# Effective Strategies for the Sale of a Business Owned by an S Corporation

## 51st Annual Notre Dame Tax & Estate Planning Institute

**November 7, 2025**

*C. Wells Hall III*
*Nelson Mullins Riley & Scarborough LLP*
*Charlotte, NC*

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**C. Wells Hall, III** is a partner in Nelson Mullins Riley & Scarborough's Charlotte office where he advises clients on the federal, state, and multi-state tax aspects of mergers, acquisitions, reorganizations, structuring of business entities, private equity transactions, pass-through entities, estate investment trusts (REITs), and estate and gift tax planning in connection with such transactions. He represents taxpayers before the Internal Revenue Service and Tax Commissions of various states in individual and corporate tax audits and appeals.

Wells participated in the preparation of comments by the ABA Section of Taxation on the proposed Treasury Regulations under Section 1411 of the Internal Revenue Code (net investment income tax), and proposed Treasury Regulations under Section 199A (the 20% deduction for qualified business income). He is one of the original drafters of the North Carolina S Corporation Income Tax Act, and the Model S Corporation Income Tax Act endorsed by the American Bar Association and the Multi-State Tax Commission. He was a member of the drafting committee for the original enactment and subsequent revision of the North Carolina Limited Liability Company Act.

Wells is a past Chair of the ABA Section of Taxation (2022-2023), former Vice Chair - Pro Bono and Outreach, a former Member of Council, and former Chair of the S Corporation Committee of the Section. He is a former Chair of the North Carolina Bar Association Section of Taxation. Wells is a past President of the American College of Tax Counsel, a Trustee of the American Tax Policy Institute, and a former Regent and North Carolina State Chair of the American College of Trust & Estate Counsel.

Wells is a frequent speaker at the NYU Institute on Federal Taxation and the NYU Summer Institute on Wealth Taxation, the Southern Federal Tax Institute, the UNC J. Nelson Young Tax Institute, the Tulane Tax Institute, the Virginia Tax Institute, and other national and regional tax programs. He is a frequent contributor to numerous tax periodicals.

Wells has been recognized professionally by the North Carolina Business Journal Legal Elite; The Best Lawyers in America: Tax Law, Trusts and Estates; North Carolina Super Lawyers: Tax; and Chambers USA: America's Leading Lawyers for Business, Tax (Band 1). In 2023, the North Carolina Bar Association Tax Law Section recognized Wells with its first Lifetime Achievement and Service Award.

Wells received his B.S. from North Carolina State University and his J.D. from Duke University School of Law.

Wells acknowledges with appreciation the contributions of Jerald D. August of August Tax Law, Blue Bell, Pennsylvania for his contributions to the preparation of this outline, previous versions of which have been published in connection with the proceedings of the NYU Institute on Federal Taxation, NYU School of Professional Studies.

## I. INTRODUCTION

### 1.01. *When a Business Operated as an S Corporation is an Acquisition Target*

Planning for the acquisition or disposition of stock or assets of a closely held business, which in general, may be operated as an S corporation or a limited liability company (LLC) taxable as a partnership, may involve both nontaxable and taxable asset and equity ownership rights in such S corporations and LLCs. The tax identity and residence of the acquiring entity or group will also have a direct bearing on the overall set of factors to consider and evaluate. Many of the same rules which govern acquisitions of S corporations will substantially intersect with regular or C corporations which are target companies.

When an S corporation is the target, particularly in a stock acquisition, legal counsel for both the acquirer as well as the target S corporation will want to separately determine if the purported S corporation status of the target is correct. There is no statute of limitations affirmative defense that may be successfully raised against the Commissioner for the failure of a corporation to maintain its Subchapter S status. Due diligence performed by seller's counsel includes consideration of the validity of the election for the most recent set of consecutive years in which the corporation filed an S corporation return as well as whether there is a risk that an unintended termination of Subchapter S status had occurred. As part of this review the eligibility rules governing Subchapter S and its shareholders must be inspected. This includes the corporate and shareholder level disqualification issues, including the one class of stock limitation. It may necessitate the review of shareholders' estate plans which tax counsel might not otherwise be privy. The acquisition itself, or steps leading to close of the transaction may involve the use of another corporation or entity and/or involve the termination of the target corporation's S election. The timing of the date of termination of Subchapter S status will be critically important in order to ensure that the allocation of income or loss in the acquisition year is properly allocated to the party agreed to be responsible for the payment of federal and state income tax for such period. The termination of S status may turn-off application of the built-in gains tax under Section 1374 or the passive investment income tax under Section 1375. It may further implicate whether the target corporation may re-elect S status before the required five-year period set by statute. An ownership change may expedite the ability to re-elect sooner if otherwise desired.

Once there is relative calm over S corporation status of the target, which issue can also be relevant to an S corporation acquiring target, there are models or projections of gain or loss to the target corporation and its shareholders as well as cost basis and cost recovery allowances available to the acquiring entity. In some contexts, as will be discussed below, the cost basis obtained in the target's assets may throw off additional cost recovery and amortization deductions. Such tax savings generated in post-acquisition periods of the target's lines of business may be the subject of whether the buyer will "share" such tax savings to be realized with the shareholders of the target as part of a "tax receivables agreement."

The acquisition modeling process further requires the projected allocation of income and loss in the year of a disposition of stock or termination of S status, the application of the pass through rules under Section 1366, and adjustments to stock basis for the pass through income, distributions, and losses under Section 1367, and basis step up, or alternatively, the carryover basis for the purchaser under Subchapter S assets or stock respectively all determined in accordance with the Internal Revenue Code of 1986 (the "Code").[1] There is also the much wider world of Subchapter C and the rules governing tax-free and taxable acquisitions, redemptions, distributions, and carryover of tax attributes. Such rules apply to S corporations and their shareholders unless there is a specific provision in Subchapter S that is inconsistent with such treatment. Therefore, acquisitions of S corporation targets will closely resemble acquisition rules pertaining to C corporations. In fact, S corporations may also have one or more C corporation subsidiaries or even own the stock of a parent C corporation and members of an affiliated group of C corporations filing consolidated returns. When the target is an LLC classified as a partnership or disregarded entity for income tax purposes, the transaction may qualify for a stepped-up basis for the acquiring entity whether structured as an entity purchase or asset purchase.[2] In other situations the target partnership may first convert into a C corporation under Section 351 prior to the closing of the acquisition. This idea will further be discussed below.

In certain types of acquisitive transactions, the overriding concern may be to preserve the S corporation's election or pass though treatment as a limited liability company for state law purposes, in order to avoid double taxation currently or in the future under Subchapter C, or the built-in gains tax under Subchapter S. There are also inside (asset) basis and outside (stock) basis dichotomies in assessing the potential tax impacts. Associated with this issue are gain or loss characterization rules as well as timing issues, such as the availability or non-availability of the installment sale method under Section 453 for reporting gain with respect to a deferred payment obligation. There are also change of control issues that may be implicated in a particular acquisition, particularly in structuring bonus compensation payments or cashing out or replacing stock options granted to key executives of the target. Change of control thresholds may further result in the reduction or elimination of certain tax attributes of the target corporation. In direct or deemed asset acquisitions, the potential application of the anti-churning rules for purchased intangibles under Section 197(f), may have to be considered although this rule, contained in Section 197(f), has limited applicability from a practical standpoint.[3]

### 1.02. *Tax Aspects of Corporate Mergers and Acquisitions*

The tax considerations relating to the sale and purchase of assets by an S corporation or the sale or purchase of the stock of an S corporation are similar to the tax consequences of asset sales and purchases by C corporations and sales and purchases of C corporation stock, with a number of twists and turns thrown in that are unique to S corporations and their shareholders. Some of the issues unique to the sale of assets by S corporations include the potential application of the built-in gain tax under Section 1374 to the extent the assets are sold within the applicable five year recognition period or otherwise involve an installment sale obligation, the timing of the liquidation of the S corporation following the sale of all or substantially all of the assets of the S corporation, the receipt (and subsequent

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

[2] See Sections 1012, 338(h)(10), 336(e). See also Regs. §§1.338-5, 1.338-6, 1.338(h)(10)-1(b)(4), 1.336-3, 1.336-4.

[3] This is because the applicable testing date for an anti-churning transaction was for intangibles acquired by a related party after August 10, 1993 seeking to improperly benefit from the 15 year amortization of purchased intangibles, including goodwill.

distribution) by the target corporation (S or C) of installment sales obligations received in consideration for the sale of assets and issues related to contingent earn-outs contained in asset purchase agreements. With respect to sales of S corporation stock, the provisions of Section 1(h) must be considered in determining the character of the gain recognized on the sale of the stock, and special attention must be paid to stock sales where a Section 338(h)(10) election or a Section 336(e) election is made to treat the stock sale as an asset sale for federal tax purposes. While not the subject of this article, the potential impact of state and local income, sales and federal and state payroll and withholding obligations cannot be overlooked. Where the target corporation has gross receipts, payroll or property in many states (or foreign countries as well) there may be outstanding tax compliance issues that must be considered by tax counsel for the target corporation which will also be the subject of much scrutiny and required production by counsel for the acquiring corporation or business entity.

