1.301-1(g).

\(^{143}\)This assumes that the distributing S corporation has no earnings and profits. If the distributing corporation has earnings and profits, the distribution is controlled by section 1368(c), and the recovery of basis is limited to the accumulated adjustments account; thereafter, the distribution is a dividend to the extent of available earnings and profits, and after both the accumulated adjustments account and available earnings and profits have been exhausted, capital gain results. See supra Part VI.C.

\(^{144}\)§ 301(d).
to $700 under section 1367, reflecting the $400 of passed-through gain. B
takes the distribution into account as a $1,000 distribution pursuant to sec-
tion 301(b). B reduces the basis of the stock of the S corporation to $0 and
recognizes a $300 capital gain under section 1368. B takes a $1,000 basis in
Blackacre pursuant to section 301(d). Note that B’s total gain recognized is
$700 and the character of the $400 of section 1366 passed-through gain can
differ from the $300 of section 1368 capital gain on the distribution.

The following illustrates the impact of an S corporation’s distribution of
property subject to debt. Assume that individual B owns all of the stock of X
Corporation, which has an S election in effect. B’s basis in B’s stock is $500.
X Corporation distributes Blackacre, with a fair market value of $1,000 and a
basis of $600 to B. Blackacre is subject to a mortgage debt of $150, which B
assumes. X Corporation recognizes a gain of $400 under section 311(b), as it
would have recognized that gain had it sold Blackacre to B for its fair market
value. The presence of the mortgage debt does not affect the gain recognized.
The character of the gain is determined in the same manner as if X Corpora-
tion had sold Blackacre to B. The $400 gain passes through to B under sec-
tion 1366 and retains its character when reported by B. B increases the basis
of B’s S corporation stock from $500 to $900 under section 1367, reflecting
the $400 of passed-through gain. B takes the distribution into account as an
$850 distribution pursuant to section 301(b), which directs that the amount
of the distribution is the gross fair market value of the property, reduced the
amount of the corporation’s debts assumed by the shareholder in connection
with the distribution. B reduces the basis of the stock of the S corporation by
$850 to $50 and does not recognize any gain under section 1368. B takes a
$1,000 basis in Blackacre. The amount of the debt assumed by B is not taken
into account in determining B’s basis in Blackacre.

2. Distributions of Loss Property by an S Corporation

As is the case with a C corporation, section 311(a) bars the recognition of
any loss if an S corporation distributes property with a basis in excess of its
fair market value. Because section 311(a) bars the recognition of loss at the S
corporation level, there is no loss to pass through to the shareholders under
section 1366. As with distributions of appreciated property, under section
1368, receipt of distributed loss property is tax-free to the shareholder to the
extent of the shareholder’s basis in the stock.145 The shareholder reduces the
basis of the stock with respect to which the distribution was made by the fair
market value of the property less any corporate debt assumed in connection
with the distribution.146 If the fair market value of the property (net of any
debt assumed) exceeds the shareholder’s stock basis, the shareholder recog-
nizes capital gain.

145 See supra Part VI.C for limitations on this principle if the distributing S corporation has
earnings and profits.
146 § 301(b).
Under section 301(d), the shareholder's basis in the distributed property is its fair market value. Thus, the loss inherent in the property "disappears." There is no provision analogous to section 267(d), which itself does not apply, so upon the subsequent sale of the property received in the distribution for more than its fair market value on the date of the distribution, the shareholder must recognize gain.

The realized but disallowed corporate level loss might reduce the shareholder's basis in their stock under section 1367(a)(2), but that result is not clear since a loss disallowed by section 311(a) is nowhere specifically described in section 1367(a)(2). Section 1367(a)(2)(D) reduces basis for any expense that is not deductible and not chargeable to capital account. Although a loss disallowed by section 311(a) is not, strictly speaking, an "expense," presumably on the basis of section 1367(a)(2)(D), Regulation section 1.1367-1(c)(2) requires a basis deduction for a loss disallowed by section 267(a)(1), and this is analogous.

Even if the disallowed loss reduces the shareholders' stock basis, the basis reduction would occur after taking the property distribution into account.\(^{147}\) Furthermore, we think that any basis adjustment would have to be held in suspense pending an increase in basis above zero. If the stock basis is not reduced, the corporate level loss is preserved for the shareholders to be realized on disposition of the stock or in the form of tax-free distributions.

\section*{E. Distributions Following Termination of S Corporation Status}

Following termination of an S election, distributions of money may be received by shareholders as a tax-free reduction of basis to the extent of the accumulated adjustment account,\(^ {148}\) which if one has not theretofore been maintained, must be established by determining the undistributed net taxable income of the S corporation that has been passed through to the shareholders. The distribution must be made within the "post-termination transition period" as defined in section 1377(b), generally at least a one-year period after termination of S corporation status, although the period may differ in certain specified circumstances.\(^ {149}\) If the shareholders fail to withdraw previously taxed income from the corporation within the applicable period, the privilege of tax-free distribution under section 1368 is lost and subsequent

\begin{itemize}
  \item \textit{Compare} Reg. § 1.1367-1(f), with I.R.C. § 1368(d) (providing for taking increases in basis into account prior to any distribution).
  \item I.R.C. § 1371(e)(1).
  \item The post-termination transition period is defined in section 1377(b) as the period beginning on the last day of the corporation's taxable year as an S corporation and ending on the later of (1) one year after the last day of the S corporation taxable year; (2) the due date for the tax return for the last taxable year as an S corporation (including extensions); (3) 120 days after any determination pursuant to a post-termination audit of a shareholder that adjusts any item of S corporation income, loss, or deduction for the period the corporation was an S corporation; or (4) if there is a judicial determination or administrative agreement that the corporation's S election terminated in an earlier taxable year, 120 days after the date of the determination. \textit{See also} Reg. § 1.1377-2.
\end{itemize}
corporate distributions are taxable under section 301, that is, subsequent distributions are taxable dividends if supported by sufficient earnings and profits. (If the corporation has always been an S corporation, generally earnings and profits will arise only in the period following termination of the election.)

Section 1371(e)(1) prescribes that only distributions of "money" may be tax-free during the post-termination transition period. Under a requirement of the pre-1983 subchapter S rules, distributions of money during the first two and one-half months of the taxable year were received tax-free by the shareholders as distributions of previously taxed income of the prior taxable year. Taxpayers attempted various devices to circumvent this "money" distribution requirement, but with a marked lack of success. This case law remains relevant under section 1371(e)(1).

F. Redemption of Stock of an S Corporation

A stock redemption by an S corporation is governed by section 302, which may produce surprising results in any case that is not a complete redemption. If a redemption qualifies for exchange treatment by virtue of section 302(a), section 1001 applies to determine the shareholder's treatment of the proceeds from the stock repurchased by an S corporation. Only the basis of the stock actually redeemed offsets the redemption proceeds before gain is recognized. If an S corporation redeems stock in a transaction that receives sale or exchange treatment pursuant to section 301(a) and the S corporation has an accumulated adjustments account, the accumulated adjustments account is reduced by the ratable share of the S corporation's accumulated adjustments account, after first applying the accumulated adjustments account to distributions governed by section 1368.

If the redemption does not qualify under section 302(b) and is treated as a section 301 distribution pursuant to section 302(d), the S corporation distribution rules of section 1368 apply, meaning that the basis of all of the stock is taken into account before gain is recognized. The Service has issued a

Otherwise, distributions during the taxable year were taxed as dividends to the extent of the current year's earnings and profits. After current earnings were distributed, distributions of prior years' undistributed taxable income were also received tax-free by shareholders.

See, e.g., DeTreville v. United States, 445 F.2d 1306, 1308 (4th Cir. 1971) (holding that two transactions should be treated as one where the shareholders purported to receive cash distributions and immediately purchased property from the corporation; the transactions were in substance a distribution of property); Stein v. Commissioner, 65 T.C. 336, 341-42 (1975) (holding that the fact that shareholders were in constructive receipt of amounts credited to their accounts on the books of the corporation did not satisfy the money requirement); Roesel v. Commissioner, 56 T.C. 14, 24-25 (1971), nonacq. 1978-2 C.B. 1 (finding that cash distribution and subsequent loan to corporation by shareholders were disregarded and the transaction was treated as a taxable distribution of the debt obligations).

Reg. § 1.1368-2(c). In addition, the S corporation's accumulated earnings and profits are reduced pro tanto. I.R.C. § 312(n)(7).

Private Letter Ruling stating that a redemption that is treated as a section 301 distribution under section 302(d), and thus a distribution subject to sections 301 and 1368, does not create a second class of stock.\textsuperscript{154} According to Revenue Ruling 95-14,\textsuperscript{155} when an S corporation shareholder receives proceeds in a redemption that is characterized as a distribution under section 301, the entire redemption distribution is treated as a distribution for purposes of section 1368 that reduces the corporation's accumulated adjustments account.\textsuperscript{156}

In the C corporation context, planning techniques generally are designed to bring the redemption within section 302(b)—a substantially disproportionate redemption under section 302(b)(2) or a redemption not essentially equivalent to a dividend under section 302(b)(1)—to obtain the most favorable tax results, that is, a capital gain (or loss) transaction with recovery of basis rather than a dividend. Conversely, in the case of S corporations, failing to meet section 302(b) results in greater basis recovery in gain situations. Thus, in a subchapter S situation, from a tax perspective, section 302(b) usually is a rocky shoal to be avoided, not a safe harbor to be sought. However, meeting section 302(b) remains more desirable in situations where the redeemed shareholder realizes a loss with respect to the redeemed stock (although section 267 often may disallow the loss).

Consider the following example. S corporation has 100 shares of common stock outstanding, which are owned by four unrelated shareholders as follows: A, 28 shares; B, 25 shares; C, 24 shares; and D, 23 shares. The corporation redeems seven shares from A, which changes A's interest from 28% (28/100) to 22.6% (21/93). Assume that A's basis for all 28 shares was $100 per share (for a total of $2,700) and A received $1,050 ($250 per share). If section 1368 applies, A recognizes no gain and the basis of A's remaining 21 shares is $1,650 ($2,700 - $1,050). But if section 302(a) controls, A recognizes a gain of $450 ($1,050 - $700) and the basis of A's remaining 21 shares is $2,100. A's redemption cannot qualify under any subsection of section 302(b)(2) other than section 302(b)(1). Because as a result of the redemption, A has lost the power to combine with one other shareholder in order to exercise majority control, Revenue Ruling 76-364, treats the redemption as not essentially equivalent to a dividend under section 302(b)(1).\textsuperscript{157} Thus, A would recognize a gain of $450 and the basis of A's remaining 21 shares is $2,100. If, however, only three shares were redeemed from A, reducing A's interest to 26% (25/97), A would not have lost the power to combine with one other shareholder in order to exercise majority control and the distribution likely would not qualify as not essentially equivalent to a dividend under section 302(b)(1). In that case, section 1368 would govern the tax conse-

\textsuperscript{154}P.L.R. 2012-07-002, supra note 153.
\textsuperscript{155}Rev. Rul. 95-14, supra note 153.
\textsuperscript{156}The corporation's accumulated adjustments account is a corporate account that is not apportioned among the shareholders but is allocated pro rata among distributions during the year. Reg. § 1.1368-2(a)(1).
quences of the distribution and A would recognize no gain, while reducing the basis of A's remaining 25 shares by $450 (3 x $150), to $2,250.

Some dark clouds, however, have a silver lining. Assume now that A's basis in the S corporation stock was $250 per share (for a total of $7,000). If the corporation redeems seven shares for $1,050 ($250 per share) in a transaction controlled by section 302(a), A recognizes a loss of $700 ($1,050 - $1,750) rather than merely reducing the basis of A's remaining shares to $5,950. If, however, only three shares were redeemed and section 1368 thus governed the tax treatment of the transaction, A would not recognize any loss and merely would reduce the basis of the remaining 25 shares by $450, to $8,550.

Yet another surprising aspect of the application of subchapter C to S corporations arises in the case of partial liquidations. Suppose an S corporation has two businesses of equal size and value—it packages sushi for sale in grocery stores and frozen fish bait for sale in bait and tackle stores—which it has conducted for more than five years. It sells one business for cash and distributes the cash to its shareholders. The amount of cash distributed is an amount that equals one-half of the stock value and more than one-half of the basis of the stock of each shareholder. In a partial liquidation of a closely held corporation, the number of shares deemed surrendered is considered to be the same ratio of total shares as the amount of the distribution bears to the value of all corporate assets prior to the distribution, regardless of actual shares surrendered. Because this transaction automatically qualifies as a partial liquidation under section 302(e), and thus is a redemption under section 302(b)(4), basis recovery by the shareholders before recognizing capital gain likely is limited to an amount equal to one-half of each shareholder's stock basis.

Although in a subchapter S situation section 302(b) usually is a rocky shoal to be avoided, not a safe harbor to be sought, the consequences of a complete termination of interest under section 302(b)(3) are not changed where gain is realized, regardless of whether, if applicable, the section 318 family attribution rules have been effectively waived pursuant to section 302(c)(2). In either case, there will be a tax-free recovery of the shareholder's basis in all of the taxpayer's shares, and the amount of the distribution in excess of the basis will be taxed at capital gain rates. In a loss situation, however, unless the family attribution rules have been properly waived, recognition of the loss on a distribution classified as a section 301(a) distribution might be disallowed or suspended.

G. Application of Section 304 to S Corporations

Section 304 may apply to the sale of S corporation stock to a controlled corporation to produce unexpected consequences. Section 304 provides that a sale of stock by the shareholder of one controlled corporation to another controlled corporation is to be treated as a redemption distribution. The sales proceeds received in such a transaction are treated as a corporate redep-

\footnote{Rev. Rul. 56-513, 1956-2 C.B. 191.}
tion distribution that must meet the test of either section 302 or section 303 to qualify for sale or exchange treatment.\(^{159}\) If the transaction does not qualify for sale or exchange treatment under either section 302 or section 303, the transaction is treated as a section 351 contribution of the stock that was "sold" and a section 301 distribution by the purchasing corporation of the money or property that was received by the seller.

Section 304 is designed to prevent a shareholder from escaping dividend treatment on a transaction formally structured as a sale but which is similar to a redemption. Because of the controlled nature of the corporations involved, there might not be a significant economic change in the shareholder's overall position to warrant sales treatment. Although section 304 was designed to deal with distributions of earnings and profits by C corporations, it should apply to S corporations\(^{160}\)—particularly S corporations that have earnings and profits as a result of a C corporation history—and the results will vary depending on the exact nature of the transaction.

Section 304 deals with two basic factual patterns: sales between brother-sister corporations and sales involving parent-subsidiary corporations.