In planning for the acquisition or disposition of stock or assets of a C corporation, consideration may be given to either a direct purchase of assets, or purchase of stock.[4] The latter strategy is favored by sellers in order to report any gain from the transaction as long-term capital gain.[5] Of course, there are other benefits with a straight stock sale, including the exclusion of gain under Section 1202 of the Code when the stock qualifies a "qualified small business stock," as discussed further in Section II. A. below, and transactions effectuated as a (taxable) reverse or forward triangular merger, treated as a stock sale rather than an asset sale. In the case of a stock sale or a transaction treated as a stock sale, the liabilities of the corporation that are assumed or taken subject to by the acquirer are not included in computing the "amount realized" for the sale of shares under Section 1001. In addition, in an asset sale, double taxation is visited upon the selling shareholders. Purchasers of all of a corporation's stock may indeed discount the amount paid for the shares due to the continuation of the built-in gain inside the corporation and that liabilities assumed cannot be added to the cost basis in the shares. There also is the potential for a "disappearing basis" problem where the acquiring corporation, for example, liquidates the target corporation as part of the acquisition either immediately or as part of a step-transaction. In other words, the stock basis in the acquisition corporation's purchasing the stock disappears and the liquidation of its new target subsidiary (former S or C corporation and potential members of a consolidated C group that went along for the journey) yields a carryover basis in the target corporation's asset to the acquiring parent corporation.[6] A C corporation may also be acquired in a deemed asset purchase either from the sale of a parent corporation's stock in wholly owned subsidiary or as a result of a deemed sale election.[7]

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

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

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

6 Sections 337, 332.

7 See Sections 338(h)(10), 336(e)(may be a person other than a corporation that is a qualified purchaser).

The wider world of Subchapter C and the rules governing tax-free and taxable acquisitions, redemptions, distributions, carryover of tax attributes, etc. applies to mergers and acquisitions of both C and S corporations. In certain types of acquisitive transactions, the overriding concern will be to preserve the S corporation's election in order to avoid double taxation currently or in the future under Subchapter C or the built-in gain tax under Subchapter S. This will be the situation where an S corporation is the acquiring corporation of another S corporation. There are also inside (asset) basis and outside (stock) basis dichotomies in assessing the potential tax impacts. Associated with this issue are gain or loss characterization rules as well as timing issues, such as the availability or non-availability of the installment method. There are also change of control issues that may trigger certain tax consequences in a particular acquisition, particularly in structuring bonus compensation payments to key executives of the target (so called "golden parachutes").[8] The availability of 15 year amortization of purchased Section 197

[8] See Sections 280G, 83(a), 421-423, 162(m), 409A, 457, 4999. Prior to the TCJA of 2017, an employer could generally deduct reasonable compensation for personal services as an ordinary and necessary business expense. Section 162(m), which only applies to a publicly held corporation (15 USC §78c) limits the deductibility of compensation expenses in the case of publicly traded corporate employers. The otherwise allowable deduction for compensation with respect to a "covered employee", as defined, of a publicly held corporation is limited to no more than $1M per year. A covered employee includes the (1) the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year and (2) any employee whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934 ("Exchange Act") by reason of being among the corporation's four most highly compensated officers for the taxable year (other than the chief executive officer). The regulations under Section 162(m) provide that whether an employee is the chief executive officer or among the four most highly compensated officers should be determined pursuant to the executive compensation disclosure rules promulgated under the Exchange Act. Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account under §162(m): (i) remuneration payable on a commission basis; (ii) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met ("performance-based compensation"); (iii) payments to a tax-favored retirement plan (including salary reduction contributions); (iv) amounts that are excludable from the executive's gross income (such as employer-provided health benefits and miscellaneous fringe benefits); and (v) any remuneration payable under a written binding contract in effect on February 17, 1993. Also excluded from "compensation" for this purpose for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of compensation is deferred until after termination of employment. Compensation qualifies for the exception for performance-based compensation where: (i) it is paid solely on account of the attainment of one or more performance goals; (ii) such goals are set out in writing by a compensation committee consisting solely of two or more outside directors; (iii) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate majority-approved vote prior to payment, and (iv) prior to payment, the compensation committee certifies that the performance goals were satisfied. The TCJA of 2017, §13601(b)(1)-(3)) revises the definition of a "covered employee" to include both the CEO and CFO. See amended §162(m)(3)(A). The provision also includes the three (rather than four) most highly compensated officers for the taxable year who are required to be reported on the company's proxy statement. This includes such officers not required to file a proxy statement, but the corporation otherwise meets the revised definition of a publicly traded corporation. See amended §162(m)(3)(B). The provision extends the applicability of Section 162(m) to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs. The definition may include certain additional corporations that are not publicly traded, such as large private C or S corporations. The exception for "performance-based compensation and commissions" is eliminated. Therefore, excess compensation is taken into account with respect to a covered employee for a taxable year that exceeds $1M and therefore is not deductible under §162. This provision is effective for taxable years beginning in 2018. A grandfather rule is also provided.

intangibles, which includes goodwill and going-concern value, licenses and permits issued by a government, covenants not to compete, know-how (including patents and copyrights), customer and supplier based intangibles will be important allocation issues to the acquisition entity or corporation. In direct or deemed asset acquisitions, the potential application of the anti-churning rules for purchased intangibles under Section 197(f)(9) must also be considered. Given the limitless amount of material and complexity present in the law, this outline is limited to highlighting the general considerations and special problems faced by S corporations and their shareholders engaging in mergers and acquisitions.

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

Mergers and acquisitions (M&A) of closely held businesses proliferated in the years before the global economic crisis of 2008 and re-emerged in significance as middle market M&A activity has returned to normalcy, at least until the COVID-10 pandemic of 2020. Current middle market M&A activity has resulted from both strategic and financial buyers, as well as the infusion of private equity into the marketplace.

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

Private equity investors and private equity funds actively acquire portfolio investments through the buyout of operating companies from the founder shareholders, as well as from purchases of businesses from diversified companies operating many businesses, subsidiaries, and divisions, wishing to divest a non-core business or a business that it is unable to make profitable. Many of these middle market businesses have been operated as S corporations. Of course, private equity firms acquiring business entities may continue to operate the business in its long-standing format, whether as a C corporation (or consolidated group of C corporations), S corporation or multiple owner entity taxable as a partnership.[9] See discussion below.

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

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

Federal law has encouraged private equity investments through various tax and other incentives for over 50 years. The Small Business Investment Act of 1958 permitted banks and bank holding

[9] But see Rev. Rul. 99-6, 1999-1 C.B. 432.

companies to invest in Small Business Investment Corporations (SBICs) subject to certain restrictions.[10] The involvement of banks in private equity investments through the 1960s and 1970s provided the basis for the development of a professional private equity industry in the United States.

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

1.04. *Recent Tax Law Changes Affecting Structure of Merger or Acquisition of a Privately Owned Corporation*

[1] Corporate Income Tax Rate Changes.

Before the Tax Cuts and Jobs Act of 2017 (the "TCJA"), corporations were subject to graduated rates of income tax that resulted in a 35% corporate rate for taxable income over $10M, with a phase out of the lower rate for taxable income over $100,000. Certain personal service corporations were subject to a maximum rate of tax at 35%. The maximum rate of a corporation's net capital gain were also 35%. The Tax Cuts and Jobs Act of 2017 reduced the corporate income tax to 21% and repealed the maximum corporate tax rate on net capital gain as obsolete. The Inflation Reduction Act of 2022 imposes a new 15% corporate alternative will apply if the minimum tax exceeds the taxpayer's regular tax, including its base erosion and anti-abuse tax for the tax year.[11] The corporate alternative minimum tax is effective for tax years beginning after Dec. 31, 2022.

On July 4, 2025, President Trump signed into law the One Big Beautiful Bill Act (the "**OBBBA**"). The OBBBA extended or made permanent many of the tax provisions introduced under the 2017 Tax Cuts and Job Act ("**TCJA**") that were otherwise set to expire at the end of 2025 and provided for many other domestic and international tax law changes.

The OBBBA made permanent the lowered individual income tax rates temporarily provided for under the TCJA. Absent legislative action, these lowered rates were set to expire at the end of 2025. As a result of the OBBBA, the maximum individual tax rate remains permanently set at 37%. The rates for the seven tax bracket rates are now permanently fixed at 10%, 12%, 22%, 24%, 32%, 35% and 37%.

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

[11] Inflation Reduction Act Sec. 10101(f). Section 55(b).

In sum, the OBBA's international tax reforms require multinational clients to revisit their global tax planning, model the impact of higher U.S. inclusions, and take advantage of new FTC and sourcing rules to minimize double taxation. The changes also bring the U.S. system closer to the evolving global consensus on minimum taxation, reducing the risk of foreign top-up taxes and international disputes.

[2] Dividends Received Deduction.

Under Section 243(a) a corporation is allowed a deduction for dividends received from other taxable domestic corporations. In general, the deduction is 70% of the dividend received. This produces a maximum rate of corporate income tax of 10.5%. For a domestic corporation's holding 20% or more of the stock of another C corporation, the amount of the deduction is 80% of the dividend received. Such dividends are taxed at a maximum corporate income tax rate of 7%. For dividends received from a member of the same affiliated group, the DRD is generally 100% of the dividend.[12] The TCJA reduces the 70% DRD to 50% and the 80% DRD to 65%. This will yield the same tax rate as under prior law as the reduction is based on the reduced corporate income tax rate of a flat 21%. For dividends paid by a foreign affiliate to a domestic corporation which is a US shareholder, Section 245A permits a 100% deduction equal to the foreign-source portion of such dividend. An S corporation is not treated as a "domestic corporation" for this purpose but may have a C corporation subsidiary which can take advantage of Section 245A.[13]

[3] Former Corporate Alternative Minimum Tax (C-AMT).

Prior to the TCJA corporations were subject to the C-AMT to the extent that the tentative minimum tax exceeds its regulator tax. The tentative minimum tax is computed at the rate of 20% on the AMTI in excess of $40,000, i.e., the exemption amount, which phases out by an amount equal to 25% of the amount that the corporation's AMTI exceeds $150,000. AMTI is the taxpayer's taxable income increased by certain preference items. A corporation with average gross receipts of less than $7.5M for the prior three taxable years is exempt from the corporate minimum tax. The $7.5M million threshold is reduced to $5M for the corporation's first three-taxable year period. A major item included in the corporation's AMT base is the "adjusted current earning ("ACE") adjustment. The ACE adjustment is equal to 75% of the amount by which adjusted current earnings of a corporation exceed AMTI. The NOL carryover of a corporation cannot reduce the AMT base by more than 90% of the NOL. Nonrefundable business credits allowed for regular tax purposes are not allowable for C-AMT. Where a corporation is subject to the C-AMT, the amount of C-AMT is a credit for use in any subsequent tax year where the taxpayer's regular tax liability exceeds its tentative minimum tax in such later year. The corporate AMT is repealed by the TCJA of 2017. Existing C-AMT credits are refundable for any tax year beginning after 2017 and prior to 2022 in an amount equal to 50% (100% for tax years beginning in 2021) of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability.

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[12] Sections 243(a)(3), 243(b)(1). See also Section 1504(a).

[13] See August, "The Maze of Tunnels and Bridges Pass-Through Entities Must Traverse in Reporting Subpart F and GILTI Income Inclusions and Previously Taxed Income Recoveries," Corporate Taxation (WG&L), Jul/Aug 2021; President Biden's "Made in America" Tax Plan: Reversing the International Tax Benefits Extended to U.S. Corporations Under the TCJA, Corporate Taxation (WG&L), May/Jun 2021; Rizzi, "Dividends Received and New Section 245A", Corporate Taxation (WG&L) (May/Jun 2019).

[4] Replacement of Former Corporate Alternative Minimum Tax in the TCJA 2017 with Base Erosion Tax Under New Section 59A.

In replacing the corporate alternative minimum tax, and in response to earnings stripping enforcement efforts by members of the G-20, the U.S. independently enacted, in the TCJA 2017, a base erosion minimum tax to prevent large, public, multinational companies from stripping earnings out of the U.S. through payments to foreign affiliates that are deductible for U.S. tax purposes. The tax is structured as an alternative minimum tax that applies when a multinational company reduces its regular U.S. tax liability to less than a specified percentage of its taxable income, after adding back deductible base eroding payments and a percentage of tax losses claimed that were carried from another year. The "base erosion minimum tax" is 10% (5% for years beginning in 2018) of the "modified taxable income" of a subject taxpayer over an amount equal the regular tax liability reduced by applicable credits of the corporation. The rate climbs to 12.5% for taxable years beginning after 2025. The BEATs tax only applies to large C corporations. The tax applies to deductible payments to foreign affiliates from domestic corporations, as well as on foreign corporations engaged in a U.S. trade or business in computing the tax on their effectively connected income (ECI). The BEAT tax is applicable to: (i) a corporation other than a regulated investment company (RIC); (ii) real estate investment trust (REIT) or an S corporation. It must have average annual gross receipts for the immediately preceding 3-year period of at least $500M and its "base erosion percentage" for the taxable year is 3% (and possibly in some instances 2%) or higher.[14] The base erosion minimum tax can apply (i) to U.S. affiliates of foreign multinationals, e.g., affiliates are funded with foreign related party debt, and (ii) to foreign corporations engaged in a U.S. trade or business in computing the U.S. tax on their effectively connected income with a U.S. trade or business ("effectively connected income" or ECI). In the case of a foreign corporation engaged in a U.S. trade or business, only gross receipts taken into account in determining effectively connected income (ECI) are counted. If the foreign person is the taxpayer, the gross receipts of any U.S. person that is part of the taxpayer's single employer group under Section 52 are aggregated with the foreign taxpayer's and are not limited to ECI.

[5] Corporate Alternative Minimum Tax for Tax Years Beginning After 2022.

The Inflation Reduction Act of 2022 enacts a new corporate alternative minimum tax of 15% of a corporation's adjusted financial statement income. This tax applies to "applicable corporations" where the minimum tax is determined to be in excess of the taxpayer's regular tax, including its base erosion and anti-abuse tax for the year.[15] The corporate alternative minimum tax is effective for tax years commencing after December 31, 2022.[16]

The term "applicable corporation" is based on financial statement income. An "applicable corporation" for a tax year is any corporation (*other than an S corporation*, regulated investment company (RIC), or real estate investment trust (REIT) that meets a 3-tax-year-period average annual adjusted financial statement income test for one or more earlier tax years that end after December 31, 2021. The new "Pillar Two" styled tax will apply if the average annual adjusted financial statement income for the 3-tax-year period (determined without regard to loss carryovers) exceeds $1 billion. A special rule will apply to members of a foreign-parented multinational group, under which the average annual adjusted financial statement income for a corporation has to equal or exceed $100 million, if the adjusted financial

[14] See Section 59A(e)(1).

[15] See Section 55(b).

[16] See Inflation Reduction Act, Section 10101(f).

statement income of all members of the group (as adjusted) exceeds $1 billion.[17] Adjusted financial statement income is net income (or loss) of the taxpayer based on the taxpayer's publicly issued applicable financial statements. With a group financial statement, net income loss of the group that are allocable to members of that group into account where the corporations file consolidated returns. In addition, adjusted financial statement income of disregarded entities owned by the corporation, and the corporation's distributive share of adjusted financial statement income of partnerships in which the corporation has an interest, are also included. Various adjustments are required to determine adjusted financial statement income. As an example, income (but not losses) of controlled foreign corporations (CFCs) are taken into account, but a foreign corporation's income that is not effectively connected with the conduct of a U.S. trade or business is excluded. Notwithstanding the financial-statement-income basis of the tax, certain items are taken into account on a tax basis, rather than on a financial statement (book) income basis.[18]

A foreign tax credit (FTC) is permitted in computing the corporate MT. This will include direct foreign or U.S. possessions taxes that are taken into account on the corporation's applicable financial statement and paid or accrued (for tax purposes) by the applicable corporation. The applicable corporation or group may take a limited indirect credit for foreign or U.S. possessions taxes paid by controlled foreign corporations. Unused indirect corporate AMT foreign taxes will be carried forward for up to five years.[19]

[6] Net Operating Losses of Corporations.

A net operating loss (NOL) is allowed corporations and individuals in computing taxable income in an amount equal to the aggregate of the NOL carryovers and NOL carrybacks for that year. Under the law prior to the TCJA, the NOL deduction was not subject to a limitation based on taxable income.[20]

[7] Individual Tax Rates Modified and Reduced.

The tax rates introduced by the TCJA 2017 start at 10% and increase to 37%. The net investment income tax (Obama Medicare Tax of 3.8% under Section 1411) still applies. The individual alternative minimum tax is still in effect. As per Section 172(b)(2), where an NOL is not used in the first year to which it is carried, the loss can be carried to a second year (with certain modifications). Prior to TCJA, generally net operating losses could be carried back two years and forward 20 years. The TCJA limits the NOL deduction for taxable years beginning in 2018 to 80% of taxable income, and precludes the carryback of NOLs to prior years, limiting to carryforwards only.

[8] Deduction for Qualified Business Income.

Enacted under the TCJA, Section 199A allows a 20% deduction from taxable income for a taxpayer other than a corporation. An S corporation is an individual. The deduction applies at the individual S shareholder level as it does for partners in a partnership. Section 199A treats each shareholder or partner as receiving his allocable share of the items needed for computing the Section 199A deduction.

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17 See Section 59(k).

18 See Section 56A.

19 Section 56(I).

20 See also Sections 381, 382, 384.

The deduction equals the sum of lesser of (a) the "combined qualified business income amount" and (b) 20% percent of the excess of (i) taxable income (computed without regard to Section 199A) over (ii) the sum of any "net capital gain" plus any "qualified cooperative dividends." The second amount is the lesser of (a) 20% of the qualified cooperative dividends or (b) taxable income reduced by net capital gains. The amount determined under the formula may not exceed the taxable income reduced by the net capital gain. The combined qualified business income amount includes certain amounts with respect to each qualified trade or business. In addition, the combined qualified business income amount includes 20% of qualified REIT dividends and qualified publicly traded partnership income. The amount determined for any QBI is subject to a limitation. The limitation is the lesser of: (a) 20% of ABI or (b) the greater of (i) 50% of W-2 wages with respect to the qualified trade or business or (ii) the sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis after the acquisition of "qualified property". The unadjusted basis is the cost of the property immediately after the acquisition of the property involved and is not reduced by depreciation taken on the asset after its acquisition. The W-2 wages and qualified property apply separate as to each trade or business. For individuals whose income does not exceed a threshold amount, the 20% deduction is allowed even if the trade or business is not a QBI but is a specified service trade or business. The threshold amount is $157,500 ($315,000 for a joint return) (with inflation adjustments). This rule phases out if the taxpayer's taxable income is up to $50,000 more than the threshold amount ($100,000 or more for a joint return). Final regulations have been issued under Section 199A that apply to taxable years beginning after August 24, 2020.[21] Taxpayers may elect to apply the amendments made to Regs. §§ 1.199A-3 and 1.119A-6 for taxable years beginning on or before August 24, 2020. As an alternative, taxpayers may elect to rely on the February 2019 Proposed Regulations for taxable years beginning on or before August 24, 2020. Section 199A does not apply to taxable years beginning after December 31, 2025 unless Congress decides to extend its application. §199A(i).[22]

[9] Limitation on Deductions for Business Interest.

Frequently an acquisition is a "leveraged acquisition" in which case the buyer obtains financial from institutional or private investors, including foreign institutions or investors, in acquiring a domestic corporation. One of the benefits of the financing is the ability for the acquiring corporation to deduct interest subject to whether such interest is required to be capitalized under Section 263A(f) or Section 461(g) or the so-called INDOPCO regulations.[23] Interest is generally deducted by a taxpayer as it is paid or accrued, depending on the taxpayer's method of accounting. Where an obligation is issued with original issue discount ("OID"), a deduction for interest is allowable over the life of the obligation on a yield to maturity basis.

[a] *Investment Interest: Section 163(d).*

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

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[21] See Section 7805(b)(7).

[22] See *Sword*, "Lack of GOP Wave Dims Section 199A Permanence Changes, Group Says", Tax Notes, Nov. 14, 2022. The comment reports that the Joint Committee on Taxation's 2017 estimate on making §199A permanent was more than $50 billion per year. "The Main Street Tax Certainty Act (H.R. 1381)" (also S.480).

[23] See also Sections 163(e)(5), 163(f), 267. See also Faber, "INDOPCO: The Unsolved Riddle", 47 Tax Law 607 (1994); Silverman & Weinstein, "INDOPCO and the Tax Treatment of Reorganization Expenses," 75 Tax Notes 243 (1997).