Section 304(a)(1) applies to sales of stock in the brother-sister context only if "one or more persons are in control" of each corporation. "Control" for this purpose is defined in section 304(c)(1) as ownership of 50% or more of either combined voting power or value of all classes of stock.\(^{161}\) Control of the corporation, the stock of which is sold, (the issuer) is measured before the sale, while control of the corporation to which the stock is sold (the purchaser) is measured after the sale (to take account of the possibility that some of the consideration paid for the issuer's stock might be stock of the purchaser).\(^{162}\)

In measuring 50% ownership for testing control, the attribution rules of section 318 apply, but sections 318(a)(2)(C) and 318(a)(3)(C)—dealing with attribution from and to corporations—are applied by substituting a greater than five percent threshold of ownership for the normal greater than 50% threshold.\(^{163}\)

If section 304(a)(1) applies to a sale of stock in one controlled corporation to another controlled corporation, the transaction is treated as a redemption of stock by the acquiring corporation. However, whether the redemption qualifies for sale or exchange treatment, rather than treatment as a section 301 distribution, is tested by applying section 302(b) with reference to the change in the selling shareholder's ownership in the stock of the corporation.

\(^{159}\)For qualification for sale or exchange treatment under section 303 of a sale of stock subject to section 304, see Webb v. Commissioner, 67 T.C. 293, 309 (1976), aff'd per curiam, 572 F.2d 135 (5th Cir. 1978).


\(^{161}\)See Rev. Rul. 89-57, 1989-1 C.B. 90 (an individual who owned "less than 50 percent of" the voting stock, but more than "50 percent of the total value of" the outstanding stock of a corporation, controlled the corporation).

\(^{162}\)Reg. § 1.304-5(b).

\(^{163}\)I.R.C. § 304(c)(3)(B).
that issued the stock that was sold. But if after the application of section 302(b) the transaction is characterized as a section 301 distribution, dividend status is determined with reference to the combined earnings and profits of both corporations, looking first to the earnings and profits of the acquiring corporation and then to the earnings and profits of the corporation that issued the stock that was sold. Furthermore, if the transaction is treated as a section 301 distribution, the transferor is deemed to have contributed the exchanged stock to the acquiring corporation in exchange for stock of the acquiring corporation in a section 351 transaction following which that stock is promptly redeemed. Thus, for purposes of determining the transferor's basis in the acquiring corporation, the transferor's basis of the issuing corporation stock deemed to have been contributed to the acquiring corporation in the section 351 transaction is transferred (under section 358) to the shares of stock of the acquiring corporation deemed to have been issued and promptly redeemed. If the combined earnings and profits of the corporations are insufficient to support dividend treatment for the entire amount received by the shareholder, the basis of all of the stockholder's shares of the acquiring corporation, and not merely the redeemed shares, is taken into account in determining the portion of the distribution that is a return of capital under section 301(c)(2). If the amount of the distribution exceeds the combined earnings and profits of the corporations, but is less than the sum of the combined earnings and profits of the corporations and the basis transferred from the issuing corporation stock to the acquiring corporation stock that is deemed to have been issued and redeemed, the excess transferred basis is added to the basis of the shareholder's remaining stock in the acquiring corporation.

Under section 1371(a), section 304 applies to transactions involving S corporations even though section 304 was enacted to prevent a C corporation shareholder from escaping dividend treatment on a transaction formally structured as a sale but which has similarities to a redemption. In the context of an S corporation, if the transaction is treated as a section 301 distribution, section 1368 supplants section 301(c) and dividend treatment does not apply unless there is a dividend out of S corporation earnings and profits under section 1368(c). For an S corporation with no earnings and profits, section 1368(b) controls and no dividend ever can result.

While the application of section 304 to sales of stock in one C corporation to another C corporation is fairly easily summarized, the impact of section 304 in the S corporation context will vary depending on the exact nature of the transaction. There are three principal variations: (1) a sale of C corporation stock to a commonly controlled S corporation; (2) a sale of

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164 § 304(b)(1).
165 § 304(b)(2).
166 Reg. § 1.304-2(a).
167 See id.; Reg. § 1.302-2(c).
S corporation stock to a commonly controlled C corporation; and (3) a sale of S corporation stock to another commonly controlled S corporation. In all three instances, another layer of complexity is added if an S corporation has earnings and profits from a C corporation history. Note that in the second and third variations, the S election of the corporation, the stock of which has been sold, terminates because the purchaser is an ineligible shareholder. The application of section 304 can best be explained through examples.

Example 1—Sale of C corporation stock to a commonly controlled S corporation with no C corporation history. A owns 60% of the voting common stock of X Corporation (60/100 shares), which is a C corporation with earnings and profits of $40. A's basis in the X Corporation stock is $60. A owns 70% of Y Corporation, which is an S corporation with no earnings and profits. A's basis in the Y Corporation stock is $210. A sells 30 shares of X Corporation to Y Corporation for $300. A controls X Corporation before the transaction and controls Y Corporation after the transactions, so section 304 applies. After the transaction, A owns 30% of X Corporation directly and 21% by attribution through Y Corporation, for a total ownership of X Corporation of 51%. A reduction in stock ownership from 60% to 51% cannot qualify as a redemption under section 302(b)(1)-(3). Thus, the transaction is treated as a section 351 contribution by A of 30 shares of X Corporation stock to Y Corporation for hypothetical stock of Y Corporation that is promptly redeemed in exchange for $300 in a transaction governed by section 301, and thus section 1368, since the distributing corporation is an S corporation. Because Y Corporation has no earnings and profits, the distribution is first applied against A's basis in Y Corporation. A's basis in the Y Corporation stock was $210, and A's basis in the hypothetical Y Corporation stock that was redeemed was $30. Under the "spillover" rule applicable to section 1368 distributions, A can apply both the $30 basis of the hypothetical Y Corporation stock that was redeemed, as well as the $210 basis in A's original Y Cor-

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168 See Benjamin v. Commissioner, 66 T.C. 1084 (1976), aff'd, 592 F.2d 1259 (5th Cir. 1979) (holding a redemption of voting preferred stock did not qualify under section 302(b)(1) because of the shareholder's continuing voting control over the corporation after the redemption); Rev. Rul. 77-218, 1977-1 C.B. 81 (eight percent reduction in actual and constructive ownership that left the shareholder with more than 50% of the voting stock because of the attribution rules was not a meaningful reduction even though all of the shares actually owned by the taxpayer were redeemed).

The examples assume that the distribution from Y Corporation does not qualify as a partial liquidation under section 302(b)(4). Blaschka v. United States, 393 F.2d 983 (Ct. Cl. 1968), concluded that when section 304 overlaps with the partial liquidation rules of § 302(b)(4), qualification for sale and exchange treatment under section 304 is determined by applying the test for a partial liquidation with reference to the acquiring corporation, rather than with reference to the issuing corporation. Id. at 987.

169 See F.S.A. 2000-41-009 (Oct. 13, 2000) (purchase of C corporation stock by an S corporation with both earnings and profits and an accumulated adjustments account for an amount not in excess of accumulated adjustments account was applied entirely against basis of stock of purchasing corporation).

170 Reg. § 1.1367-1(c)(3); see supra text accompanying note 131.
poration stock, for a total basis recovery of $240. Of the remaining $60, $40 is treated as a dividend based on X Corporation's $40 of earnings and profits, with the remaining $20 treated as gain under section 1368(c)(3).

Example 2—Sale of C corporation stock to a commonly controlled S corporation with a C corporation history. Assume all of the basic facts in Example 1, except that Y Corporation has a C corporation history. Y Corporation has an accumulated adjustments account of $180 and earnings and profits of $50. Once again the "spillover" rule provides A with $240 of available basis, but now section 1368(c)(1) limits A's basis recovery to the accumulated adjustments account, before application of Y Corporation's $50 of earnings and profits to the distribution. Thus, (1) the first $180 of the distribution is applied against A's $240 basis, reducing it to $60; (2) the next $50 is a dividend pursuant to section 1368(c)(2); (3) the next $60 is applied against remaining $240 of basis; and (4) the last $10 is a dividend based on X Corporation's earnings and profits.

Example 3—Sale of S corporation stock to a commonly controlled C corporation. A owns 60% of the voting common stock of X Corporation (60/100 shares), which is an S corporation with no C corporation history. A's basis in the X Corporation stock is $800. A owns 70% of Y Corporation, which is a C corporation with earnings and profits of $500. A's basis in the Y Corporation stock is $210. A sells 30 shares of X Corporation to Y Corporation for $300, which appears to result in a $100 loss. However, as in the preceding two examples, section 304 applies, and A's reduction in stock ownership of X Corporation from 60% to 51% cannot qualify as a redemption under section 302(b)(1)-(3). Thus, the transaction is treated as a section 351 contribution by A of 30 shares of X Corporation stock to Y Corporation for hypothetical stock of Y Corporation, which is promptly redeemed in exchange for $300 in a transaction governed by section 301, and since Y Corporation, the purchaser, is not an S corporation, section 301(c), and not section 1368, controls. Because Y Corporation's earnings and profits exceed the amount of the distribution, all $300 is a dividend. A now has a $610 basis ($210 + $400) in the 70 shares of Y Corporation stock. X corporation's S election terminates because it now has a corporate shareholder.

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172 Id. ("That portion of the distribution in excess of Acquiring's accumulated adjustment account is treated as a dividend to the extent it does not exceed the accumulated earnings and profits of both Acquiring and Issuing.").
173 As noted previously, the accumulated adjustments account is not apportioned among shareholders, Reg. § 1.1368-2(a)(1), so the entire account is available to support application of the distribution against the basis of the stock.
Example 4—Sale of stock of an S corporation with a C corporation history to a commonly controlled C corporation. B owns 60% of the voting common stock of Z Corporation (60/100 shares), which is an S corporation with a C corporation history; Z Corporation has earnings and profits of $100 and an accumulated adjustments account of $400. B's basis in the Z Corporation stock is $800. B owns 70% of Y Corporation, which is a C corporation with earnings and profits of $200. B's basis in the Y Corporation stock is $200. B sells 30 shares of Z Corporation to Y Corporation for $400, which appears to result in no gain or loss. However, as in the prior examples, section 304 applies, and B's reduction in stock ownership of Z Corporation from 60% to 51% cannot qualify as a redemption under section 302(b)(1)-(3). Thus, the transaction is treated as a section 351 contribution by B of 30 shares of Z Corporation stock to Y Corporation for hypothetical stock of Y Corporation, which is promptly redeemed in exchange for $400 in a transaction governed by section 301, and since Y Corporation, the purchaser, is not an S corporation, section 301(c), and not section 1368, controls. Because Y Corporation has earnings and profits of $200 and Z Corporation has earnings and profits of $100, B has a $300 dividend. B has a recovery of basis in Y Corporation of $100, and B's basis in the 70 shares of Y Corporation stock is now $500 ($200 + $400 - $100). Z Corporation's S election terminates because it has a corporate shareholder.\(^{175}\)

Example 5—Sale of stock of an S corporation with a C corporation history to a commonly controlled S corporation with a C corporation history. B owns 60% of the voting common stock of Z Corporation (60/100 shares), which is an S corporation with a C corporation history; Z Corporation has earnings and profits of $100 and an accumulated adjustments account of $200. B's basis in the Z Corporation stock is $300. B owns 70% of Y Corporation, which is an S corporation with a C corporation history. Y Corporation has earnings and profits of $150 and an accumulated adjustments account of $100. B's basis in the Y Corporation stock is $100. B sells 30 shares of Z Corporation to Y Corporation for $400, which appears to result in a $250 gain. However, as in the prior examples, section 304 applies, and B's reduction in stock ownership of X Corporation from 60% to 51% cannot qualify as a redemption under section 302(b)(1)-(3). Thus, the transaction is treated as a section 351 contribution by B of 30 shares of Z Corporation stock to Y Corporation for hypothetical stock of Y Corporation, which is promptly redeemed in exchange for $400 in a transaction governed by section 301, and since Y Corporation, the purchaser, is an S corporation, section 1368, controls. Under the principles applied in Example 2, the "spillover" rule provides B with $250 of available basis ($100 + $150), but now section 1368(c)(1) limits A's basis recovery to the accumulated adjustments account, before application of either Y Corporation's $200 of earnings and profits or Z Corporation's $100 of earnings and profits to the distribution. Assuming that only Y Corporation's accumulated

\(^{175}\)§§ 1362(d)(2), 1361(b)(1)(B).
adjustments account is available to support a return of basis under section 1368(c)(1), the $400 distribution is treated as follows: (1) the first $100 of the distribution is applied against A's $250 basis, reducing it to $150; (2) the next $150 is a dividend pursuant to section 1368(c)(2); (3) the next $100 is a dividend out of Z Corporation's earnings and profits; (4) the remaining $50 is applied against B's remaining $150 of basis in the Y Corporation stock, reducing it to $100. Z Corporation's S election terminates because it has a corporate shareholder and Y Corporation does not own sufficient Z Corporation stock to file a Q Sub election.

Example 6—Sale of stock of an S corporation with a C corporation history to a commonly controlled S corporation with no C corporation history. D owns 60% of the voting common stock of Z Corporation (60/100 shares), which is an S corporation with a C corporation history; Z Corporation has earnings and profits of $100 and an accumulated adjustments account of $200. D's basis in the Z Corporation stock is $200. D owns 70% of Y Corporation, which is an S corporation with no C corporation history. D's basis in the Y Corporation stock is $300. D sells 30 shares of Z Corporation to Y Corporation for $400, which appears to result in a $100 gain. However, as in the prior examples, section 304 applies, and D's reduction in stock ownership of Z Corporation from 60% to 51% cannot qualify as a redemption under section 302(b)(1)-(3). Thus, the transaction is treated as a section 351 contribution by D of 30 shares of Z Corporation stock to Y Corporation for hypothetical stock of Y Corporation, which is promptly redeemed in exchange for $400 in a transaction governed by section 301, and thus section 1368, since the distributing corporation is an S corporation. Because Y Corporation has no earnings and profits, the distribution is first applied against D's basis in Y Corporation. D's original basis in the Y Corporation stock was $300 and D's basis in the hypothetical Y Corporation stock that was redeemed was $100. Under the spillover rule applicable to section 1368 distributions, D can apply both the $100 basis of the hypothetical Y Corporation stock that was redeemed, as well as the $300 basis in D's original Y Corporation stock, for a total basis recovery of $400. Z Corporation's accumulated earnings and profits are irrelevant. Note that if either Z Corporation or Y Corporation had simply distributed $400 to D, D would have recognized income—a $100 dividend.

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176 There is no authority supporting the "transfer" of any of Z Corporation's accumulated adjustments account to Y Corporation, but one might assert by analogy to section 304(b)(2) and the purpose of the accumulated adjustments account, which is to avoid double taxation of S corporation pass-through income, that the accumulated adjustment account should also transfer.

177 See § 1361(b)(3); infra Part VII.

178 See F.S.A. 2000-41-009 (Oct. 13, 2000) (purchase of C corporation stock by an S corporation with both earnings and profits and an accumulated adjustments account for an amount not in excess of accumulated adjustments account was applied entirely against basis of stock of purchasing corporation).