[b] *Earnings Stripping: Former Section 163(j).*

Former Section 163(j) disallowed the deduction for disqualified interest paid or accrued by where two threshold tests are met: (i) the obligor's debt-to-equity ratio exceeds 1.5 to 1.0 ("safe harbor" rule); and (ii) obligor's net interest expense exceeds 50% of its adjusted taxable income, as computed. Disqualified interest includes interest paid or accrued to: (i) related parties when no Federal income tax is imposed with respect to such interest; (ii) unrelated parties in certain instances in which a related party guarantees the debt; or (iii) to a real estate investment trust ("REIT") by a taxable REIT subsidiary of that trust.[24] Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation can be carried forward three years.[25] Under TCJA, for tax years beginning after 2017, Section 163(j) limits the deduction for net business interest expense to 30% of the adjusted taxable income of the business. Disallowed business interest may be carried forward indefinitely, subject to certain restrictions applicable to partnerships. Taxpayers whose average annual gross receipts for the three-tax year period ending with the earlier tax year do not exceed $25M are exempt from this restriction. The business interest limitation doesn't apply to certain regulated public utilities and electric cooperatives. Real property trades or businesses can elect out of the provision if they use the alternative depreciation system (ADS) to depreciate applicable real property used in a trade or business. Farming businesses may also elect out if they use ADS to depreciate any property used in the farming business with a recovery period of ten years or more. An exception from the limitation is also provided for interest on floor plan financing, defined as financing for the acquisition of motor vehicles, boats, or farm machinery for sale or lease and secured by that inventory. Where a tax treaty reduces the rate of tax on interest, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed by the treaty, bears to the rate of tax imposed without regard to the treaty.[26] It is important to note that the Section 163(j) limitation is applied at the partnership or S corporation level.[27] Unlike Section 199A deductions, excess interest of a pass through entity still reduces the outside basis of each partner or shareholder in an S corporation.

[c] *Beyond "Earnings Stripping": Broadening The Impact of Section 163(j).*

Revised Section 163(j), as enacted under the TCJA 2017, imposes a ceiling on allowable deductions for interest paid or accrued on debt properly allocable to any trade or business. More specifically, Section 163(j) limits certain taxpayers' deduction for 'business interest' in a tax year to the sum of three amounts: (i) 'business interest income' for the year; (ii) 'floor plan financing interest' for the year; and (iii) most prominently, 30% of the taxpayer's 'adjusted taxable income' for the year.[28] Any deduction denied under revised Section 163(j) generally rolls forward to the next succeeding tax year, when it is combined with the taxpayer's 'business interest' for the succeeding year, and then applied against the Section 163(j) limitation. the combined amount is subjected to Section 163(j) once again. Other limitation provisions such as Section 163(e) or Section 267(a)(3)(B) that may be deferred do not enter the Section 163(j) portal until the deferral provision allows it.

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24 Section 685(j)(3).
25 Section 163(j)(2)(B)(ii).
26 Section 163(j)(5)(B).
27 See Section 163(j)(4).
28 See Section 163(j)(1)(B).

[d] *Exemption for Small Businesses From Section 163(j)*

A taxpayer whose gross receipts are less than the amount specified in Section 448(c) (generally $25 million a year, based on the average of the three preceding tax years) avoids Section 163(j) unless it is a tax shelter prohibited from using cash method accounting. In addition, Section 163(j)(7) excludes four types of trades or businesses from the limitation despite falling over the gross receipts threshold. Such exemptions include the performance of services as an employee, an electing real property trade or business,[29] an electing farming business and certain regulated utilities involved in furnishing or selling electricity, water, sewage disposal, or gas or steam through a local distribution system; or in transporting gas or steam by pipeline. A drawback of the election out of Section 163(j) is that the electing taxpayer must use the alternative depreciation system for some or all of its assets, rather than the accelerated depreciation that might otherwise be available under Section 168.

[e] *Limited to Business Interest.*

Only 'business interest' is limited by Section 163(j) which is interest paid or accrued on debt that is 'properly allocable to a trade or business.' The statute is silent on the method by which indebtedness should be allocated to, or away from, a trade or business covered by Section 163(j). Business interest does not include 'investment interest' as defined in Section 163(d). Because Section 163(d) applies only to individuals, the IRS has previously stated that all interest paid or accrued by a C corporation should be treated as 'business interest.[30]

[f] OBBBA Changes to Section 163(j).

When first introduced by the TCJA, the Section 163(j) definition of adjusted taxable income was earnings before interest, taxes, depreciation and amortization ("**EBITDA**"). However, beginning with the 2022 tax year, adjusted taxable income was computed after taking into account depreciation, amortization and depletion. This decreased adjusted taxable income and reduced the amount of net business interest expense that could be deducted in any given year. The OBBBA goes back to the expanded EBITDA calculation of adjusted taxable income. The OBBBA also expands the definition of motor vehicles for purposes of the floor plan financing exception to Section 163(j). Motor vehicles now include any trailer or camper that is designed to provide temporary living quarters for recreational, camping or season use that is designed to be towed by or affixed to a motor vehicle. These changes are applicable to tax years beginning after December 31, 2024.

Another OBBBA change is that the definition of adjusted taxable income now excludes certain foreign income (i.e., Subpart F income and global intangible low-taxed income). This change, which could negatively impact the amount of net business interest expense a taxpayer can deduct, has a delayed effective date. It goes into effect for taxable years beginning after December 31, 2025.

[10] <u>Enhanced Expensing of Tangible Personal Property.</u>

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[29] See Section 163(j)(7)(B) (first sentence). This includes 'any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.' Section 469(c)(7)(C).

[30] See IRS Notice 2018-28, 2018-16 IRB 492 (see final regulations). See Rizzi, "Final Section 163(j) Regulations: The Brave New World", Corporate Taxation (WG&L) 47 WGL-CTAX 29.

Under the law prior to the TCJA, Section 168(k) provided that a taxpayer that owned "qualified property" was allowed, subject to the phase-down rules discussed below, additional depreciation at a 50% rate (bonus depreciation) in the year that the property was placed in service (with corresponding reductions in basis and, therefore, reductions of the regular depreciation deductions otherwise allowed in the placed-in-service year and in later years. The TCJA increases the bonus depreciation rate to 100% for all qualified property and canceled certain "phase-down" rules.

The OBBBA further expanded the enhanced expensing provisions. The OBBBA increased the Section 179 limitation on amounts that taxpayers can expense from $1 million to $2.5 million, while also increasing the phaseout threshold from $2.5 million to $4 million. These higher amounts apply to property placed in service in taxable years beginning after December 31, 2024.

The OBBBA also brought back 100% bonus depreciation and made it permanent for qualified property acquired and placed in service on or after January 19, 2025. Qualified property includes most tangible personal property with a recovery period of 20 years or less as well as computer software, water utility property, qualified film or television production, and qualified live production.

The OBBBA also introduced 100% bonus depreciation for qualified production property ("**QPP**"). Nonresidential real property generally does not qualify for bonus depreciation as it has a recovery period of 39 years, which exceeds the 20-year requirement to qualify as qualified property. However, it may now get the benefit of bonus depreciation if it is QPP.

QPP is nonresidential real property used as an integral part of the manufacturing, production, or refining of tangible personal property (excluding food and beverage products prepared in the same building as a retail establishment in which the property is sold) if:

(i) The original use of the property begins with the taxpayer;
(ii) Construction of the property begins after January 19, 2025 and before January 1, 2029;
(iii) The property is placed in service before January 1, 2031; and
(iv) The taxpayer elects to designate the property as QPP.

Bonus depreciation for QPP is not available for the portion of property used for office space, lodging, parking, research and development activities or other functions unrelated to the manufacturing, production or refining of the tangible personal property.

Additional changes were made to the depreciation schedule for certain projects that qualify for the technology-neutral credits, *e.g.*, section 48E, will still qualify for the 5-year MACRS depreciation schedule. However, the OBBBA provides that projects qualifying under the "legacy" credit provisions, *e.g.*, projects eligible for the credit allowed under section 48, that begun construction after the 2024 tax year. The "legacy" projects most likely to be affected are geothermal heat pumps because these have until December 31, 2034 to begin construction and claim the "legacy" credits, while other "legacy" projects must have begun construction by December 31, 2024.

The enhanced expensing rules may further motivate acquirers of target corporations to engage in direct asset purchases or deemed asset purchase under Section 338(h)(10) or Section 336(e).[31]

[31] See also Section 179.

[11] Excess Business Loss Disallowance Rule.

Under the TCJA, new Section 461(a) provides that for a tax year of a non-corporation beginning after 2017 and prior to 2026, a taxpayer's excess business loss (EBL) is disallowed.[32] Such losses are carried forward and treated as part of the taxpayer's NOL carryforward for subsequent taxable years. An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. The threshold amount for a taxable year is $250,000 (or twice the otherwise applicable threshold amount in the case of a joint return). The threshold amount is indexed for inflation. In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner's distributive share and each S corporation shareholder's pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation are taken into account in applying the limitation under the provision for the taxable year of the partner or S corporation shareholder. This limitation applies after application of Sections 1366(d) (basis limitation), 704(d)(basis limitation), 465 (at-risk limitation) and 468 (passive activity loss rule). It should be noted that employment income is not treated as "business income" for purposes of Section 461(l). It is difficult to understand the tax policy rationale to Section 461(l) which had been set to expire for tax years beginning after 2025.[33] There doesn't seem to be one since cash losses are subject to limitation. If there is any rationale worth considering is the idea that the provision was that the provision was put into the TCJA to offset the tax losses from the reduced rate of tax on individuals, trusts and estates for qualified business income under Section 199A. Perhaps if Section 199A is repealed, Congress will do "the right thing" and repeal Section 461(1). It should repeal Section 461(1) regardless. The news from Washington, however, on this provision is not good. The Inflation Reduction Act extended the limit on excess business losses for non-corporate taxpayers through December 31, 2028. It is indeed most ironic that Section 2304 of the CARES Act temporarily suspended Section 461(l).[34]

1.05. *The Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act")*

In the wake of the COVID-19 pandemic, the Senate passed the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act" or the "Act") on March 25, 2020, and the House passed the Act and the President signed the Act into law on March 27, 2020. The CARES Act contains numerous substantive and technical changes to the Internal Revenue Code, designed to provide relief to taxpayers affected by the coronavirus and taxpayers generally. The CARES Act provides more than $2 trillion in financial assistance to combat the economic consequences of the coronavirus. This is the largest economic stimulus in U.S. history, dwarfing that of the $800 billion stimulus package that Congress passed in response to the 2008 financial crisis.

The CARES Act includes $350 billion in aid to small businesses, $500 billion in corporate aid, direct one-time payments of up to $1,200 per adult and $500 per child, $100 billion in grants to hospitals, and numerous tax relief provisions, many of which reversed or revised the revenue offsets for the reduction of the corporate tax rate by the TCJA.

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[32] See Section 461(l)(1)(B).

[33] See Hodaszy, "The Curious Case of Section 461(l): Why This Unclear And Unwise New Rule Should Be Construed As Narrowly As Possible", 73 Tax Law. 61 (Fall, 2019).

[34] See Wallace, "The Troubling Case Of The Unlimited Pass-Through Deduction; Section 2304 Of The CARES Act", U.Chi. L. Rev. Online (6/29/2020).

The CARES Act in effect reversed the provisions of the TCJA which eliminated carrybacks of net operating losses ("NOLs") and limited the use of NOL carryforwards to 80% of taxable income. The new provision allows business taxpayers to aggregate NOLs from tax years 2018, 2019, and 2020 and carry them back up to five years. Notably, the five-year carryback would allow corporations to apply losses to years in which the corporate tax rate was 35%, which has the effect of increasing the value of NOLs carried back. Additionally, the provision temporarily removes the 80% taxable income limitation, allowing NOLs to fully offset taxable income for tax years beginning before January 1, 2021. As a practical matter, NOL carrybacks that arise during a taxable year are generally calculated at the close of a company's taxable year meaning that the relief this provision provides with respect to 2020 NOLs will be delayed until the end of the tax year and the filing of the 2020 tax returns with the carryback adjustments. Special rules apply to NOLs incurred by REITs and life insurance companies and with respect to the availability of credits for prior year alternative minimum tax liability of corporations. The CARES Act also provides Treasury with regulatory authority to modify the application of limitations on NOLs and other tax attributes under Section 382.

[1] The Foreign Derived Intangible Income and Global Intangible Low-Taxed Income.

U.S. C or regular corporations with foreign-source and foreign-derived income, including those owning 10% or more of the shares of non-U.S. corporations that are treated as controlled foreign corporations ("CFCs"), the carryback provisions of the CARES Act must be analyzed in light of the global intangible low-taxed income ("GILTI") and foreign-derived intangible income ("FDII") provisions enacted by the TCJA. In certain circumstances, this interplay of these provisions may vitiate the tax benefits of the new NOL carryback provisions.[35]

GILTI was enacted by the TCJA to spur U.S. multinationals to repatriate their intangible assets, such as patents and intellectual property, from low-tax jurisdictions by taxing the "under-taxed" earnings on these assets. GILTI operates by immediately taxing earnings from intangible assets in certain low tax jurisdictions. Earnings subject to this tax allow corporations to deduct 50% of the GILTI and claim a foreign tax credit for 80% of foreign taxes paid or accrued on GILTI. The aim thus was to impose a GILTI-related tax only where the income realized by the CFC was not subject to at least a 13.125% tax by its "low-tax" jurisdiction. Under the GILTI rules, a U.S. Shareholder of any CFC must include in gross income for a tax year its global intangible low taxed income in a manner that strongly resembles (but is not the same as required) income inclusions of Subpart F income. As to a U.S. Shareholder, GILTI is the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. The U.S. Shareholder's net deemed tangible income return is an amount equal to 10% of the aggregate of the shareholder's pro rata share of the qualified business asset investment ("QBAI") of each CFC with respect to which it is a U.S. Shareholder. The U.S. shareholder's GILTI inclusion amount is calculated based on certain items – such as tested income, tested loss, and QBAI – of each CFC owned by the U.S. shareholder (tested items). The stock attribution rules under Section 958 apply for purposes of determining whether a foreign corporation is a CFC and also for purposes of determining whether a person is a U.S. Shareholder under Section 951(b).

[35] August, "The Maze of Tunnels and Bridges Pass-Through Entities Must Traverse In Reporting Subpart F and GILTI Income Inclusions and Previously Taxed Income Recoveries", Corporate Taxation (WG&L) (July/August 2021); "The Tax Cuts and Jobs Act of 2017 Introduces Major Reforms To The International Taxation of US Corporations", Practical Tax Lawyer (Winter 2018); "President Biden's 'Made in America' Tax Plan: Reversing The International Tax Benefits Extended To US Corporations Under The TCJA", Corporate Taxation (WG&L) (May/June 2021).

The formula for GILTI, which is calculated at the U.S. Shareholder level, is:

GILTI = Net CFC Tested Income – (10% × QBAI) less interest expense.

In contrast, the FDII provisions were enacted as an inducement for U.S. corporations to retain (or move) their intangible assets in (or to) the U.S., while licensing them to non-U.S. persons. To achieve this aim, the TCJA extended a similar 37.5% deduction (also under Section 250 of the Code) of their "deemed intangible income" that is foreign derived. The Section 250 deduction is reduced for years after 2025, from 37.5% to 21.875% for FDII and from 50% to 37.2% for GILTI. The Biden Administration has proposed, however the repeal of the FDII provision as well as proposing a reduction of the amount of the deduction for GILTI.[36]

This interplay arises when the sum of GILTI and FDII (determined without regard to the Section 250 deductions) exceeds the taxable income of the U.S. corporation. In that event, there is a "carve-back" of the amount of Section 250 deductions. Thus, for example, a U.S. corporation, by reason of a NOL carryback, could lose the benefit of its Section 250 deductions (which are not subject to carryback or carry forward).

Therefore, it appears that a U.S. corporation with GILTI or FDII will be faced with the choice either of carrying back NOLs (for example, to 2018 or 2019) and effectively forfeiting Section 250 deductions or carrying forward those NOLs to offset (expected) U.S. income, which is currently taxed at the lower corporate rate (21%).

[2] Expedited Credit for Prior Year Minimum Tax Liability for Corporations.

The TCJA repealed the corporate alternative minimum tax ("AMT"). As part of this repeal, corporations who were previously subject to the tax received refundable credits which were made available over several years ending in 2021. The Act repeals the 2021 timeline and allows eligible companies to apply for an immediate refund of AMT amounts that would otherwise be deferred under the TCJA.

[3] Revision of Limitation on Business Interest Deduction.

As noted above, the TCJA limited the amount of deductible business interest expense to 30% of the taxpayer's adjustable taxable income ("ATI") for the tax year plus floor plan financing interest.[37] ATI does not take into account certain tax items including non-business expenses, business interest, the Section 199A deduction and through 2021, depreciation, amortization and depletion.[38] The Act relaxes this

[36] See, in general, August, "The Maze of Tunnels and Bridges Pass-Through Entities Must Traverse in Reporting Subpart F and GILTI Income Inclusions and Previously Taxed Income Recoveries," Corporate Taxation (WG&L), Jul/Aug 2021; "President Biden's 'Made in America' Tax Plan: Reversing the International Tax Benefits Extended to US Corporations Under the TCJA", Corporate Taxation (WG&L), May/Jun 2021.

[37] See Jordan D. August, "The Business Interest Deduction Limitation: The New Code Section 163(j)", 32 No. 2. Prac. Tax Law. 25 (Winter, 2018). Werlhof, 'Understanding the Business Interest Expense Limitation,' 100 Practical Tax Strategies 25 (April 2018); Werlhof, 'Final Business Interest Limitation Rules Present Opportunities,' 133 Journal of Taxation 14 (November 2020).

[38] Section 163(j)(8); Reg. 1.163(j)-1(b)(1). Depreciation, amortization, or depletion capitalized per § 263A is deemed included in taxable income regardless of when the capitalized amount is recovered. See Reg. 1.163(j)-1(b)(1)(iii) and Reg. 1.163(j)-2(h)(3), Example 3.

amount and enables taxpayers to elect to increase the Section 163(j) limitation from 30% to 50% for any taxable year beginning in 2019 or 2020. Additionally, for tax years beginning in 2020, businesses may use their 2019 ATI to calculate the interest expense limitation which will likely be higher due to the economic downturn. While partnerships are still subject to the 30% limitation for 2019. The Act provides that 50% of any interest deductions that are suspended by the 30% income limitation in 2019 can be applied or "freed up" in 2020 without regard to any income limitations. The remaining 50% will continue to be subject to the normal Section 163(j) limitations. Many businesses are likely to benefit from the revised limitations due to the sudden economic downturn and grim short-term forecasts. However, real estate businesses that elected out of the Section 163(j) limitations and as a result were required to transition to longer depreciation methods for their assets, will likely not benefit from the new provisions. Additionally, some taxpayers, including taxpayers subject to the BEAT, may elect not to increase their Section 163(j) limitation in order to utilize their excess interest expense to offset income in future years.

Small businesses, as defined, are not subject to Section 163(j). Under Section 163(j)(3), a small business, the taxpayer's average annual gross receipts—including certain gross receipts of certain related entities—cannot exceed $26 million for 2021 ($27 million for 2022; the amount is indexed for inflation).[39] The small business exception does not apply where the taxpayer is a tax shelter. A pass through entity, such as an S corporation or partnership, is a tax shelter ("syndicate")[40] where more than 35% of losses for the tax year are allocated to shareholders, limited partners or entrepreneurs. Losses are determined without regard to Section 163(j) and excludes gain or loss from the sale of capital assets, depreciable assets or real property used in a trade or business. The regulations permit an annual election to use allocations made in the prior year instead of the current year in determining whether the reporting entity is a tax shelter (syndicate).[41]

[4] Expensing of Qualified Improvement Property.