179 See supra text accompanying note 170.

and a $100 capital gain if Z Corporation had made the distribution or a $100 gain if Y Corporation had made the distribution. In this example, it turns out that the application of section 304 is advantageous to D. This is an interesting illustration of the late, great Marty Ginsburg's "Law of Moses's Rod": "[E]very stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part[,]" although in this case the stick was crafted by Congress, not the Commissioner.

Other, more complicated examples can be derived, and in some of them the answers are not exactly clear. However, the foregoing examples suffice to illustrate the complexity of the intersection of subchapter S and section 304 and the surprising results that may occur in some instances.

H. Stock Dividends: Section 305

Subject to five exceptions, section 305 provides that a distribution of a corporation's own shares to its shareholders as a dividend on their existing shares is tax-free. In such a case, section 307 provides for an apportionment of the basis of the shareholder's original shares between the original shares and the new shares received in the distribution in proportion to their respective fair market values. Like the other rules of subchapter C, section 305 applies to S corporations as well as to C corporations. Thus, if an S corporation issues a stock dividend that is tax-free under section 305, the shareholder's basis of the original stock is apportioned between it and the dividend stock relative to their respective fair market values. In the case of a stock dividend that is not tax-free under section 305, the stakes are somewhat different when subchapter S interacts with subchapter C. In the case of a C corporation, if a stock dividend is taxable to the extent of the C corporation's available earnings and profits, the distribution is currently taxable under section 301(c)(1) and the stock received in the distribution takes a fair market value basis under section 301(d). In the case of an S corporation, however, if a stock dividend is not tax-free under section 305 (and did not result in termination of the S election), pursuant to section 1368 the shareholder would reduce the basis of the original stock by the fair market value of the dividend stock, which again would take a fair market value basis. A stock dividend that is not tax-free under section 305 (and does not result in termination of the S election) by

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182 See Reg. § 1.307-1.
183 If an S corporation distributes a stock dividend that is taxable under section 305(b) it almost always would result in termination of the S election, as discussed in the next paragraph, and pursuant to section 1362(d)(2)(B) the corporation's S election would terminate as of the day of the taxable stock dividend distribution. This would result in the distribution having been made by a C corporation during the post-termination transition period, discussed supra in the text accompanying note 148.
an S corporation that has earnings and profits will be taxable as dividend to the extent it exceeds the S corporation's accumulated adjustments account.\textsuperscript{184}

Section 305 can be used to facilitate the creation of nonvoting common stock of an S corporation that can then be transferred to family members (or trusts for the benefit of family members\textsuperscript{185}) of the original shareholder for estate planning purposes. Assume, for example, that individual A owned all 100 shares of the voting common stock of an S corporation and the corporation issued 50 shares of nonvoting common stock to A. This qualifies as a tax-free distribution under section 305(a). Assume further than the fair market value of the 100 shares of voting common stock before the distribution was $200 per share ($20,000 total) and that after the distribution the fair market value of the 100 shares of voting common stock is $150 per share ($15,000 total) and the fair market value of the 50 shares of nonvoting common stock is $100 per share ($5,000 total).\textsuperscript{186} If the original aggregate basis of the 100 shares of voting common stock was $8,000, the post-distribution aggregate basis of the 100 shares of voting common stock would be $6,000 ($8,000 x ($15,000 + ($15,000 + $5,000))), or $60 per share, and the post-distribution aggregate basis of the 50 shares of nonvoting common stock would be $2,000 ($8,000 x ($5,000 + ($15,000 + $5,000))), or $40 per share.

Absent poor tax planning, it is unlikely that any of the five exceptions in section 305(b) to the tax-free treatment of stock dividends under section 305(a) will apply in the S corporation context. Section 305(b)(1) provides that where the shareholder has an explicit election to receive stock or cash the stock distribution will be taxable. This provision applies principally to dividend reinvestment plans, which generally exist only in publicly held corporations. If such a distribution were made by an S corporation, the distribution would result in termination of the election. A stock distribution is taxable under section 305(b)(2) if it has the result of (1) an increase in the proportionate interest of some shareholders coupled with (2) a receipt of property (including cash) by other shareholders in a distribution subject to section 301. This rule applies almost exclusively to situations in which the corporation has two different classes of stock, for example, with one class paying dividends in cash and the other paying dividends in additional stock. A corporation with such a capital structure could not qualify to make an S election. If such a distribution were made by an S corporation that had one class of stock, the distribution would result in termination of the election. Section 305(b)(3) taxes stock distributions when some shareholders receive common stock while others receive preferred, again a capital structure that would disqualify the corporation from making an S election or would terminate the S election. Section 305(b)(4), which currently taxes all stock dividends received by hold-

\textsuperscript{184}I.R.C. § 1368(c).
\textsuperscript{185}For trusts that qualify as S corporation shareholders, see supra text accompanying note 12.
\textsuperscript{186}Valuation of the shares before and after the distribution is a factual question that must be answered by appraisal.
ers of preferred stock, likewise is not relevant to S corporations, which cannot issue preferred stock. Finally, section 305(b)(5), dealing with distributions of convertible preferred stock, similarly is not relevant to an S corporation that wants to retain its S corporation status.

I. Liquidation of an S Corporation

1. Generally

Liquidating distributions by an S corporation are subject to the liquidation rules of subchapter C. Gain and loss are recognized on both the corporate and shareholder levels, but the section 1367 basis adjustments apply to mitigate double taxation. The liquidation of an S corporation differs significantly from the liquidation of a partnership, which generally is tax-free under section 731, unless the partners receive disproportionate distributions of “hot assets”—generally (1) inventory with a fair market value of more than 120% of its basis, (2) accounts receivable, and (3) property subject to depreciation recapture (or any other recapture rule).187

Section 336 requires recognition of gain or loss at the corporate level on a liquidation distribution of property (not cash) as if the property were sold for its fair market value. However, section 336(d) limits losses for certain non-pro rata distributions of items of property to a majority shareholder and distributions of certain recently contributed property. The most significant limitation on loss recognition is found in section 336(d)(1)(A)(i), which disallows any loss with respect to a specific item of loss property that is distributed to a shareholder who is related within the meaning of section 267—generally a more than 50% shareholder—if the property is not distributed among all shareholder in undivided interests proportionate to their shareholdings.188 In addition, section 336(d)(2) disallows losses on the distribution to a majority shareholder of property acquired by the corporation in a section 351 transaction, or as a contribution to capital, within the five-year period ending on the date of distribution, regardless of whether the property had a built-in loss at the time of the acquisition.

The gain or loss recognized at the corporate level is passed through to shareholders under section 1366, and the shareholders' bases in their stock are adjusted accordingly pursuant to section 1367. The character of the gain and loss allocated to the shareholders is determined by the nature of the property at the corporate level—ordinary (including recapture), section 1231, or capital (including “unrecaptured section 1250 gain”) determined on an asset-by-asset basis.

187 See I.R.C. § 751(b)-(d).

188 See C.C.A. 2012-37-017 (Sept. 14, 2012) (noting applicability of section 336(d) to liquidating distributions by an S corporation, but not expressly explaining the interaction with section 1367).

189 I.R.C. § 1366(b).
Section 1239 treats as ordinary income any gain recognized with respect to any property distributed to a shareholder who owns more than 50% of the value of the stock (taking into account attribution under section 267(c), excluding section 267(c)(3)) if the shareholder holds the property as depreciable property. Thus, for example, if an S corporation distributes to its sole shareholder a building, having an adjusted basis of $100,000 and a fair market value of $1.0 million, the entire $900,000 gain is passed through to the shareholder as ordinary income, without regard to any applicable depreciation recapture, if the shareholder holds the building for use in a trade or business. The purpose for which the corporation held the building is not relevant under section 1239. Any gain recognized by the corporation with respect to the land on which the building is located would remain section 1231 gain.

If section 336(d) applies to disallow a loss with respect to distributed property, the basis of the shares in the S corporation must be reduced under section 1367 before computing the gain or loss recognized by the shareholders on the liquidating distribution. Section 1367(a)(2)(D) requires a reduction in basis for expenses that are neither deductible nor chargeable to capital account. This adjustment is necessary to prevent the shareholder from recognizing the disallowed deduction by realizing less gain or greater loss on the subsequent sale of the stock. The regulations provide that the items included in the ambit of section 1367(a)(2)(D) include, among other items, losses disallowed under section 267 relating to related party transactions. Although the regulations do not address losses disallowed under section 336(d), the same principles apply.

Note that the basis of the shares of all shareholders, and not merely the distributee shareholder, must be reduced. Under section 331, liquidating distributions are treated as received by the shareholders in exchange for their stock; gain is recognized to the extent the distribution exceeds basis, or loss is recognized if the distribution is less than the shareholder's basis. The amount of the liquidating distribution is the amount of money plus the fair market value of any property received by the shareholder. The amount of the distribution is reduced by the amount of any of the corporation's debts assumed by the shareholder.

On the shareholders' individual tax returns, passed-through capital gains and losses are netted with the gains or loss recognized under section 331 (and any other capital gains and losses recognized to the shareholder for the year), as well as any section 1231 gain or loss (whether passed-through from the S corporation or otherwise derived) that is characterized as capital gain.

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190 Reg. § 1.1367-1(c)(2).
191 Cf. Ball v. Commissioner, 105 T.C.M. (CCH) 1257, 2013 T.C.M. (RIA) § 2013-39 (holding unrecognized gain on the deemed § 332 liquidation on a QSub election for an existing subsidiary is not "exempt" income that permits a basis increase under section 1367(a)(1)(A), and non-recognition under section 332 does not create an item of tax-exempt income under section 1366(a)(1)(A), but defers recognition through substituted basis rules).

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or loss under the rules of section 1231. Gain or loss on the liquidating distribution is recognized in situations where the shareholder’s stock basis is not the same as the shareholder’s ratable share of the corporation’s asset bases, for example, where there are two or more shareholders and one or more contributed appreciated or depreciated property in a section 351 transaction and the corporation took a section 362(a) transferred basis in the property or where the shareholder acquired the stock by purchase or bequest.

Note that section 1368 applies only to distributions to which section 301(c) would otherwise apply and not to the section 331 liquidation distribution.193 Both the corporate gain and loss recognized under section 336 are taken into account by the shareholders in making basis adjustments under section 1367 before determining gain or loss realized on the liquidation distribution under section 331. Section 1368(d), which provides that passed-through losses for the year are taken into account after distributions, only applies to distributions covered by section 1368.

Pursuant to section 334(a), the shareholder’s basis in each item of property received in the liquidation is its fair market value. The basis is not affected by the shareholder’s assumption of any of the corporation’s debts in connection with the liquidation.194

The following example illustrates the application of the rules governing S corporation distributions.195 X Corporation has been an S corporation since it was formed. A owns 60% and B owns 40% of the stock of X Corporation. A’s basis for the stock was $280,000; B’s basis for the stock was $220,000. X Corporation liquidates by distributing Blackacre to A and Whiteacre to B. The fair market value of Blackacre is $1.2 million and X Corporation’s basis in Blackacre is $200,000. The fair market value of Whiteacre is $1.1 million and its basis is $1.4 million; Whiteacre is subject to a $300,000 mortgage, which B assumes. Both properties were held for sale to customers in the ordinary course of business. X Corporation recognizes $1.0 million of ordinary income on the distribution of Blackacre and a $300,000 ordinary loss on the distribution of Whiteacre (assuming section 336(d)(2) does not apply). 60% of the gain and loss is allocated and taxed to A, and 40% of the gain and loss is allocated and taxed to B.

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193I.R.C. § 1368(a).
195These calculations omit any potential impact of the 3.8% tax on the net investment income of individuals, estates, and trusts under section 1411. See supra note 92.
A receives a liquidation distribution of $1.2 million. Subtracting A's $700,000 basis in the stock, A recognizes a $500,000 capital gain on the liquidation distribution under section 331. A's basis in Blackacre is its $1.2 million fair market value. B receives property worth $1.1 million, but subject to a $300,000 mortgage. The liquidation distribution to B is reduced by the amount of the mortgage.\(^\text{196}\) B receives a distribution of $800,000. Subtracting B's $500,000 basis in the stock, B recognizes a $300,000 capital gain on the liquidation distribution. B's basis in Whiteacre is its $1.1 million fair market value unreduced by the amount of the mortgage lien.

2. Liquidation Distribution of a Section 453 Installment Obligation

Distribution of a section 453 installment obligation generally results in immediate recognition of gain to the corporation under either or both of sections 311 and 453B, and the gain will be passed through to the shareholders.

Section 453B(h), however, provides a narrow exception for the distribution of an installment obligation acquired by an S corporation on the sale of its assets within 12 months preceding complete liquidation of the corporation. Corporate level gain is not triggered by the distribution in liquidation of the installment obligation, and the shareholder does not treat receipt of the installment obligation itself as a payment in exchange for the shareholder's stock in the liquidation.\(^\text{197}\) Section 453B(h) does not apply for purposes of determining the corporation's tax liability under subchapter S. Thus, the corporation is not relieved from recognition of gain on the distribution of an installment obligation that triggering the built-in gain tax of section 1374 or the tax on passive investment income of section 1375.

The receipt of each installment payment by the shareholder is a taxable event. Thus, S corporation shareholders are permitted to defer recognition of liquidation gain in the same manner that section 453B(h) permits deferral of recognition by C corporation shareholders. Section 453B(h) requires that the character of the shareholder's gain be determined as if the corporation had recognized the gain and the gain had passed through to the shareholders under section 1366.


\(^{197}\) I.R.C. § 453B(h).
VII. Qualified Subchapter S Subsidiaries

A. Generally

An S corporation may own the stock of a subsidiary that is a C corporation. Such a C corporation subsidiary may elect to join in the filing of a consolidated return with its affiliated C corporations, that is, chains of controlled corporations of which the subsidiary is the common parent. However, the S corporation parent is not allowed to join in the consolidated return.198

A subsidiary of another corporation may not be an S corporation because a corporation that has another corporation as a shareholder is not eligible to make an S election. However, section 1361(b)(3) provides a special rule for “qualified subchapter S subsidiaries.” A qualified subchapter S subsidiary (QSub) is any domestic corporation that (1) is not an ineligible corporation, (2) is wholly owned by an S corporation, and (3) is one that the parent S corporation elects to treat as a QSub.199

A corporation for which a QSub election is made is not treated as a separate corporation but is considered a “disregarded entity” for income tax purposes. The existence of the stock of a QSub is ignored.200 Thus, 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.201 Transactions between the S corporation parent and the QSub are not taken into account for tax purposes.

1. Newly Formed Qualified Subchapter S Subsidiary

Just as in the case of the formation of a single-member LLC, the formation of new QSub is a nonevent. If a QSub election is made for a newly formed subsidiary, the subsidiary is treated as a QSub from its inception and both the parent and subsidiary are treated as if the subsidiary never had been formed.202 For federal income tax purposes all of the assets continue to be owned by the parent S corporation even though ownership of the assets transferred to the new QSub is effective for state law purposes.

The assumption by the QSub of the parent S corporation’s debts in connection with the transfer of assets to the QSub has no tax effect, even if the debts assumed exceed the S corporation’s basis in the transferred assets. Because the QSub is a disregarded entity for tax purposes, section 357(c) does not apply. The parent S corporation does not have a basis in the shares of the QSub that it owns because the parent S corporation is treated as directly owning all of the assets of the QSub. The parent S corporation is also treated as the debtor with respect to all of the QSub’s debts. All of the income and all of the deduc-

198 See I.R.C. § 1504(b)(8).
200 Reg. § 1.1361-4(a)(1).
201 Id.; see Vainisi v. Commissioner, 132 T.C. 1, 3-4 (2009), rev’d on other grounds, 599 F.3d 567 (7th Cir. 2010).
202 Reg. § 1.1361-4(a)(2)(i).
tions of the QSub will be reported directly on the S corporation's return and passed through to the S corporation's shareholders under section 1366.

A sale of all of the stock of a QSub stock is treated as a sale of the QSub's assets. The amount realized—the aggregate value of the consideration received—is allocated among the assets pursuant to section 1060 and the regulations thereunder. The character of the gain—ordinary (including recapture), section 1231, or capital (including "unrecaptured section 1250 gain")—is determined on an asset-by-asset basis.

2. QSub Election for a Pre-Existing C Corporation Subsidiary

If a QSub election is made for a controlled, pre-existing C corporation, the subsidiary is deemed to have liquidated under sections 332 and 337 immediately before the day the election is effective. Under section 332 no gain or loss is recognized by the parent, and under section 337 no gain or loss is recognized by the subsidiary. This treatment applies whether the subsidiary previously had been owned by the S corporation parent or is newly acquired.

If a C corporation makes an S election and makes a QSub election with respect to a subsidiary that is to be effective on the same date as the S election, the deemed subsidiary liquidation occurs immediately before the S election becomes effective, while the electing parent is still a C corporation.

Sections 332 and 337 apply when any parent corporation completely liquidates a subsidiary corporation that it controls. Through a cross reference to section 1504(a)(2), section 332(b)(1) defines "control" as holding both (1) 80% or more of the voting power, and (2) 80% or more of the total value of all stock of the corporation, except that pursuant to section 1504(a)(4), nonparticipating, nonconvertible, nonvoting preferred stock is not taken into account. Since a QSub must be 100% owned by its parent S corporation, the control requirement is ipso facto met.

When section 332 applies to the parent of a liquidating corporation, section 337 provides a general exception to the basic rule of section 336 that a liquidating corporation recognizes gain or loss on liquidating distributions. Under section 334(b), the basis of the QSub's assets remains the same as it was before the election. Cost recovery periods and depreciation and amortization methods remain unchanged. If the subsidiary previously was a C corporation, the section 1374 built-in gains tax will apply to the subsidiary's assets as if the subsidiary had made a subchapter S election. Section 381(a) provides that the tax attributes that the QSub possessed when it was still a C corporation carry over to the parent. The most notable of these tax attributes are net operating loss carryovers, capital loss carryovers, and the earnings and profits accumulations or deficits.

204 See I.R.C. § 381(c)(6); Reg. § 1.381(c)(6)-1.
205 I.R.C. § 1374(d)(8).
If, following a section 332 liquidation, the parent or the subsidiary has a deficit in its earnings and profits accounts, the parent must maintain separate earnings and profits accounts because the deficit of one corporation cannot be used to offset the surplus in the earnings and profits account of the other. Earnings and profits accumulated by the parent after the liquidation are used to exhaust the deficit account before the accumulated earnings and profits account of the parent is increased. The earnings and profits of an S corporation only are relevant to the treatment of distributions under section 1368 to the extent that the S corporation does not have an adequate accumulated adjustments account to support treatment of distributions as a return of basis.

Accounting methods and inventory methods of a C corporation that makes a QSub selection remain unchanged. However, if the C corporation maintained LIFO inventories, the QSub election will trigger LIFO recapture under section 1363(d). This provision requires a corporation that makes a subchapter S election and which has used the LIFO method of inventory accounting to include in gross income for its last year as a C corporation the amount by which its "inventory amount" (i.e., the basis it holds in its inventory) would have been if it had used the FIFO method of inventory accounting exceeds its inventory amount under the LIFO inventory accounting method. Because the FIFO inventory amount often significantly exceeds the LIFO inventory amount, section 1363(d) can impose a significant transition cost for a C corporation that becomes a QSub.

B. Termination of QSub Status

1. Revocation of QSub Election

A QSub that ceases to qualify under section 1361(b)(3)(B) or whose election has been revoked is treated as a new corporation that has acquired all of its assets and assumed all of its liabilities from its S corporation parent in exchange for the subsidiary's stock immediately before the termination of its QSub status. This hypothetical transaction is governed by general income tax principles, including section 351 and its associated sections. For purposes of determining control under section 351, equity instruments that are not treated as a second class of stock under section 1361(b)(1)(D) are disregarded. If the QSub's liabilities exceed the basis of its assets, pursuant to section 357(c), gain must be recognized by the parent.

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206 See I.R.C. § 381(c)(2)(B); Luckman v. Commissioner, 56 T.C. 1216, 1220 n.3 (1971).
207 See Reg. §§ 1.312-11(b)(2), -11(c).
208 See I.R.C. § 1368(c). For the accumulated adjustments account, see generally section 1368(d) and Regulation section 1.1368-2, discussed supra Part VI.C.
209 See § 381(c)(4)-(5).
211 I.R.C. § 1361(b)(3)(C)(i); Reg. § 1.1361-5(b)(1).

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The regulations provide that the step transaction doctrine is applicable to terminations of QSub status. Thus, a disposition of the stock of the former QSub will affect application of the control requirement section 351.212

2. Termination of Eligibility by Sale of Stock

The transfer of any of the stock of a QSub to another person by the parent S corporation results in the termination of the QSub election on the date of the transfer.213 Revenue Ruling 2004-85 held that a QSub election is terminated if the parent 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)."214

The consequences of the termination of a QSub election, and the ability to maintain QSub status if the purchaser is another S corporation that elects to continue the QSub election are discussed in Part VIII.C.3.

3. Termination of Parent's S Corporation Election

If the parent corporation’s S election terminates, a QSub election terminates automatically at the close of the last day of the parent’s last taxable year as an S corporation. For example, X Corporation, an S corporation, owns 100% of QSub Y Corporation. On January 1, 2014, X Corporation revokes its S election, effective on January 1, 2014. Because X Corporation is no longer an S corporation, Y Corporation no longer qualifies as a QSub at the close of December 31, 2013. As with any other termination of a QSub election, the event is treated as the formation of a new corporation that has acquired all of its assets and assumed all of its liabilities from the parent corporation in exchange for the subsidiary’s stock immediately before the cessation of QSub status.215 This hypothetical transaction is governed by general income tax principles, including section 351 and its associated sections. A somewhat different result occurs if an S corporation parent of a QSub merges into an S corporation or an LLC that is wholly owned by an S corporation in a section 368 tax-free reorganization, and the original S corporation parent goes out of existence, rather than having its S election terminated. Assume that T Corporation, an S corporation, owns Q Corporation, a QSub, and T Corporation merges into P Corporation, another S corporation. In this instance what would otherwise be the deemed formation of Q Corporation by T Corporation as a consequence of the termination of Q Corporation’s QSub election is disregarded. In addition to there being a valid section 368(a)(1)(A) merger of T Corporation into P Corporation, the transaction is treated as a transfer of Q Corporation’s assets to P Corporation, followed by P

212 See Reg. § 1.1361-5(b)(3), Ex. (1).
215 § 1361(b)(3)(C); Reg. § 1.1361-5(b)(1).
Corporation's transfer of these assets to Q Corporation in exchange for stock of Q Corporation. A similar result follows if T Corporation merges into a disregarded entity, either a wholly owned LLC or QSub, owned by P Corporation, although the details are a bit more complicated.

VIII. Merger & Acquisition Issues

A. Acquisitions of S Corporations

1. Sale of S Corporation Stock

As long as the purchaser of the stock of an S corporation is an eligible shareholder and the S election is not revoked, the consequences of a stock sale and purchase of an S corporation are relatively straightforward. The selling shareholders recognize capital gain or loss on the stock sale. In computing the gain or loss on the sale of shares, the selling shareholders' bases in the shares must first be adjusted under section 1367 to reflect any passed-through income or loss from the portion of the taxable year prior to the sale.

If the corporation continues to be an S corporation, its income for the year of the sale must be apportioned between the selling shareholders and the acquiring shareholders. Section 1377(a) provides that each shareholder's pro rata share of an S corporation's items passed through under section 1366 is determined on a day-by-day, share-by-share method if the ownership of shares changes during the year.

Pursuant to authority granted in section 1377(a)(2), the regulations allow an S corporation to close its year for purposes of allocating income among shareholders if a shareholder completely terminates the shareholder's interest and the corporation and all of the shareholders who are affected consent. If stock is sold, the affected shareholders are the seller and the purchaser(s); if stock is redeemed by the corporation, however, all shareholders are affected and must consent. The regulations provide a similar election if any shareholder disposes of more than 20% of the outstanding stock of the corporation during the taxable year but has not disposed of all of the shareholder's stock. In this case, the regulations require consent of all shareholders, not
just the "affected shareholders." The Treasury has not amended the regulations to conform to the consent requirements in section 1377(a)(2), apparently because they were not promulgated under authority of that particular Code section.

Neither the selling shareholders nor the corporation has any other tax consequences. The bases of the S corporation's assets remain the same and cost recovery periods are unaffected. The purchaser takes a section 1012 cost basis in the stock of the S corporation. The S election continues in effect notwithstanding the change in ownership. Section 1362(c) provides that an S election remains in effect until terminated under section 1362(d), and the mere sale of part or all of the stock of an S corporation to new owners who are eligible shareholders is not a termination event under section 1362(d). If, however, the purchaser of any stock of an S corporation is not an eligible shareholder, the S election is automatically terminated as of the date on which the purchaser acquires the stock.

Section 1362(e) generally requires a pro rata allocation of S corporation income between a short subchapter S year ending on the day before termination of the S election and a short subchapter C year beginning on the date of the termination. Income allocated to the short subchapter C year is annualized for purposes of determining the tax payable under section 11. The tax is then prorated to the number of days in the short subchapter C year.

The corporation can elect to use the closing of the books method with the consent of all of the shareholders who held stock during any part of the short subchapter S year plus the shareholder on the first day of the short subchapter C year. Section 1362(e)(6)(D) provides that allocations of the S corporation's income for the year of sale between the selling shareholders and the purchasing shareholders must be based on the closing corporate books method if there is a sale or exchange of more than 50% of the corporation's stock during a year in which the corporation's S election terminates. In such a situation, the proration method is not available. Section 1362(e)(6)(D) also applies if the purchaser of more than 50% of the corporation's stock during a year is an eligible shareholder but the corporation revokes the S election effective in the year of stock the sale and purchase.

2. Sale of Assets of an S Corporation Followed by Liquidation

The results of the sale of all of the assets of an S corporation followed by its liquidation are straightforward as long the section 1374 tax on built-in gain is inapplicable, which is the case if the S corporation has maintained S corporation status for ten years and has not acquired assets of a C corporation in a transaction to which section 381 applies, for example, the liquidation
of a C corporation subsidiary or an asset-acquisition section 368 reorganization. The S corporation recognizes gain and loss on the sale of its assets based on the price of each asset as determined under section 1060 and Regulation section 1.338-4. The recognized gains and losses are passed through to the S corporation's shareholders under section 1366. This passed-through gain or loss is then taken into account by the shareholders as a basis adjustment to their stock under section 1367.

The gains and losses are ordinary, section 1245 (or other recapture), section 1231, capital gain, or "unrecaptured section 1250 gain" (a subset of section 1231 gain taxed as capital gain), as the case may be. As described above in Part VI.H., when the S corporation liquidates, the S corporation's shareholders recognize gain or loss with respect to their stock pursuant to section 331. The character of the gain or loss is capital.

On the shareholders' individual tax returns, passed-through capital gains and losses are netted with the gains or loss recognized under section 331 (and any other capital gains and losses recognized to the shareholder for the year), as well as any section 1231 gain or loss (whether passed-through from the S corporation or otherwise derived) that is characterized as capital gain or loss under the rules of section 1231.

If the S corporation election has not been in effect for ten years or the S corporation has acquired assets of a C corporation within ten years, then in addition to the above results, the section 1374 tax on built-in gains applies. As noted previously, in such a case the section 1367 passed-through gain on the sale of the assets is reduced by the amount of the corporate level tax.

3. Section 338(h)(10) Election on Purchase and Sale of S Corporation Stock

Section 338(h)(10) permits an election to treat a "qualified stock purchase" of S corporation stock by another corporation (but not by individuals) as an asset sale and purchase. All of the shareholders of the S corporation, including any shareholders who have not sold their stock, and the acquiring corporation must consent to the election.

A "qualified stock purchase" is defined in section 338(d)(3) (through a cross reference to section 1504(a)(2)) as the acquisition by purchase within a 12 month period of both (1) 80% or more of the voting stock and (2) 80% or more of the total value of all stock of the S corporation. A "purchase" under section 338(h)(3) includes any "acquisition" that is not specifically excluded. However, section 338(h)(3) provides three specific exclusions: (1) stock the basis of which is determined in whole or in part with reference to the transferor's basis, that is, transferred basis stock, and stock acquired from a decedent; (2) stock acquired in certain nonrecognition transactions, including section 351 transactions and corporate reorganizations; and (3) stock acquired from a person from whom it would be attributed to the purchaser under section 318.

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228 I.R.C. § 338(h)(10); see Reg. § 1.338(h)(10)-1(c)(1).
229 See Reg. § 1.338(h)(10)-1(c)(3).
If section 338(h)(10) election is made, the shareholders of a subchapter S corporation treat the stock sale as a sale of assets by the corporation. The S corporation recognizes gain and loss on the deemed sale of its assets based on the aggregate deemed sale price (ADSP) as determined under Regulation section 1.338-4. If all of the stock of the S corporation is acquired within the 12 month window, generally the ADSP equals the sum of (1) the amount realized on the sale of the target S corporation stock plus and (2) the target S corporation’s liabilities (which would include any section 1374 tax liability triggered by the deemed asset sale). If at least 80%, but less than all, of the stock of the target S corporation has been purchased, then the ADSP is computed by “grossing up” the amount realized on the sale of the stock within the 12 month window by dividing the amount realized by the percentage of target corporation stock that was so purchased. The purpose of this computation is to approximate the fair market value of 100% of the stock of the target in cases where the acquiring corporation purchases less than 100% of the target stock within the 12 month acquisition period. The ADSP does not reflect any tax liability (except section 1374 tax liability) attributable to the S corporation resulting from the deemed sale of the target S corporation’s assets because the gain recognized by the target S corporation on the deemed sale of its assets is passed through to the corporation’s shareholders who pay the resulting taxes.