The TCJA allowed, by amending Section 168, full (100% bonus depreciation) expensing of cost of depreciable tangible assets, such as machinery and equipment through 2022, then phased out the provision over the subsequent five years through 2026. The TCJA eliminated pre-existing definitions for: (i) qualified leasehold improvement property; (ii) qualified restaurant property; and (iii) qualified retail improvement property. It replaced such definitions with one category called qualified improvement property ("QI Property"). A general 15-year recovery period was intended to have been provided for QI Property. However, that specific recovery period failed to be reflected in the statutory text of the TCJA. Thus, under the TCJA, QI Property falls into the 39-year recovery period for nonresidential rental property. That makes the QI Property category ineligible for 100% Bonus Depreciation. For property with longer production periods, the phase out of the provision extended through 2027. The Conference Report for the TCJA described an intention to treat "qualified improvement property," which generally include any improvements to the interior portion of nonresidential real property that do not enlarge the building or improve its internal structural framework (other than elevators or escalators), as 15-year property, which would in turn render it eligible for the 100% expensing. However, language of Section 168(k) as incorporated in the TCJA failed to achieve that intended result.

The CARES Act includes a technical correction to the TCJA, Section 168(e)(3)(E)(vii), and enables businesses to immediately deduct costs associated with improving facilities or "qualified

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39 See §448(c). See Werlhof, supra, fn. 32.

40 §§ 448(d)(3); 461(i)(3); 1256(e)(3)(B).

41 §§ 163(j)(7)(A)(ii) and (iii).

improvement property" as opposed to depreciating those improvements over 39 years. The Act makes this correction retroactive to January 1, 2018 (allowing companies to file amended returns for 2018 or 2019 when beneficial). QI Property also is specifically assigned a 20 year class life for the Alternative Depreciation System.[42] Congress expects that this change will incentivize businesses to invest in improvements despite difficult financial conditions. Notably, the newly corrected 100% deduction for qualified improvement property may generate net operating losses that are now, pursuant to the Act, permitted to be carried back for up to five years.[43]

1.06. *International Tax Law Changes under the OBBBA*.

The OBBBA represents the most significant overhaul of U.S. international tax rules since the Tax Cuts and Jobs Act ("TCJA") of 2017. The OBBBA extends and modifies many TCJA provisions while introducing international tax changes.

[1] Modification of the Section 250 Deduction for FDII and GILTI (Now NCTI)

The OBBBA reduces the Section 250 deduction for foreign-derived deduction eligible income ("**FDII**") from 37.5% to 33.34%, and for net controlled foreign corporation ("**CFC**") tested income ("**NCTI**," formerly GILTI) from 50% to 40%, effective for tax years beginning after December 31, 2025. This change creates an effective 14% tax rate for both FDII and NCTI versus the prior 12.5% FDII effective tax rate and 10.5% GILTI effective tax rate.

As an example, a U.S. multinational with $90 million of net CFC tested income in 2026 will now be eligible for a $36 million deduction (40%), rather than the $45 million deduction (50%) under prior law. This increases the effective U.S. tax rate on such income, narrowing the gap with the 15% GMT rate under pillar 2 and reducing the incentive to shift profits to low-tax jurisdictions.

[2] Redefinition of GILTI and Repeal of the Deemed Tangible Income Return

As noted above, the OBBBA renames GILTI as "net CFC tested income" or "NCTI" and repeals the exclusion for a deemed return on tangible property ("**QBAI**"). This means all tested income of CFCs is now subject to current U.S. taxation, regardless of the CFC's investment in tangible assets.

Previously, a U.S. shareholder of a CFC with $10 million of tested income and $50 million of QBAI (tangible assets) would exclude $5 million (10% of QBAI) from GILTI, only including $5 million. Under the OBBBA, the full $10 million is included, increasing the U.S. tax base and aligning more closely with pillar 2's approach, which generally does not provide a similar QBAI exemption.

[3] Increase in the Deemed Paid Foreign Tax Credit Percentage

The OBBBA increases the percentage of foreign taxes deemed paid that can be claimed as a credit under Section 960(d) from 80% to 90% for net CFC tested income. A U.S. corporation with $10 million of

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[42] Section 168(g)(3)(B).

[43] For an excellent summary of the tax law with regard to residential real estate incentives see Staff, Joint Committee on Taxation, "Present Law and Background Relating to Tax Incentives for Residential Real Estate," July 18, 2022 reproduced in Tax Notes July 18, 2022. This JCT Report includes a review of "QI Property" as it relates to nonresidential real property improvements.

net CFC tested income and $2 million of foreign taxes paid can now claim a $1.8 million credit (90%), up from $1.6 million (80%). This reduces the risk of double taxation and brings the U.S. regime closer to the pillar 2 GMT, which allows a 100% credit for foreign taxes.

[4] Modification of Foreign Tax Credit Limitation and Sourcing Rules

The OBBBA provides that certain deductions (notably interest and R&D) are not allocated to foreign source net CFC tested income for foreign tax credit ("**FTC**") purposes and allows up to 50% of income from inventory produced in the U.S. and sold through a foreign branch to be treated as foreign-sourced. For purposes of this Section, the term "foreign branch" means an integral business operation carried on by a U.S. person outside the United States. Whether the activities of a U.S. person outside the United States constitute a foreign branch operation must be determined under all the facts and circumstances. Evidence of the existence of a branch includes, but is not limited to, the existence of a separate set of books and records, and the existence of an office or other fixed place of business used by employees or officers of the U.S. person in carrying out business activities outside the United States.

Consequently, a U.S. manufacturer with a foreign branch selling U.S.-produced goods abroad can now treat up to half of the income from those sales as foreign-sourced, potentially increasing the FTC limitation and reducing residual U.S. tax on such income.

[5] Permanent Extension of the Look-Through Rule for CFCs

The OBBBA makes permanent the look-through rule of Section 954(c)(6), which allows certain payments between related CFCs to be excluded from subpart F income. As an example, a U.S. parent with multiple CFCs can continue to structure intercompany loans and royalties without triggering subpart F inclusions, facilitating global cash management and intellectual property outbound planning.

[6] Restored Limitation on Downward Attribution and New Foreign Controlled U.S. Shareholder Rules

The OBBBA restores the pre-TCJA limitation on downward attribution of stock ownership (section 958(b)), preventing U.S. persons from being treated as owning stock held by foreign persons. It also introduces new rules for "foreign controlled U.S. shareholders" and "foreign CFCs," requiring certain inclusions similar to subpart F and GILTI for U.S. shareholders controlled by foreign persons.

A U.S. subsidiary of a foreign parent that previously became a U.S. shareholder of a CFC solely due to downward attribution will no longer be subject to subpart F or GILTI inclusions on that basis. However, if the U.S. subsidiary is itself controlled by a foreign person, it may now be subject to new inclusion rules under Section 951B. However, the elimination of downward attribution is particularly important in the context of portfolio loan interest planning as a foreign person deemed a CFC cannot receive the portfolio interest exclusion under Section 881(c).

[7] Modification of Pro Rata Share Rules for Subpart F Income

The OBBBA aligns the determination of a U.S. shareholder's pro rata share of subpart F income with the period of actual ownership during the year, rather than year-end ownership. Therefore, a U.S. shareholder who acquires CFC stock mid-year will now include only the portion of subpart F income

attributable to the period of ownership, reducing the risk of being taxed on income earned before acquisition.

[8] Repeal of 1-Month Deferral for Specified Foreign Corporations

The OBBBA repeals the ability of specified foreign corporations to elect a taxable year ending one month later than the U.S. parent, eliminating the so-called "1-month deferral." A U.S. multinational with a CFC that previously used a November 30 year-end to defer income recognition will now be required to conform the CFC's year-end to the U.S. parent, accelerating the inclusion of CFC income.

[9] Coordination of Business Interest Limitation with Capitalization

The OBBBA clarifies that the Section 163(j) business interest limitation applies before capitalization, and that disallowed interest is not subject to future capitalization. A U.S. corporation with significant capitalized interest under Section 263A will now apply the Section 163(j) limitation first, potentially reducing the amount of interest that must be capitalized and simplifying compliance.

[10] Base Erosion Minimum Tax ("**BEAT**")

The BEAT is a corporate minimum tax imposed under Section 59A on corporations with average annual gross receipts of at least $500 million for the three-taxable-year period ending with the preceding tax year. The minimum tax is designed to target large corporations that reduce their U.S. tax liability by making deductible payments to foreign related parties. The BEAT operates as an additional tax, separate from the regular corporate income tax, and is intended to ensure that corporations engaging in significant base erosion activities (related party sales, services, etc.) pay a minimum level of U.S. tax.

Under the OBBBA, the BEAT additional tax calculation rate is increased from 10% to 10.5% exposing more corporate income to an additional BEAT tax.

[11] Other Notable International Provisions

(a) Proposed Section 899: The proposed Section 899, which would have imposed retaliatory US tax measures on residents of countries enacting Pillar 2 undertaxed profits rules, digital service taxes, or other discriminatory taxes against US corporations, has been removed from the OBBBA.

(b) Full Expensing of Domestic R&D: Domestic R&D expenses can be immediately deducted, while foreign R&D remains subject to 15-year amortization. Note that in the case of U.S. subsidiaries of foreign corporations if the R&D is carried out by the U.S. subsidiary, there are opportunities for indirect benefit from this part of the OBBBA.

## II. GENERAL ACQUISITION AND SALE PATTERNS IN ACQUIRING A C CORPORATION

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

### 2.01. *Sale of Qualified Small Business Stock ("QSBS") and the Section 1202 "Game Changer"*

Many of the private equity backed companies are structured as C corporations for the specific purpose of qualifying as "Qualified Small Business Stock" ("QSBS") for purposes of Section 1202 of the Code. Pursuant to Section 1202(a)(2), the gross income of a taxpayer (other than a corporation) shall exclude 50% to 100% of certain gain from the sale or exchange of QSBS held by the taxpayer for more than 5 years, subject to a $10 million limitation with certain exceptions.