The recognized gains and losses on the deemed asset sale are passed through to the S corporation’s shareholders under section 1366. The deemed passed-through gain or loss is then taken into account by the shareholders as a basis adjustment to their stock under section 1367, following which the S corporation is deemed to have been liquidated in a transaction in which the S corporation shareholders recognize gain or loss under section 331. In many cases the shareholders’ basis in their stock will closely approximate the amount of the deemed liquidation distribution because of the basis adjustment resulting from the pass-through of the gain or loss on the deemed asset sale. No additional gain or loss is recognized on the stock sale.

Whether the section 338(h)(10) election is desirable or not depends on the net cash received by the shareholders after taxes. Simply computing the amount of gain or the amount of taxes and comparing these amounts is not adequate to answer the question. The sales price differs, being more if the election is made, and the character of the gain is affected by the election. The net cash received is a function of both the price (not the amount of the gain without regard to character) and the amount of the taxes.

Assume that C and D each own 50 of the 100 outstanding shares of common stock of S Corporation. C’s basis in the stock is $6.0 million; D basis in

\[ \text{ADSP} = \text{Amount Realized} + \text{Target S Corporation's Liabilities} \]

\[ \text{ADSP} = \frac{\text{Amount Realized}}{\text{Percentage of Stock Purchased}} \]

(See Reg. § 1.338-4(c).

(See Reg. § 1.338(h)(10)-1(e), Ex. (10).

(See Reg. §§ 1.338(h)(10)-1(d)(4), -1(d)(5).

(See Reg. § 1.338(h)(10)-1(d)(5).
WHEN SUBCHAPTER S MEETS SUBCHAPTER C

the stock is $4.0 million. The assets recorded on S Corporation's balance sheet consist of the following:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$1,000,000</td>
<td>$9,000,000</td>
</tr>
<tr>
<td>Factory Land</td>
<td>$5,000,000</td>
<td>$6,000,000</td>
</tr>
<tr>
<td>Factory Building</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$3,000,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Patent</td>
<td>$4,000,000</td>
<td>$8,000,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$18,000,000</strong></td>
<td><strong>$30,000,000</strong></td>
</tr>
</tbody>
</table>

S Corporation owes Bank $5.0 million.

Another corporation has proposed to purchase all of the S Corporation either (1) for $26.0 million in cash ($13.0 million each) if C and D agree to make a section 338(h)(10) election, or (2) $24.0 million in cash ($12.0 million each) if there is no section 338(h)(10) election.

Whether the election is desirable or not depends on the net cash received by the shareholders after taxes. Because the sales prices differ, being more if the election is made, and if the election is made the character of the gain is affected, simply computing the amount of gain or the amount of taxes and comparing these amounts is not adequate to answer the question. The net cash received is a function of both the price (not the amount of the gain without regard to character) and the amount of the taxes.

If there is no section 338(h)(10) election, C and D each recognize the gain on their stock sale. C's gain is $6.0 million ($12.0 million amount realized - $6.0 million basis). C's tax liability is $1.2 million ($6.0 million x 20%) and C's net after-tax cash is $10.8 million ($12.0 million - $1.2 million). D's gain is $8.0 million ($12.0 million amount realized - $4.0 million basis). D's tax liability is $1.6 million ($8.0 million x 20%) and D's net after-tax cash is $10.4 million ($12.0 million - $1.6 million).

If a section 338(h)(10) election is made and each shareholder receives $13.0 million for the stock, the ADSP is simply the sum of the amount realized on the sale of the stock, plus the corporation's liabilities. The tax liability resulting from the deemed asset sale is not taken into account in computing the liabilities because the taxes are paid by the shareholders, they are not corporate liabilities. Thus, the ADSP is $31.0 million ($26.0 million + $5.0 million debt to Bank).

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334 These calculations omit any potential impact of the 3.8% tax on the net investment income of individuals, estates, and trusts under section 1411. See supra note 92.

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Applying the rules of Regulation section 1.338-6, the corporation recognizes gain and loss on its assets as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount Realized</th>
<th>Basis</th>
<th>Gain</th>
<th>Character</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$9,000,000</td>
<td>$1,000,000</td>
<td>$8,000,000</td>
<td>Ordinary</td>
</tr>
<tr>
<td>Factory Land</td>
<td>$6,000,000</td>
<td>$5,000,000</td>
<td>$1,000,000</td>
<td>§1231</td>
</tr>
<tr>
<td>Factory Building</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$0</td>
<td>§1231</td>
</tr>
<tr>
<td>Equipment</td>
<td>$2,000,000</td>
<td>$3,000,000</td>
<td>($1,000,000)</td>
<td>§1231</td>
</tr>
<tr>
<td>Patent</td>
<td>$8,000,000</td>
<td>$4,000,000</td>
<td>$4,000,000</td>
<td>§1231</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$1,000,000</td>
<td>$0</td>
<td>$1,000,000</td>
<td>Capital235</td>
</tr>
</tbody>
</table>

Assuming that C and D have no other relevant capital gains and losses or section 1231 gains or losses and that they both are in the 39.6% marginal tax bracket, the amounts passed through to each shareholder under section 1366 are as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Gain</th>
<th>Character</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$4,000,000</td>
<td>Ordinary</td>
</tr>
<tr>
<td>Factory Land</td>
<td>$ 500,000</td>
<td>$1231</td>
</tr>
<tr>
<td>Factory Building</td>
<td>$ 0</td>
<td>$1231</td>
</tr>
<tr>
<td>Equipment</td>
<td>($500,000)</td>
<td>$1231</td>
</tr>
<tr>
<td>Patent</td>
<td>$2,000,000</td>
<td>$1231</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$ 500,000</td>
<td>Capital</td>
</tr>
</tbody>
</table>

Each shareholder realizes $4.0 million of ordinary gain, triggering $1.584 million of tax liability. Each shareholder also realizes $2.0 million of net section 1231 gain, and $500,000 of capital gain. The tax liability resulting from the passed through section 1231 gain and capital gain cannot be computed until the gain or loss recognized by each shareholder on the deemed liquidation is determined.

Pursuant to section 1367, C and D each increases the basis of the stock of S Corporation by the passed through gain from the deemed asset gain prior to determining the gain or loss recognized under section 331 on the deemed liquidation. Each of them increases the respective stock basis by $6.5 million. C's new basis in the stock is $12.5 million, and D's new basis in the stock

235 This assumes that the goodwill was not a section 197 amortizable intangible. If the goodwill were a section 197 amortizable intangible, to the extent of prior depreciation, the gain would be section 1245 ordinary income recapture gain and any gain in excess of section 1245 recapture would be section 1231 gain.
is $10.5 million. C's section 331 capital gain on the deemed liquidation is $500,000 ($13.0 million amount realized - $12.5 million basis). D's section 331 capital gain on the deemed liquidation is $2.5 million ($13.0 million amount realized - $10.5 million basis). These amounts are combined with $2.0 million of section 1231 gain, and $500,000 of capital gain that was passed through to each of them under section 1366. C recognizes a total capital gain (including section 1231 gain) of $3.0 million, and has a tax liability on his capital gain of $600,000 ($3.0 million x 20%). D recognizes a total capital gain (including section 1231 gain) of $5.0 million, and has a tax liability on the capital gain of $1.0 million ($5.0 million x 20%).

Adding the $1.584 million of tax liability of each shareholder resulting from the passed-through ordinary income, C's total tax liability is $2.184 million. Subtracting this amount from the $13.0 million cash proceeds from the stock sale leaves C with $10.816 million in cash after taxes. D's total tax liability is $2.584 million, which leaves D with $10.416 million in cash after taxes. Comparing these results with the after tax cash received by each shareholder absent a section 338(h)(10) reveals that both C and D are better off after taxes by accepting $13.0 million for the stock with a section 338(h)(10) election rather than accepting only $12.0 million without the section 338(h)(10) election.

<table>
<thead>
<tr>
<th></th>
<th>Without § 338(h)(10)</th>
<th>With § 338(h)(10)</th>
<th>Without § 338(h)(10)</th>
<th>With § 338(h)(10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>Gross Cash</td>
<td>$12,000,000</td>
<td>$13,000,000</td>
<td>$12,000,000</td>
</tr>
<tr>
<td></td>
<td>Total Taxes</td>
<td>$1,200,000</td>
<td>$2,184,000</td>
<td>$1,600,000</td>
</tr>
<tr>
<td></td>
<td>Net Cash</td>
<td>$10,800,000</td>
<td>$10,816,000</td>
<td>$10,400,000</td>
</tr>
<tr>
<td>D</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

It is not always true that the shareholders are better off making a section 338(h)(10) election. Every transaction must be analyzed on its particular facts using the methodology set forth above. There are no useful rules of thumb, but generally speaking a section 338 election tend to be less advantageous the greater the amount of ordinary income inherent in the S corporation's assets. Assume that in the preceding example the S corporation had acquired the patent as part of an asset purchase of another business and that the patent thus was an amortizable section 197 intangible. As a result, to the extent of prior amortization, the gain would be section 1245 ordinary income recapture.\(^{236}\) Assume further that the S corporation had claimed $2.0 million of

\(^{236}\)See I.R.C. §§ 197(f)(7), 1245.

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amortization with respect to the patent. In this case the corporation recognizes gain and loss on its assets as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount Realized</th>
<th>Basis</th>
<th>Gain</th>
<th>Character</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$9,000,000</td>
<td>$1,000,000</td>
<td>$8,000,000</td>
<td>Ordinary</td>
</tr>
<tr>
<td>Factory Land</td>
<td>$6,000,000</td>
<td>$5,000,000</td>
<td>$1,000,000</td>
<td>§1231</td>
</tr>
<tr>
<td>Factory Building</td>
<td>$5,000,000</td>
<td>$5,000,000</td>
<td>$0</td>
<td>§1231</td>
</tr>
<tr>
<td>Equipment</td>
<td>$2,000,000</td>
<td>$3,000,000</td>
<td>($1,000,000)</td>
<td>§1231</td>
</tr>
<tr>
<td>Patent</td>
<td>$8,000,000</td>
<td>$4,000,000</td>
<td>$2,000,000</td>
<td>Ordinary</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$1,000,000</td>
<td>$0</td>
<td>$1,000,000</td>
<td>Capital²³⁷</td>
</tr>
</tbody>
</table>

Assuming that C and D have no other relevant capital gains and losses or section 1231 gains or losses and that they both are in the 39.6% marginal tax bracket, the amounts passed through to each shareholder under section 1366 are as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Gain</th>
<th>Character</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$4,000,000</td>
<td>Ordinary</td>
</tr>
<tr>
<td>Factory Land</td>
<td>$500,000</td>
<td>§1231</td>
</tr>
<tr>
<td>Factory Building</td>
<td>$0</td>
<td>§1231</td>
</tr>
<tr>
<td>Equipment</td>
<td>$(500,000)</td>
<td>§1231</td>
</tr>
<tr>
<td>Patent</td>
<td>$1,000,000</td>
<td>Ordinary</td>
</tr>
<tr>
<td>Goodwill</td>
<td>$500,000</td>
<td>Capital</td>
</tr>
</tbody>
</table>

Each shareholder realizes $5.0 million of ordinary gain, triggering $1.98 million of tax liability. Each shareholder also realizes $1.0 million of net section 1231 gain, and $500,000 of capital gain. As in the first example, C and D each increase the basis of the stock of S Corporation by $6.5 million. C's new basis in the stock is $12.5 million, and D's new basis in the stock is $10.5 million. C's section 331 capital gain on the deemed liquidation is $500,000 ($13.0 million amount realized - $12.5 million basis). D's section 331 capital gain on the deemed liquidation is $2.5 million ($13.0 million amount realized - $10.5 million basis). These amounts are combined with $1.0 million of

²³⁷ This assumes that the goodwill was not a section 197 amortizable intangible. If the goodwill were a section 197 amortizable intangible, to the extent of prior depreciation, the gain would be section 1245 ordinary income recapture gain and any gain in excess of section 1245 recapture would be section 1231 gain.
section 1231 gain, and $500,000 of capital gain that was passed through to each of them. C recognizes a total capital gain (including section 1231 gain) of $2.0 million, and has a tax liability on his capital gain of $400,000 ($2.0 million x 20%). D recognizes a total capital gain (including section 1231 gain) of $4.0 million, and has a tax liability on the capital gain of $800,000 ($4.0 million x 20%).

Adding the $1.98 million of tax liability of each shareholder resulting from the passed-through ordinary income, C’s total tax liability is $2.38 million. Subtracting this amount from the $13.0 million cash proceeds from the stock sale leaves C with $10.62 million in cash after taxes. D’s total tax liability is $2.78 million, which leaves D with $10.22 million in cash after taxes. Comparing these results with the after tax cash received by each shareholder absent a section 338(h)(10) reveals that both C and D are better off after taxes by accepting $12.0 million for the stock without a section 338(h)(10) election rather than accepting $13.0 million with the section 338(h)(10) election.

<table>
<thead>
<tr>
<th></th>
<th>Without § 338(h)(10)</th>
<th>With § 338(h)(10)</th>
<th>Without § 338(h)(10)</th>
<th>With § 338(h)(10)</th>
</tr>
</thead>
<tbody>
<tr>
<td>C Gross Cash</td>
<td>$12,000,000</td>
<td>$13,000,000</td>
<td>$12,000,000</td>
<td>$13,000,000</td>
</tr>
<tr>
<td>Total Taxes</td>
<td>$1,200,000</td>
<td>$2,380,000</td>
<td>$1,600,000</td>
<td>$2,780,000</td>
</tr>
<tr>
<td>Net Cash</td>
<td>$10,800,000</td>
<td>$10,620,000</td>
<td>$10,400,000</td>
<td>$10,220,000</td>
</tr>
</tbody>
</table>

Furthermore, in some cases, one shareholder might be better off with a section 338(h)(10) election, while another will be better off by not making the election. This possibility is illustrated by the following example, which admittedly is an unlikely fact pattern.

E and F each own 50 of the 100 outstanding shares of common stock of an S corporation. E’s basis in the stock is $2.0 million; F’s basis in the stock is $3.0 million. The corporation has two assets—an ordinary income asset, with a basis of $3.0 million and a fair market value of $7.0 million, and a capital asset held for more than one year, with a basis of $1.0 million and a fair market value of $1.0 million.238 Acquiring Corporation has offered to purchase the stock of the S corporation either by (1) paying a total of $8.0 million in cash for the stock ($4.0 million each) if E and F agree to make a section 338(h)(10) election, or (2) $7.0 million in cash for the stock ($3.5 million each) if there is no section 338(h)(10) election.

238 The disparity between the aggregate basis of the shares and the aggregate basis of the assets, in the absence of corporate debt in this example, might be explained, in part, by the capital asset having been contributed by E at a time when its fair market value was $1.0 million, thereby resulting in a basis reduction under section 362(e)(2)(C) election.

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Without a section 338 election, E recognizes a long-term capital gain of $1.5 million ($3.5 million - $2.0 million) and incurs a tax liability (at 20%) of $300,000, leaving E with $3.2 million after taxes. F recognizes a long-term capital gain of $500,000 ($3.5 million - $3.0 million) and incurs a tax liability (at 20%) of $100,000, leaving F with $3.4 million after taxes. With a section 338(h)(10) election and a stock purchase price of $4.0 million to each shareholder, each of E and F recognizes passed-through ordinary income of $2.0 million. E's tax liability is $792,000 (at 39.6%) with respect to the $2.0 million of ordinary income. E increases the basis of the stock by $2.0 million to $4.0 million, and recognizes neither a gain nor loss on the deemed liquidation of the S corporation. After taxes, E has $3.208 million ($4.0 million - $792,000), which is more than E would have after taxes by selling for the lesser amount without the section 338 election. F increases the basis of the stock by $2.0 million to $5.0 million and recognizes a $1.0 million long-term capital loss ($4.0 million - $5.0 million) on the deemed liquidation of the S corporation. F's tax liability is $792,000 (at 39.6%) with respect to the $2.0 million of ordinary income, and if F has capital gains against which the capital loss can be offset, F saves at least $200,000 of taxes that otherwise would be due with respect to those capital gains,239 for a net tax liability of $592,000. After taxes, F has $3.408 million ($4.0 million - $592,000), which is more than F would have after taxes by selling for the lesser amount without the section 338 election. But if F does not have any capital gains against which those capital losses can be offset, then after claiming $3,000 of the capital loss against the ordinary income, F has only $3.209 million after taxes,240 which is less than the $3.4 million that F would have after taxes by selling for the lesser amount without the section 338 election. The comparison of the consequences assuming that F cannot absorb the capital losses is shown in the following table.

<table>
<thead>
<tr>
<th></th>
<th>E</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>With</td>
<td>With</td>
</tr>
<tr>
<td></td>
<td>§338(h)(10)</td>
<td>§338(h)(10)</td>
</tr>
<tr>
<td>Gross</td>
<td>$3,500,000</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$3,200,000</td>
<td>$3,208,000</td>
</tr>
<tr>
<td>Total</td>
<td>$300,000</td>
<td>$792,000</td>
</tr>
<tr>
<td>Taxes</td>
<td>$792,000</td>
<td>$792,000</td>
</tr>
<tr>
<td>Net</td>
<td>$3,200,000</td>
<td>$3,208,000</td>
</tr>
</tbody>
</table>

239 F would save even more in taxes if the long-term capital loss offset short-term capital gains.
240 The calculation is as follows: $4.0 million - ($2.0 million - $3,000 x .396) = $3.209 million.
In this case, because the section 338(h)(10) election requires the consent of all of the shareholders, it will not be made unless the shareholder whose position is improved by making a section 338(h)(10) election compensates the other shareholder. In some cases (but not in all cases), the first shareholder cannot economically compensate the other sufficiently to make the election without surrendering all of his benefit because the after-tax cash benefit from the section 338(h)(10) to one shareholder does not sufficiently exceed the detriment to the other shareholder. In such a case, the election likely will not be made.

As a result of application of section 453(h) and 453B(h), shareholders of an S corporation who have sold their stock for section 453 installment notes and made a section 338(h)(10) election may report both their passed-through gain (to the extent it is eligible for installment reporting\(^2\)) and their section 331 gain on the installment method.\(^2\) The computations are daunting.

A section 338(h)(10) election can be available where individuals are the real purchasers in interest if the purchasers form a corporation that makes an S election. The new S corporation makes a qualified stock purchase of stock of target S corporation. Both the target S corporation and the acquiring S corporation make the section 338(h)(10) election. The acquiring S corporation makes a QSub election for the target S corporation. This is treated as a section 332 tax-free liquidation with a post section 338(h)(10) election transferred basis. However, where the purchaser(s) are individuals or a partnership, the same result can be achieved under the recently promulgated section 336(e) regulations discussed in the following section of this Part of this Article.

4. Section 336 Election on Purchase and Sale of S Corporation Stock

Section 336(e), enacted as part of the Tax Reform Act of 1986 in conjunction with the repeal of the General Utilities doctrine,\(^2\) authorizes regulations allowing a corporation that sells, exchanges, or distributes stock in another corporation (target) meeting the requirements of section 1504(a)(2) to elect to treat the disposition as a sale of all of target's underlying assets in lieu of treating it as sale, exchange, or distribution of stock.\(^2\)

A qualified stock disposition for which a section 336(e) election may be made is any transaction or series of transactions in which stock meeting the requirements of section 1504(a)(2) (80% of voting power and value) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation or the shareholders of an S corporation in a disposition (as defined in Regulation section 1.336-1(b)(5)), during the 12 month disposi-

\(^2\)Passed-through gain on inventory and property held for sale in the ordinary course of business and depreciation recapture are not eligible for installment reporting. I.R.C. § 453(b)(2),(i).

\(^2\)See Reg. §§ 1.338(h)(10)-1(d)(8), -1(e), Ex. (10).


\(^2\)See I.R.C. § 336(e); Reg. § 1.336-2(a).
ination period (as defined in Regulation section 1.336-1(b)(7)). A section 336(e) election is available for qualifying dispositions of target stock to noncorporate transferees, as well as to corporate transferees. Furthermore, amounts of stock transferred to different transferees, in different types of transactions are allowed to be aggregated in determining whether there has been a qualified stock disposition. Thus, for example, the sale by each of two equal shareholders of an S corporation of all of their stock to four different purchasers, whether individuals, partnerships, corporations, or trusts, within a 12 month period would constitute a qualified stock disposition.

An election for an S corporation target requires a binding written agreement between the target S corporation and all of the S corporation shareholders, including shareholders who do not sell stock, before the due date of the tax return for the year of the stock disposition and an election statement attached to the return for the year of the disposition. The S corporation must retain a copy of the written agreement.

In general, if a section 336(e) election has been made for a sale of S corporation stock, the treatment of the selling shareholders, the purchasing shareholder(s), and the S corporation itself are similar to their treatment if a section 338(h)(10) election had been made. The sale or exchange of the target S corporation stock is disregarded. Instead, the S corporation is treated as selling all of its assets to an unrelated person in a single transaction at the close of the disposition date for an aggregate deemed asset disposition price (ADADP). Additionally, the deemed sale and purchase of the assets of the S corporation constitutes a deemed sale and purchase of any subsidiary stock owned by it, and a section 336(e) election may, but is not required to, be made for the deemed sale and purchase of the stock of a subsidiary if it constitutes a qualified stock disposition.

The ADADP is the sum of the “grossed-up amount realized” on the sale of the stock plus the amount of the S corporation’s liabilities. In general, the grossed-up amount realized equals (1) (a) the amount realized on the sale or exchange of the stock (determined as if the S corporation shareholders

245 Reg. § 1.336-1(b)(6)(i). Stock transferred to a related party (determined after the transfer) is not considered in determining whether there has been a qualified stock disposition. Reg. § 1.336-1(b)(5)(i)(C).

A transaction that meets the definition of both a qualified stock disposition and a qualified stock purchase under section 338(d)(3) generally will be treated only as a qualified stock purchase and does not qualify for a section 336(e) election. Reg. § 1.336-1(b)(6)(ii).

246 See Reg. § 1.336-1(b)(2).

247 See Reg. § 1.336-1(b)(6)(i).

248 Reg. § 1.336-2(b)(3). A protective section 336(e) election may be made if there is uncertainty whether a transaction constitutes a qualified stock disposition, for example, the disposition date is the first day of the 12 month disposition period that may span two taxable years. A protective election will have no effect if the transaction does not constitute a qualified stock disposition, but it will otherwise be binding and irrevocable. Reg. § 1.336-2(j).


250 Reg. § 1.336-3(b)(1).
were required to use the corporation's accounting methods and the installment method were not available, without regard to the selling costs), (1) (b) divided by the percentage of the stock (by value, determined on the disposition date) sold, (2) minus the selling costs incurred by the shareholders in connection with the sale or exchange of the stock. The ADADP is allocated among the disposition date assets in the same manner as the aggregate deemed sale price (ADSP) is allocated under Regulations sections 1.338-6 and 1.338-7 to determine the amount realized from each of the sold assets. The S corporation recognizes the deemed disposition tax consequences from the deemed asset disposition on the disposition date while it is owned by the selling shareholders.\(^{251}\) The tax consequences of the deemed asset sale pass through to the S corporation shareholders pursuant to section 1366 and they adjust the basis of their stock for resulting gain or loss pursuant to section 1367. The S corporation is then treated as liquidating in a transaction, which at the shareholder level is governed by section 331, in which capital gain or loss is recognized.\(^{252}\)

The S corporation is then treated as having purchased all of its assets from an unrelated party for an amount equal to the adjusted grossed-up basis (AGUB) as determined under Regulation section 1.336-4.\(^{253}\) The S corporation determines its new basis in its asset by allocating the consideration deemed paid in the transaction in the same manner as it would had a section 338(h)(10) election been available and made.\(^{254}\) A section 336(e) election generally does not affect the immediate tax consequences (for example, stock basis) to a purchaser of target stock. If the corporation still qualifies to be an S corporation, a new election is required to maintain S corporation status.\(^{255}\) If a new S election is made, the purchasing shareholders benefit from the reduced gain and increased depreciation deductions that will affect the amount of income or loss passed-through to them due to the resulting increase in the basis of the S corporation's assets. (It is unlikely that the purchasers will agree to a section 336(e) election that would result in a step-down in the basis of the corporation's assets absent unusual circumstances such as the shift of basis from nondepreciable capital assets to ordinary income and depreciable or amortizable assets.)

The analysis of whether an election under the section 336(e) regulations is advantageous from the selling shareholders' perspective follows the same methodology used to determine whether a section 338(h)(10) election is advantageous.

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\(^{252}\) Reg. § 1.336-2(b)(1)(iii).

\(^{253}\) Reg. § 1.336-2(b)(1)(ii).

\(^{254}\) The allocation is pursuant to Regulation sections 1.338-6 and 1.338-7.

\(^{255}\) See Reg. § 1.336-2(b)(1)(ii).

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5. Acquisition of an S Corporation by Another Corporation in a Section 368 Tax-Free Reorganization

a. Generally. An S Corporation can be acquired by either an S corporation or a C corporation in a tax-free reorganization under section 368 in the same manner as a C corporation can be acquired. All of the rules governing corporate reorganizations generally apply when an S corporation is the acquired corporation. If the acquired S corporation survives the reorganization and the acquiring corporation is a C corporation, it ceases to be an S corporation. Since after the acquisition the former S corporation shareholders do not own any stock in the surviving target corporation, the former S corporation shareholders cannot receive tax-free distributions under section 1371(e) during the section 1377(b) post-termination transition period.256

Moreover, if any shareholder has passed-through losses that have been suspended under section 1366(d), those losses are gone forever if the S corporation survives the acquisition, as in a section 368(a)(1)(B) stock-for-stock exchange or a section 368(a)(2)(E) reverse triangular merger. However, the regulations provide that if another corporation acquires the assets of an S corporation in an asset acquisition to which section 381(a) applies, the loss is available to the shareholder as a shareholder of the acquiring corporation.257 Where the acquiring corporation is an S corporation, a suspended loss of a shareholder of the transferor S corporation that is disallowed prior to or during the taxable year of the transaction is treated as incurred by the acquiring S corporation with respect to that shareholder if the shareholder is a shareholder of the acquiring S corporation after the transaction. Where the acquiring corporation is a C corporation, a post-termination transition period arises the day after the last day that an S corporation was in existence. A suspended loss will be allowed to the extent of the adjusted basis of a former S corporation shareholder that is a shareholder of the acquiring C corporation after the reorganization and during the post-termination transition period.258

If the acquiring corporation in an asset-acquisition section 368 reorganization is another S corporation, the accumulated adjustments account of the acquired S corporation will be merged into the accumulated adjustments account of the acquiring corporation after the reorganization.259

If in a section 368 reorganization a shareholder receives boot—cash or property (including debt securities) other than stock of the acquiring corporation (or the acquiring corporation's parent in the case of triangular reorganizations)—the shareholder must recognize any realized gain under section 356, but only to the extent of the amount of cash or the fair market value of the other property received. Section 356(a)(2) treats recognized gain on the

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256 For the definition of the post-termination transition period, see supra note 149.
257 Reg. § 1.1366-2(c)(1).
258 Reg. § 1.1366-2(c)(1); see also Reg. § 1.1366-2(b).
259 Reg. § 1368-2(d)(2).
distribution of boot as a dividend if the exchange "has the effect of the distribution of a dividend."\textsuperscript{260}

It is generally advantageous in the case of an acquisition of an S corporation for boot to be treated as a dividend under section 356(a)(2). If the distribution has the "effect of a dividend" under section 356(a)(2), the boot is treated under section 1368 as return of capital to be applied against the stock basis to the extent of an available accumulated adjustments account, even if earnings and profits are present.\textsuperscript{261} To extent the boot as gain exceeds the available accumulated adjustments account, the boot is a dividend to the extent of available earnings and profits.\textsuperscript{262}

In the C corporation context, it is the Service's position, at least in the case of section 368(a)(1)(D) reorganizations involving identical shareholdings of the two corporations, that "the combined earnings and profits of" both corporations are taken into account to support dividend treatment under section 356(a)(2).\textsuperscript{263} The Fifth Circuit has followed the Service's approach,\textsuperscript{264} but the Tax Court and Third Circuit have held that dividend status is measured by the earnings and profits of the target corporation.\textsuperscript{265} There are no other precedential authorities directly on point, but in one of the common-shareholdings section 368(a)(1)(D) reorganization cases, the Tax Court reasoned that "[t]he legislative history of the section leads to the conclusion that Congress was concerned with a bailout of the earnings and profits of the transferor corporation, and Congress did not seem to consider that there could be, under certain circumstances, a bailout of those of the transferee as well."\textsuperscript{266}

Some leading commentators take the position, without citing authority, that only target corporations' earnings and profits are available to support section 356(a)(2) dividend treatment of boot in any reorganization.\textsuperscript{267} The Service, however, appears to continue to believe that the logic of \textit{Commissioner v. Clark}\textsuperscript{268} requires looking to the earnings and profits of both corporations.\textsuperscript{269}

\textsuperscript{260}In \textit{Commissioner v. Clark}, 489 U.S. 726 (1989), the Supreme Court held that dividend equivalency under section 356(a)(2) is to be tested by treating the boot as received as a redemption of the stock of the surviving corporation after the reorganization. \textit{Id.} at 743-45. Under this approach redemption status is tested by applying the test of section 302(b) to the reduction in ownership of the acquiring corporation represented by the hypothetical issue and redemption of shares represented by the boot.

\textsuperscript{261}See F.S.A. 1994-1866052 (Dec. 15, 1994) (applying the accumulated adjustments accounts of both corporations in an all-cash section 368(a)(1)(D) reorganization involving two S corporations wholly owned by the same shareholder).