#### [1] Qualified Small Business Stock.

Under Section 1202(c), in order for stock to be treated as QSBS, the stock must be (i) stock in a C corporation; (ii) stock that was (A) originally issued after 1993 and (except as provided in Section 1202(f) and Section 1202(h)) (B) acquired by the taxpayer at its original issue (directly or through an underwriter), (1) in exchange for money or other property (not including stock), or (2) as compensation for services provided to such corporation (other than services performed as an underwriter of such stock);[44] (iii) the corporation must be a qualified small business (a "QSB") (iv) the corporation meets the active business requirements of Section 1202(e) (the "Active Business Requirements") and (v) pursuant to Section 1202(c)(1) and the Treasury Regulations promulgated thereunder, no redemption of stock that is seeking to qualify as QSBS may occur (A) during the four year period beginning on the date two years before the issuance of stock seeking to qualify as QSBS if such redemption is of stock held by the stockholder seeking QSBS treatment or a related person (as set forth under Section 707(b) or (B) during the two year period beginning on the date one year before the issuance of stock if such redemption is of stock having an aggregate value (as of the time of any such redemption) exceeding five percent of the aggregate value of all of the Company's stock at the beginning of such two year period (each, a "Prohibited Redemption.").

#### [2] Stock in a C Corporation.

Pursuant to Section 1202(c), QSBS must be stock in a C corporation. Under Section 1202(c)(1), in order to qualify as QSB stock, the relevant stock must have been issued after August 10, 1993, and the stock must (1) have been issued as either compensation for services or in exchange for money or other property that is not stock and (2) have been acquired by its current holder when it was originally issued (the "Original Issue Requirements").

Under Section 1202(f), if stock in a corporation is acquired solely through the conversion of other stock in such corporation which is QSBS in the hands of the taxpayer, (i) the stock acquired shall be treated as QSBS in the hands of the taxpayer and (ii) the stock acquired shall be treated as having been held for the same period that the converted stock was held.

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[44] Section 1202(c)(1)(B).

[3] Qualified Small Business.

Under Section 1202(d), a "qualified small business" or QSB is defined as any domestic corporation that is a C corporation if (A) the aggregate gross assets of the corporation (or any predecessor) at all times before the relevant stock issuance did not exceed $50 million, (B) the corporation's aggregate gross assets immediately after the relevant stock issuance (taking into account amounts received in the stock issuance) does not exceed $50 million, and (C) the corporation agrees to submit any reports to the IRS and to shareholders as the IRS may require (the "QSB Requirement).

[4] Gross Assets Test.

The gross assets test under Section 1202(d) (the "Gross Assets Test") measures the value of the aggregate gross assets of the corporation at all times from formation until immediately after the relevant stock issuance (determined taking into account amounts received in the issuance). At any such time, the value of the aggregate gross assets of the corporation may not exceed $50,000,000. The "value of the aggregate gross assets" of a corporation is generally equal to (i) the amount of cash held by the corporation, plus (ii) the aggregate adjusted bases of other property held by the corporation.[45] In calculating a corporation's aggregate gross assets, the basis of all property contributed to the corporation (and any corporate property whose basis is determined by reference to contributed property) is equal to the fair market value of the property when it was contributed.[46]

[5] Aggregation Rules and Other Items.

For purposes of determining if the corporation is a QSB, all corporations that are members of the same parent-subsidiary controlled group are treated as a single corporation.[47] A parent-subsidiary controlled group is a group defined in Section 1536(a)(1), except that the ownership requirement is satisfied with more than 50% stock ownership. Under Section 1536(a)(1) (as modified by Section 1202(d)(3)(B)(i)), a "parent-subsidiary" group is one or more chains of corporations connected through stock ownership with a common parent corporation if stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of each of the corporations is owned by the parent corporation.

[6] Active Business Requirements.

Qualified Small Business Stock must be stock in a corporation that meets the "active business requirements" of Section 1202(e) and an eligible C corporation. Under Section 1202(e), in order to meet the "active business requirement", the issuing corporation must use at least 80% of its assets (determined by value) in the active conduct of one or more qualified trades or businesses during substantially all of the taxpayer's holding period for such stock.

[7] Qualified Trade or Business.

The Company has represented that at all times since its formation through the dates of the Share Issuances (i) the Company has been engaged in the Business and (ii) the Company has engaged

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45 Section 1202(d)(2)(A).
46 Section 1201(d)(2)(B).
47 Section 1202(d)(3).

employees for the purpose of carrying on the Business and it has conducted the Business on a for-profit basis. Accordingly, the Company is engaged in a "trade or business."[48]

Section 1202(e) provides that a "qualified trade or business" is any trade or business other than (i) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, (ii) any banking, insurance, financing, leasing, investing, or similar business, (iii) any farming business (including the business of raising or harvesting trees, (iv) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and (v) any business of operating a hotel, motel, restaurant, or similar business (each a "Disqualified Business").

[8] 80% Assets Test.

Pursuant to Section 1202(e), at least 80 percent (by value) of the corporation's assets must be used in the active conduct of one or more qualified trades or businesses.[49] A corporation will fail to meet the requirements of Section 1202(e) for any period during which more than 10 percent of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries of the corporation.[50] A corporation will be treated as a subsidiary if the parent owns more than 50 percent of the combined voting power of all classes of stock entitled to vote, or more than 50 percent in value of all outstanding stock, of such corporation.[51]

A corporation does not satisfy the active business test if more than 10% of the value of its assets consists of real property not used in the active conduct of a trade or business. Owning, dealing in, and renting real property are not treated as the active conduct of a qualified trade or business. However, the Company has represented that it does not hold any real estate not used in the active conduct of the Business, therefore, we have concluded that the Company should not fail to meet the 80% Asset Test as a result of any ownership of real property.

[9] Eligible Corporation.

To meet the "active business requirements", the issuing corporation must also be an "eligible corporation." An eligible corporation is a domestic corporation that is not (1) a domestic international sales corporation (DISC) or a former DISC, (2) a regulated investment company (RIC), a real estate investment trust (REIT), or a real estate mortgage investment conduit (REMIC), or (3) a cooperative.[52]

[10] Prohibited Redemptions.

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[48] *See* Higgins v. Commissioner 312 U.S. 212 (1941); Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987).

[49] Section 1202(e)(1).

[50] Section 1202(e)(5)(B).

[51] Section 1202(e)(5)(C).

[52] For stock acquired before March 23, 2018, the term "eligible corporation" did not include a corporation for which an election under former Section 936 (relating to the calculation of foreign tax credits of a corporation with activities in U.S. territories) was in effect, or which had a direct or indirect subsidiary for which an election under former Section 936 was in effect.

Stock will not be treated as QSBS if, in one or more purchase during the four-year period beginning on the date two years before the issuance of the relevant stock, the issuing corporation purchases (directly or indirectly) more than a "de minimis" amount of its stock from the taxpayer or from a person "related" to the taxpayer (within the meaning of Sections 267(b) or 707(b) of the Code) (such disqualifying redemption(s), a "Direct Redemption").[53] A redemption of stock will exceed a "de minimis" amount only if the aggregate amount paid for the stock exceeds $10,000 and more than two percent of the stock held by the taxpayer and related persons (within the meaning of Sections 267(b) or 707(b) of the Code) is acquired by the corporation, provided, that (i) the percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons (within the meaning of Sections 267(b) or 707(b) of the Code) immediately before the purchase and (ii) the percentage of stock acquired in multiple purchases is the sum of the percentage determined for each separate purchase.[54]

In addition, stock will not be treated as QSBS if, in one or more purchases during the two year period beginning on the date that that is one year before the relevant issuance of stock (the "Two Year Period," as applicable to a given issuance of stock), the corporation purchases more than a "de minimis" amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding five percent of the aggregate value of all of the issuing corporation's stock as of the beginning of such Two Year Period (such disqualifying redemption(s), a "Significant Redemption").[55] A redemption of stock will exceed a "de minimis" amount only if the aggregate amount paid for the stock exceeds $10,000 and more than two percent of all outstanding stock is purchased, provided, that (i) the percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase and (ii) the percentage of stock acquired in multiple purchases is the sum of the percentage determined for each separate purchase.[56] For purposes of Significant Redemptions, a redemption is disregarded if the stock was acquired by the shareholder in connection with the performance of services as an employee or director, and the redemption from the shareholder is incident to the shareholder's retirement or other bona fide termination of services.[57]

[11] <u>OBBBA Changes to Section 1202</u>.

Prior to the enactment of the OBBBA, taxpayers were required to hold qualified small business stock ("**QSBS**") for a period of at least five years before the exclusion of gain on the disposition of QSBS was available (for QSBS acquired after September 27, 2010). The OBBBA shortens the holding period required before the QSBS exclusion applies for stock acquired after July 4, 2025.

Rather than the "all or nothing" approach taken under current law, where a holder of QSBs must hold it for at least five years or no exclusion applies, the OBBBA changes the QSBS rules to permit some exclusion to be taken if the stock is held for only three or four years before being sold. The new holding period and exclusion ratios for QSBS are as follows:

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53 Section 1202(c)(3)(A); Treasury Regulations Section 1.1202-2(a).
54 Treasury Regulations Section 1.1202-2(a)(2).
55 Section 1202(c)(3)(B); Treasury Regulations Section 1.1202-2(b).
56 Treasury Regulations Section 1.1202-2(b)(2).
57 Treasury Regulations Section 1.1202-2(d).

(i) QSBS held at least three years: 50% of taxable gain.

(ii) QSBS held at least four years: 75% of taxable gain.

(iii) QSBS held for at least 5 years: 100% of taxable gain.

Additionally, the OBBBA increases the exclusion amount for stock acquired after July 4, 2025. Previously, the exclusion amount was limited to the greater of (i) $10 million or (ii) 10 times the shareholder's basis in the stock. The OBBBA increases this to $15 million, and also adds a yearly inflation-based adjustment (rounded to the nearest $10,000) to the $15 million exclusion amount.

Finally, the previous limit on the $50 million "aggregate gross assets" (determined by the adjusted basis of the company's assets) restriction has been increased. Previously, if a company had over $50 million of aggregate gross assets, stock issued by it after the date on which its aggregate gross assets exceeded this amount was not eligible for the QSBS exclusion.