\textsuperscript{264}Davant v. Commissioner, 366 F.2d 874, 887-88 (5th Cir. 1966).


\textsuperscript{267}\textit{MARTIN D. GINSBURG ET AL., MERGERS, ACQUISITIONS, AND BUYOUTS} \textit{§} 801.4.3 (Aug. 2012).

\textsuperscript{268}Commissioner v. Clark, 489 U.S. 726 (1989).

The conflicting views on available earnings and profits might apply as well to determining the available accumulated adjustments account in a reorganization involving two S corporations. The Regulations provide that in an asset-acquisition reorganization the acquiring corporation succeeds to the transferor's accumulated adjustments account "as of the close of . . . transfer[,]" and "the [accumulated adjustments account] of the acquiring corporation after the transaction is the sum of the [accumulated adjustments accounts] of the corporations prior to the transaction."\(^{270}\) In a 1994 Field Service Advisory, the Office of Chief Counsel opined that in the case of section 368(a)(1)(D) reorganization involving identical shareholdings of the two corporations, the combined accumulated adjustment accounts of both corporations were available to support section 1368(c)(1) return of basis treatment for boot subject to section 356(a)(2).\(^{271}\) However, rather than resting its reasoning principally on the provision in the Regulations dealing with the post-reorganization consolidation of accumulated adjustment accounts, the Field Service Advisory reasoned that consolidation of accumulated adjustments accounts for purposes of the application of sections 356(a)(2) and 1368(c)(1) should be based on the same principles as the determination of the available earnings and profits to support dividend treatment under section 356(a)(2) and stands by the Service's position that the earnings and profits of both corporations properly are taken into account.

To say the least, there is bit of confusion in this area as to how to determine both the available earnings and profits and the available accumulated adjustments account. If the Service's "consistent method" view were to be adopted, the taxpayer-advantageous rule that "only the target's earnings and profits" support dividend treatment would work to the taxpayer's disadvantage with respect to the determination of the available accumulated adjustments account available to support return of basis treatment because only the transferor's accumulated adjustments account would be available (except possibly in cases of 368(a)(1)(D) reorganization involving identical shareholdings of the two corporations). One might hope for an asymmetrical rule in which only the target corporation's earnings and profits support dividend treatment but both corporation's accumulated adjustment accounts support return of basis treatment, but that might be asking for too much. There is a parallel structure to the rules governing the succession of the acquiring corporation to the target's accumulated adjustments account and the target's earnings and profits. Under the Regulations, the acquirer succeeds to the target's accumulated adjustment account "as of the close of the date of . . . [the] transfer,"\(^{272}\) and under section 381(c)(2) the target's earnings and profits are "deemed to have been received or incurred by the acquiring corporation as of the close of the date of the . . . transfer."

\(^{270}\) Reg. § 1.1368-2(c) (emphasis added).
\(^{272}\) Reg. § 1.1368-2(d)(2).
b. **All-Cash (D) Reorganization.** When a corporation sells all of its assets to another corporation with identical ownership and the seller liquidates, the Regulations under section 368 provide a surprising result. Rather than the transaction being treated as an asset sale and purchase followed by a liquidation, the transaction is treated as a section 368(a)(1)(D) reorganization.\(^{273}\) This rule applies to S corporations as well as to C corporations. As a result of treating the transaction as a section 368(a)(1)(D) reorganization, the selling corporation recognizes no gain or loss on the sale of the assets,\(^{274}\) and the purchasing corporation takes a transferred basis in each of the acquired assets with no adjustments.\(^{275}\) Because the selling S corporation recognizes neither gain nor loss, no gain or loss is passed through to the shareholders under section 1366 and there is no basis adjustment under section 1367 before determining the amount of gain recognized to the shareholders of the selling corporation with respect to their stock of the selling or liquidated S corporation.

The transferee corporation is deemed to have issued stock to the transferor corporation in addition to other cash, and the deeded stock and the cash are treated as being distributed to the shareholders,\(^{276}\) thus invoking section 356. To the extent that the cash received exceeds a shareholder's basis in the stock of the liquidated corporation, the shareholder must recognize gain.\(^{277}\) No loss may be recognized.\(^{278}\) If the shareholder's basis in the acquired S corporation exceeds the amount of cash received, the cash is a tax-free return of capital and the excess basis should be added to the shareholder's basis in the stock of the acquiring corporation, regardless of whether the acquiring corporation is another S corporation or a C corporation.\(^{279}\)

For purposes of determining identity of ownership, an individual and all members of the individual's family, as described in section 318(a)(2)(C), will be treated as one individual. In addition, the attribution-from-entity-rules of section 318(a)(2) are applied without regard to the 50% ownership limitation for attribution from corporations.\(^{280}\) Complete identity of ownership is not

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\(^{273} \text{Reg. § 1.368-2(j). A D reorganization is described as a transfer of assets by one corporation to another if after the transfer the transferor or one or more of its shareholders is in control of the corporation to which the assets are transferred and stock of the acquiring corporation is transferred to the shareholders of the transferor in a distribution to which section 354 or section 355 (or section 356) applies. I.R.C. § 368(a)(1)(D). Control for this purpose is determined under the 50% of vote or value test of section 304(c). § 368(a)(2)(H)(i). In a non-divisive D reorganization (one not subject to section 355), the transferor must transfer substantially all of its assets to the acquiring corporation. I.R.C. §§ 354(b)(1)(A), 368(a)(1)(D).}

\(^{274} \text{I.R.C. § 361(b).}

\(^{275} \text{See I.R.C. § 362(b).}

\(^{276} \text{Reg. § 1.368-2(l)(2)(i).}

\(^{277} \text{The results are more complex if the acquired S corporation has earnings and profits. See supra text accompanying notes 260-271.}

\(^{278} \text{I.R.C. § 356(c).}

\(^{279} \text{See I.R.C. § 358(a)(1); Temp. Reg. § 1.358-2T.}

\(^{280} \text{Reg. § 1.368-2(l)(2)(ii).}
required. The regulations disregard a *de minimis* variation in ownership. The regulations illustrate a *de minimis* variation with a situation in which A, B, and C each own, respectively, 34%, 33%, and 33% of the transferor's stock and A, B, C, and D each own, respectively, 33%, 33%, 33%, and one percent of the transferee's stock.281

6. *Divisive Reorganization of an S Corporation*

Provided that all of the other requirements of section 355 have been met, an S corporation can be divided into two (or more corporations) through a section 368(a)(1)(D) reorganization followed by a distribution of stock of the newly formed controlled corporation to the S corporation's shareholders. If section 355 applies, neither the distributing corporation nor the shareholders recognize any gain,282 and the shareholders of the distributing corporation apportion their basis in the distributing corporation between the stock of the distributing and distributed corporation under section 358.283 If section 355 does not apply to the distribution of the stock of a subsidiary, the distributing corporation recognizes gain with respect to the distributed stock pursuant to section 311(b) which passes through to the shareholders under section 1368.284 In this case, sections 301 and 1368 control the distribution at the shareholder level and the tax consequences are determined under the principles discussed in Part VI.D. If the shareholders' basis in the stock of the distributing corporation (determined at the end of the year after taking into account all passed-through gain, including the section 311(b) gain resulting from the distribution) exceeds the fair market value of the stock received (and if the distributing S corporation has a C corporation history, it has a sufficient accumulated adjustments account), the shareholders recognize no further income, but they reduce their basis in the stock of the distributing corporation *pro tanto*.285

The distributed corporation can make an immediate S election. Since it has been distributed to the shareholders of an existing S corporation, the initial post-distribution shareholders of the distributed corporation are eligible shareholders. The distributing corporation's momentary ownership of the controlled corporation in connection with the section 368(a)(1)(D) reorganization will not cause the controlled corporation to have an ineligible shareholder under section 1361(b)(1)(B).286

282 I.R.C. § 355(a) (shareholders); I.R.C. §§ 355(c), 361(c) (distributing corporation).
283 See I.R.C. § 358(b)(2); Reg. §§ 1.358-1(a), -2(a)(2). The details depend on whether the distribution was on stock or in exchange for stock of the distributing corporation.
284 McLaulin v. Commissioner, 115 T.C. 255, 265-69 (2000), aff'd 276 F.3d 1279 (11th Cir. 2001) (spin-off did not qualify under section 355 because it failed to satisfy the requirements of section 355(b)(2)(D), and section 311(b) gain passed through to shareholders under section 1368).
285 See § 358(a)-(b).
If prior to a corporate separation under section 355 an S corporation transfers an active trade or business to the distributed corporation in a section 368(a)(1)(D) reorganization and any shareholder of the distributing S corporation has a loss that has been suspended under section 1366(d), that loss will be allocated between the distributing corporation and the controlled corporation.\(^{287}\)

If prior to section 355 distribution an S corporation with an accumulated adjustments account transfers an active trade or business to the corporation to be distributed (the controlled corporation) in a section 368(a)(1)(D) reorganization, the accumulated adjustments account of the distributing corporation must be allocated between the distributing corporation and the controlled corporation.\(^{288}\) The apportionment is done in a manner similar to the manner in which the earnings and profits of the distributing corporation are allocated under section 312(h). Generally, in such a case the earnings and profits, and thus the accumulated adjustments account, are allocated in proportion to the fair market value of the assets of the distributing corporation and the controlled corporation.\(^{289}\)

Section 355 also can apply to a distribution of a C corporation subsidiary of an S corporation if the conditions for qualifying under section 355 have been met, but section 355 cannot apply to the distribution of the stock of a QSub. Because a QSub is a disregarded entity, the distribution of the stock of a QSub is either a distribution subject at the shareholder level to section 1368, or, if the qualifying conditions have been met, section 302, with the proper gain recognition and basis consequences attendant to the application of those sections. In either case, the distributing S corporation must recognize gain with respect to the assets of the QSub under section 311(a), but is barred by section 311(b) from recognizing loss.

B. Acquisitions by S Corporations

An S corporation can acquire another corporation, regardless of whether the target corporation is a C corporation, or an S corporation either by cash purchase or in a section 368 tax-free reorganization. (The acquisition of a QSub is not the acquisition of corporate stock either by purchase or by reorganization; because a QSub is a disregarded entity, the acquisition of the stock of a QSub from another S corporation is a purchase, whether for cash or the acquiring S corporation’s stock, of some of the assets of the selling S corp-

\(^{287}\)Reg. § 1.1366-2(c). The Regulation provides that “[s]uch allocation shall be made according to any reasonable method, including a method based on the relative fair market value of the shareholder’s stock in the distributing and controlled corporations immediately after the distribution, a method based on the relative adjusted basis of the assets in the distributing and controlled corporations immediately after the distribution, or, in the case of losses and deductions clearly attributable to either the distributing or controlled corporation, any method that allocates such losses and deductions accordingly.”

\(^{288}\)Reg. § 1.1368-2(d)(3).

\(^{289}\)Reg. § 1.312-10(a).
poration.) Acquiring stock of another corporation in a section 368 tax-free reorganization is viable only if acquiring S corporation stock can be issued exclusively to qualified shareholders, as defined in section 1361, and that stock is sufficient to meet either the statutory continuity of interest requirements or the regulatory requirements, whichever applies.

An S corporation acquirer can utilize any form of section 368 reorganization, including forms in which the target corporation becomes a subsidiary of the S corporation and triangular reorganizations in which a C corporation subsidiary of the S corporation is involved. The requirements with respect to the use of voting stock in certain forms of reorganizations apply with equal force to acquisitions by S corporations intended to qualify under section 368(a)(1)(B), section 368(a)(1)(C), or section 368(a)(2)(E). However, an S corporation has less flexibility than does a C corporation in determining the stock consideration used in the reorganization. Under section 1361(b)(1)(D), an S corporation is allowed to have only one class of stock, although section 1361(c)(4) allows differences in voting rights without violating the one-class-of-stock rule so long as the outstanding shares are identical with respect to the rights of the holders in the profits and in the assets of the corporation. In contrast, a C corporation can use preferred stock to affect any type of reorganization, although to qualify as a section 368(a)(1)(B) stock-for-stock reorganization the only permissible consideration is voting stock; to qualify as a section 368(a)(1)(C) stock-for-assets reorganization, as a practical matter in most cases, the only consideration allowed is voting stock, and to qualify under section 368(a)(2) as a section 368(a)(2)(E) reverse triangular merger, the shareholders owning each class of stock of the target must receive voting stock of the acquiring corporation equal to 80% of the value of the class of stock of the target that was surrendered.

If the “subsidiary” of the acquiring S corporation in a triangular reorganization is a QSub, because the QSub is a disregarded entity, the purported triangular reorganization is for purposes of tax law a merger into, or an acquisition by, the S corporation parent.290 If an S corporation has a controlled C corporation subsidiary that in turn owns a disregarded LLC, a merger of a target into the LLC in which the target shareholders receive stock of the S corporation is a section 368(a)(2)(D) forward triangular merger into the C corporation subsidiary.291

If an S corporation acquires another S corporation in a tax-free asset acquisition section 368 reorganization (or by liquidating an S corporation the stock of which it acquired in a liquidation to which section 332 applies), and the target S corporation had an accumulated adjustments account, the acquiring S corporation succeeds to the target S corporation's accumulated adjustments account.292 The combined accumulated adjustments account is not bifur-

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290 See Reg. § 1.368-2(b)(1)(iii), Ex. (2).
291 See Reg. § 1.368-2(b)(1)(iii), Ex. (4).
292 See Reg. § 1.1368-2(d)(2).
cated into subaccounts for the respective pre-reorganization shareholders of the target and the acquiring corporation. The original shareholders of one of the corporations can benefit from the augmented accumulated adjustments account of the surviving corporation that originally was attributable to the other corporation.

If an S corporation acquires all of the stock of another corporation, it may make a QSub election with respect to the newly acquired subsidiary regardless of whether the subsidiary previously was a QSub of another S corporation, a subchapter S corporation itself, or a subchapter C corporation.\footnote{See H.R. REP. No. 104-586, pt. 2, at 88-89 (1996).} As a result of the election, the subsidiary is “deemed to have liquidated under sections 332 and 337 immediately before the election is effective.”\footnote{See id. at 89.} If the subsidiary previously was a C corporation, section 1363(d) LIFO recapture will apply, and the section 1374 built-in gains tax will apply to sales of the target’s assets within ten years. If the “stock of the subsidiary was acquired by the S corporation in a qualified stock purchase,” a section 338 election may be made with respect to the subsidiary.\footnote{Reg. § 1.1361-4(b)(4).}

If both a section 338 election and a QSub election are made, then the QSub election is not effective until after the consequences of the section 338 election are taken into account. The subsidiary must file a final return for the section 338 election as a C corporation.\footnote{Reg. § 1.1361-5(b)(3), Ex. (9).}

\section*{C. Acquisition of a QSub}

\subsection*{1. Former QSub Becomes a C Corporation}

If a QSub is acquired, the original QSub election is terminated on the date of the acquisition, regardless of the identity of the acquirer.\footnote{See I.R.C. § 1361(b)(3)(C)(ii); Reg. §§ 1.1361-5(a)(1)(iii), -5(a)(4), Ex. (2).} It does not matter whether the acquisition is by purchase or via a section 368 reorganization.\footnote{See Rev. Rul. 2004-85, 2004-2 C.B. 189 (a QSub election is terminated if the parent 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).”).} The transaction is treated as follows: Assume that X Corporation owns 100\% of the stock of QSub Y Corporation, and Z Corporation, which is an unrelated C corporation, acquires all of the stock of Y Corporation. The transaction is treated as the sale by X Corporation to Z Corporation of all of Y Corporation’s assets, followed by the transfer of those assets by Z Corporation to a newly formed Y Corporation in exchange for Y Corporation stock in a transaction governed by section 351.\footnote{Reg. § 1.1361-5(b)(3), Ex. (9).}

If the assets constitute a trade or business, the sale of assets is a qualified asset acquisition under section 1060, and the stock purchase price is allocated

\begin{footnotes}
\item See id. at 89.
\item See id.
\item Reg. § 1.1361-4(b)(4).
\item See Rev. Rul. 2004-85, 2004-2 C.B. 189 (a QSub election is terminated if the parent 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).”).
\item Reg. § 1.1361-5(b)(3), Ex. (9).
\end{footnotes}
among the assets under the rules of section 1060. The basis of Y Corporation's assets also is determined by applying the rules of section 1060 to the hypothetical purchase by Z Corporation of the Y Corporation assets, which take a section 1012 cost basis, and then applying the transferred basis rule of section 362(a) to the hypothetical contribution of those assets to Y Corporation by Z Corporation. In general, the result is that Y Corporation's assets now have a fair market value basis. Z Corporation takes a section 358 exchanged basis, determined with respect to its basis in the assets, which in this case equals purchase price, in the Y Corporation stock.

The same results follow if the purchaser of the stock is a partnership, an individual, or a group of individuals. If less than all of the stock of a QSub is sold, the sale results in termination of the QSub election, and the transaction is then treated as a pro rata sale of the QSub's assets by the selling S corporation followed by the contribution by the selling S corporation and the purchaser of all of the QSub's assets to a newly formed C corporation in a transaction governed by section 351.

Legislative history indicates that section 351 will apply to the deemed contribution regardless of the percentage of stock of the subsidiary held by the subchapter S corporation that is the former QSub owner, that is, meeting the 80% control requirement of section 351 is not required. For example, if a subchapter S corporation sells 21% of the stock of a QSub, "the S corporation will be treated as selling" 21% of the subsidiary's assets, and then contributing "the assets to a new corporation in a transaction to which section 351 applies." 304

2. S Corporation Election Made by Former QSub

If all of the acquirers of stock of a QSub are eligible to be shareholders of an S corporation, an immediately effective S election can be made notwithstanding the provisions of section 1361(b)(3)(D), as long as there was no intervening day on which the corporation was a C corporation. In the example above, if the purchasers were U.S. citizen individuals A and B, not Z Corporation, an immediately effective S election can be made. The tax consequences of the sale and purchase, as well as the basis consequences for both the shareholder's stock and the target corporation's assets are the same as they would have been had there been no S election.

If an S corporation distributes the stock of a QSub to its shareholders in a section 355 transaction, the QSub election terminates and the former QSub is treated as new corporation that acquired all of its assets from its S corporation parent in a section 351 transaction. The distributed corporation can make an S corporation election that will be effective on the first day of its first

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301 See id. at 27.
302 See Reg. § 1.1361-5(c)(2).
When Subchapter S Meets Subchapter C

When a corporation files an S election within the two-month-and-15-day period following its incorporation, the date the former Q sub is regarded as a new corporation.304

3. Acquiring S Corporation Makes a New QSub Election

If the purchaser of all of the QSub stock is an S corporation, Z Corporation in the above referenced example, the new parent may make an immediately effective QSub election with respect to the newly acquired subsidiary.305 The transaction is treated as a sale of the QSub assets to the acquiring corporation. Unlike in the example immediately above, there is no hypothetical transfer of the assets by Z Corporation to Y Corporation in exchange for Y stock.

The basis of Y Corporation's assets would be determined simply by applying the rules of section 1060 to the hypothetical purchase by Z Corporation of the Y Corporation assets, which take a section 1012 cost basis. In this case, Z Corporation has no basis in the Y Corporation stock, which for income tax purposes does not exist.

D. Mergers of LLCs and S Corporations

1. Merger of an S Corporation into an LLC

The merger of an S corporation into an LLC (taxed as a partnership) under a state law statute permitting such a merger is not a tax-free reorganization under section 368.306 It will be a taxable event even if LLC units are the only consideration received in the merger. By analogy to the treatment of taxable corporate mergers,307 the merger should be treated as a transfer by the S corporation of its assets to the LLC in exchange for LLC units. While that aspect of the transaction generally is a tax-free transaction under section 721, which provides nonrecognition for the transfer of property to a partnership in exchange for a partnership interest, it automatically is followed by a taxable liquidation of the S corporation in which the LLC units (partnership interests) are distributed to the former S corporation shareholders.308

Pursuant to section 336, the S corporation recognizes gain or loss on the distribution of the LLC units in redemption of all of its stock in the same manner as if it had sold the LLC units. Thus, the gain or loss is not determined asset-by-asset. Rather, the character of the gain should be determined

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305 Reg. § 1.1361-5(c)(2).
306 See Reg. § 1.368-2(b)(1)(iii), Ex. (5).
308 Cf. id. For other possible approaches, all of which involve a taxable liquidation of the corporation, see John B. Truskowski, Cross Species Conversions and Mergers, 65 Tax Law. 591, 608-15 (2012).
under sections 741 and 751(a), which control the character of gain recognized on the taxable transfer of a partnership interest.\textsuperscript{309}

As a general rule, section 741 treats a partnership interest as a capital asset. However, section 751(a) carves out ordinary income treatment for the portion of the partnership's "unrealized receivables" and inventory. The transferor partner's, and thus the LLC's, gain or loss is determined as if the partnership had sold the unrealized receivables and inventory and distributed to the partner its distributive share of the ordinary income.\textsuperscript{310} This determination is made with respect to all of the surviving LLC's assets and net merely with reference to the assets transferred by the S corporation to the LLC in the merger. Section 741 continues to control the character of the gain or loss recognized with respect to the portion of the partner's basis and the amount realized on the sale of the partnership interest that are not allocable to unrealized receivables and inventory.\textsuperscript{311}

Unrealized receivables are broadly defined in section 751(c) to include any rights to payment for goods delivered or to be delivered or for services rendered or to be rendered, to the extent not previously includible in income.\textsuperscript{312} Furthermore, as defined in section 751(c), "unrealized receivables" also include gain that would have been treated as ordinary income under the various recapture rules, for example, section 1245(a) recapture on the sale of an asset by the partnership.\textsuperscript{313}

When a partnership holds depreciable real property, section 1(h)(6)(A) requires that a portion of the amount of long-term capital gain recognized on the sale of an interest in the partnership be characterized as "unrecaptured § 1250 gain," subject to tax at the 25 percent maximum, rather than at lower preferential capital gains rates. The amount of the gain that would have been ordinary income under section 751(a) if the partnership's unrecaptured sec-


\textsuperscript{310} Reg. § 1.751-1(a)(2).

\textsuperscript{311} This bifurcated approach may create ordinary income and a related capital loss, even in instances where a partnership interest is sold at no gain or an overall net loss. See Reg. § 1.751-1(g), Ex. (1).

\textsuperscript{312} As result of the broad definition ascribed to "unrealized receivable" in case law, section 751(a) can be applied to virtually any partnership holding valuable contracts to provide personal services. See, e.g., Ledoux v. Commissioner, 77 T.C. 293 (1981), \textit{aff'd per curiam}, 695 F.2d 1320 (11th Cir. 1983) (holding that the term "unrealized receivables" includes any contractual or other right to payment for goods delivered or to be delivered or services rendered or to be rendered); Logan v. Commissioner, 51 T.C. 482 (1968) (holding that unbilled fees for work in progress constituted unrealized receivables).

\textsuperscript{313} For purposes of section 751, the amount of potential recapture income is treated as an unrealized receivable with a basis of zero. Reg. §§ 1.751-1(c)(4), -1(c)(5). Inclusion of recapture income in the definition of unrealized receivables is significant because it results in the potential applicability of section 751(a) to every taxable transfer of partnership interest in a partnership holding depreciable property, such as machinery, equipment, and amortizable section 197 intangible assets, even though the partnership uses the accrual method of reporting and thus has no unrealized accounts receivable. See I.R.C. § 197(f)(7).
WHEN SUBCHAPTER S MEETS SUBCHAPTER C

All of the gain or loss recognized with respect to the distribution of the LLC units is passed through to the S corporation shareholders under section 1336, with a basis adjustment to their stock as required by section 1367. The S corporation shareholders then recognize gain and loss on the liquidation distribution under section 331. The amount realized by each shareholder will be the sum of (1) the value of the LLC units received and (2) any other property received by the shareholder. The former S corporation shareholders take a basis in the LLC units (as well as any other property received) received equal to the fair market value.

2. Merger of an LLC into an S Corporation

a. Former LLC Members Do Not "Control" the S Corporation After the Merger so Section 351 Does Not Apply. The merger of an LLC (taxed as a partnership) into an S corporation under a state law statute permitting such a merger will be a taxable event unless after the merger the former members of the LLC "control" the S corporation within the meaning of section 368(c), that is, they hold 80% of the voting power and 80% of the nonvoting stock of the S corporation.

If after the merger the former members of the LLC do not control the S corporation within the meaning of section 368(c), the transaction will be treated as an asset sale and purchase with the LLC as the seller and the S corporation as the purchaser. However, pursuant to section 1032, the S corporation recognizes no gain. By analogy to the treatment of a "formless" merger of partnerships under Regulation section 1.708-1(c)(3), the merger should be treated as an "assets over" transaction. The LLC is treated as transferring its assets to the S corporation in exchange for stock and then liquidating.

The amount realized by the LLC will be the sum of the (1) fair market value of the S corporation stock, (2) the cash, and (3) other property (most likely debt instruments) received by the LLC members. The LLC's gain or loss, which will be passed through to its members under the rules of subchapter K, will be determined asset-by-asset pursuant to section 1060.

The consequences of the LLC being treated as liquidating are determined under the rules of subchapter K. In general, pursuant to section 731, neither the LLC nor any of its members will recognize gain or loss on the liquida-

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314 See Reg. § 1.1(h)-1(b)(3).
315 See supra Part VI.A.
316 I.R.C. § 334(a).
317 That the merger of an LLC into an S corporation will be treated as an "assets-over" transaction is based on the rules of Regulation section 1.708-1(c)(3), dealing with mergers between partnerships, under which the merger is treated as an assets-over transaction unless the merged partnership actually distributes its assets to its partners who then contribute the assets to the surviving partnership. Under the Regulation, a "formless" merger is always treated as an assets-over merger.
tion, although an LLC member who receives cash in excess of the basis of the member's LLC units will recognize gain. As long as there is no consideration other than stock and cash, the former LLC members will take a basis in the S corporation stock received in the merger equal to their basis in the LLC units, less any cash received.\(^{318}\)

The S Corporation's aggregate basis in the assets will be a section 1012 cost basis equal to the sum of the (1) fair market value of the stock issued in the merger,\(^{319}\) (2) any cash paid, and (3) the fair market value of any other property (most likely debt instruments) paid to the LLC members. That basis is assigned to the individual assets pursuant to the rules of section 1060 and Regulation section 1.338-6. Generally speaking, all of the assets take a basis equal to their fair market values.

b. *Former LLC Members “Control” the S Corporation After the Merger.* If, after the merger, the members of the LLC control the S corporation, the merger is a section 351 transaction, and, assuming that the former LLC members do not receive boot, the members of the LLC generally will not recognize any gain or loss, except as might be required under subchapter K (which is beyond the scope of this Article).\(^{320}\)

If the debts of the LLC exceed the basis of its assets, the LLC will recognize gain in the amount of such excess under section 357(c).\(^{321}\) That gain will be passed through to the LLC members under the rules of subchapter K, and their bases in their LLC units will be increased before their basis of S corporation stock received in the merger is determined. The LLC also generally will recognize gain under section 351(b) if its members receive any consideration other than stock of the S corporation. The S corporation will take a transferred basis in the LLC's assets pursuant to section 362. The basis is determined separately for each asset,\(^{322}\) without any adjustment for the LLC's liabilities that have been assumed. But if the LLC recognizes gain under either section 357(c), because the debts of the LLC exceeded the basis of its assets, or section 351(b), because its members received consideration other than stock of the S corporation, the S corporation's basis in the assets received in the merger will be increased by the amount of such gain.\(^{323}\)

The LLC will take an exchanged basis in the stock received,\(^{324}\) which is largely irrelevant, because upon the liquidation of the LLC, the LLC mem-

\(^{318}\) See I.R.C. § 732.
\(^{319}\) See Reg. § 1.1032-1(d); Rev. Rul. 56-100, 1956-1 C.B. 624.
\(^{321}\) See supra Part III.B. Debts that will be deductible only when paid, e.g., cash method accounts receivable or accrual method liabilities the deduction for which is deferred under section 461(h), see Rev. Rul. 95-74, 1995-2 C.B. 36, are not taken into account for this purpose. I.R.C. § 357(c)(3).
\(^{322}\) See Gunn v. Commissioner, 25 T.C. 424, 438-39 (1955), aff'd per curiam, 244 F.2d 408 (10th Cir. 1957); PA. Birren & Son v. Commissioner, 116 F.2d 718, 720 (7th Cir. 1940).
\(^{323}\) I.R.C. § 362(a).
\(^{324}\) I.R.C. § 358(a).
bers' bases in the stock received will be an exchanged basis under section 732, determined with respect to their bases in their LLC interests.\textsuperscript{325}

**IX. Conclusion**

While both S corporations and partnerships are pass-through entities, their similarities extend only that far. As a corporation, an S corporation is subject to rules of subchapter C, but is not subject to any of the rules of subchapter K. Therefore, the widely held belief that the taxation of S corporations resembles that of partnerships is incorrect and inaccurate. Failure to understand the vast extent of the differences between the taxation of S corporations and the taxation of partnerships can lead to disastrous results. Furthermore, as this Article demonstrates, any practitioner advising S corporations and their shareholders must be thoroughly familiar with all of the rules of subchapter C competently to deal with any transactional issues. There are many surprises when subchapter S meets subchapter C. Some are pleasant to meet, but others are not pleasant to meet at all.

\textsuperscript{325}Under the technical rules of section 732, the LLC's basis in the stock could be relevant in determining the LLC member's basis in the stock if one or more LLC member's basis in the LLC interest is less than the LLC's basis in the stock distributed to that LLC member.