The OBBBA has increased the $50 million limitation to $75 million, and also added a yearly inflation-based adjustment to the amount of the limitation. While this is helpful to corporations hoping to incentivize investment, it is especially helpful for those who operate their business as an entity treated other than as a C corporation for tax purposes. Now, rather than needing to convert earlier in order to be eligible of the QSBS exclusion, such owners of expanding businesses can take advantage of single-level, pass-through taxation longer before converting to a C corporation and being subject to two levels of tax on the company's profits.

2.02. *Purchase and Sale of Assets*

[1] Direct Asset Purchase.

The bulk sale of the target C corporation's assets, including the acquiring person's assuming or taking subject to the liabilities of the target, constitutes a taxable sale of assets for federal income tax purposes. Under the TCJA of 2017, all taxable income of the corporation in the year of sale is reported as taxable income, subject to federal income tax at a 21% rate (plus state income tax). The sale transaction, in general, is effectuated by bill of sale and assignment of intangibles or through a state law merger in a taxable merger (i.e., forward merger or forward triangular merger).[58]

Where the sales proceeds are distributed to the shareholders, there are two levels of taxation.[59] Under the TCJA, the two levels of tax, excluding the 3.8% net investment income tax on dividend income under Section 1411, approximate 36.8% plus applicable corporate and shareholder level income taxes. The dividend distribution will not be absorbed as a non-taxable recovery of stock basis in many instances due to the presence of earnings and profits as may be substantially increased by the earnings and profits generated on the sale where the corporation selling assets remains in existence. The purchaser obtains a cost basis in the acquired assets which will benefit by cost recovery allowances including the 15 year amortization of purchased intangibles under Section 197. In most cases the dividend will constitute a qualified dividend and subject to capital gains rates (and not the ordinary income rate of

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

[59] See Sections 301(c)(1), 301(c)(3).

37%). Where a domestic corporation shareholder owns 20% or more of the target corporation's stock, then a DRD of up to 80% (or in some instances 100%) can be realized.

[2] Direct 2. Asset Purchase Followed by a Complete Liquidation.

The sale of the assets followed by a complete liquidation of the corporation has the same corporate level tax impacts, unless the transaction is recast a Type C reorganization.[60] In general, a liquidating trust is used for holdbacks and indemnification provisions as well as any target liabilities not assumed by the purchaser. The complete liquidation allows the shareholders to obtain a non-taxable basis recovery with respect to shareholders' stock basis.[61] Where a shareholder is a corporation, the same recovery of basis is permitted but gain on liquidation is taxed at the 21%. Where the corporation owns 80% or more of the target corporation's stock, the liquidation distribution to the corporate shareholder is not subject to tax under Section 332 subject to applicable exception.

[3] Section 336(e) Election.

Under operative regulations that were finally promulgated by the Treasury well after the Tax Reform Act of 1986,[62] where a corporation owns 80% or more of the stock of a target corporation under Section 1504(a)(2), and sells or distributes all of its stock in the target corporation within a 12-month disposition period, then an election under Section 336(e) can be made for the target corporation under Reg. §1.336-1(b)(11) to treat the sale of stock as the disposition of all of the assets of the target corporation and no gain or loss will be recognized by the parent corporation on the sale of such stock.[63] From a technical standpoint, the target subsidiary is treated as selling its assets, repurchasing those assets, and liquidating into its parent.[64] The Section 336(e) election may be made by domestic C corporations, members of a consolidated group, or S corporation shareholders with respect to a "qualified stock disposition" of at least 80% of the stock of its domestic subsidiary;[65] the election is made pursuant to a written, binding agreement entered into by seller and target or all S corporation shareholders on or before the due date of the federal income tax return for the taxable year that includes the disposition date.[66] A

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[60] Also note Kimbell-Diamond Milling v. Comm'r, 14 TC 74 (1950), aff'd per curium, 187 F.2d 718 (5th Cir. 1951), cert. den., 342 US 927 (1951); Rev. Rul. 2001-46, 2001-42 IRB 321; see Blanchard, "Reflections on Rev. Rul. 2001-46 and the Continued Vitality of Kimbell-Diamond," 93 Tax Notes 1875 (Dec. 31, 2001); Reg. § 1.338(h)(10)-1(c)(2) (2006), which modified Rev. Rul. 2001-46, supra, by allowing a Section 338(h)(10) election if the first step stock acquisition is a stand-alone qualified stock purchase.

[61] Brod, *Section 337 Liquidating Trusts Revisited — The IRS Revises Rev. Proc. 79-1*, 59 TAXES 286 (1981); Del Negro, *Liquidating Trusts — Their Nature and Uses*, 38 N.Y.U. Ann. Inst. on Fed. Tax. ch. 23 (1980). A liquidating trust must be treated as a trust for tax purposes and not be viewed as an association taxable as a corporation. See Reg. §301.7701-4(d); Rev. Proc. 82-58, 1982-2 CB 847 (guidelines for rulings on liquidating trust status). See National Metropolitan Bank v. US, 345 F2d 823 (Ct. Cl. 1965) (bank in liquidation held to continue in existence for tax return purposes); Anbaco-Emig Corp. v. CIR, 49 TC 100 (1967) (acq.) (no de facto dissolution despite sale of operating assets and two-year period of inactivity before starting new business).

[62] The regulations to Section 336(e) were published in the Federal Register on May 10, 2013 (TD9619) and amended on January 18, 2017 (TD 9811).

[63] See Reg. §1.338-2(h)(§336(e) election for target subsidiary.

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

[65] Reg. §1.336-1(b)(6).

[66] Reg. §1.336-2(h).

"qualified stock disposition" (QSD) is defined as a taxable sale or distribution of the target's stock to an unrelated purchaser.[67] Section 336(e) does not apply where the seller or the target is an S corporation or a foreign corporation or to transactions between "related persons". However, under Section 336(e), a deemed-asset-sale election may be made where the shareholders of 80% or more of the stock of an S corporation sell their stock within a one year period. Under Section 336(e), S corporation stock sales by one group of individuals to another, with S corporation status continuing may be deemed asset sales. The election is a joint election. Unlike Section 338(h)(10) or Section 336(g), the Section 336(e) election can be made whether the purchaser is not a corporation. The regulations generally adhere to the provisions in the Section 338 regulations in determining aggregate grossed-up basis (AGUB) and aggregate deemed asset disposition price (ADADP).[68]

2.03. *Stock Purchases Treated as Asset Acquisitions*

[1] Straight Stock Purchase by Purchasing Corporation Without Section 338 Election.

Where a purchasing corporation acquires 80% or all of the stock of a target C corporation, the acquired subsidiary retains its tax history and the tax basis in its assets. Application to S corporation target corporations is discussed below in detail. Therefore, where a Section 338 election is not made and the target corporation is subsequently liquidated into its parent corporation under Section 332, the tax basis in the target's assets and tax attributes, including carryovers and earnings and profits, will carry over to the successor corporation under Section 381. The liquidation is described further in Sections 337 and 332.[69] An acquisition of more than 50%, directly or indirectly, of a target corporation's stock over a test period of two years, results in an ownership change under Section 382 and with it a reduction in the loss and credit carryforwards of the target C corporation. With the net operating loss carryover rules now limited to 80% of the available NOLs, a Section 382 change of ownership results in an additional reduction in value of the NOLs. The change in the NOL rules may further result in the making of Section 338 elections of target corporations in order to fully utilize available net operating losses. However, where the carryover limitation under the TCJA is in effect, gain will still result since the NOLs cannot reduce gain on a dollar-for-dollar basis, only 80%. Based on a current corporate tax rate of 21%, equal amounts of gain from a deemed sale and a NOL carryforward still results in a corporate income tax of 4.2%. Unless subsequent regulations or other guidance provides rules to the contrary, the selling corporation in a Section 338(h)(10) or Section 336(e) transaction, or purchaser in a Section 338(g) election context, needs to factor into the equation the lack of full absorption of NOLs even if a limitation on the use of NOLs or built-in losses of the target under Section 382 is avoided.

[2] Qualified Stock Purchase (QSP).

A QSP involves the purchase of 80% control of the acquired corporation, within the twelve-month acquisition period, by another corporation. The qualifying acquisition of stock may be in

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

[68] Reg. §1.336-4.

[69] In certain instances the acquiring corporation will cause the acquisition to be effectuated by a foreign subsidiary. See August, "First Circuit Court of Appeals Affirms Tax Court In Timberland (TBL Licensing LLC): Full Inclusion Of Gain Required Where "Deceased" US Target Corporation Constructive Transfers Valuable Intangibles As Part Of An Outbound Type F Reorganization", Cross-Borders Column, Corporate Taxation (2023); WESTLAW.

either a single transaction or a series of transactions. For this purpose, "purchase" is defined to include any acquisition of stock except: (i) where stock basis to the purchaser is determined by reference (in whole or in part) to the adjusted asset basis of the transferor; (ii) a Section 351 acquisition type transaction; or (iii) an acquisition from a person, the ownership of whose stock would be attributed to the purchaser Section 318 exception under the option attribution rule in Section 318(a)(4). Note the availability of Section 338 to an indirect stock acquisition such as a reverse subsidiary cash merger.[70] The existence of the newly organized subsidiary that is merged into the target corporation is disregarded. Where the target corporation is liquidated, the step transaction doctrine is turned off and the transaction is treated as an asset purchase. Therefore, whether such a transaction is treated as an asset purchase is dependent on whether a Section 338 election is made or deemed made.

[3] Section 338(g): A "Plain Vanilla Section 338 Acquisition".

Under Section 338, a purchasing corporation can elect to treat the target corporation: (i) as having sold all of its assets in a single transaction on the date of the qualified stock purchase (i.e., the purchase of at least 80% of the target corporation's stock in one or more transactions within a twelve-month acquisition period) for the fair market value of the assets; and (ii) as if the target corporation were a new corporation purchasing the assets for a similar amount on the following day.[71] The effect of this deemed sale ordinarily is that the target's assets acquire a new, stepped-up basis equal to their fair market value or from a technical standpoint, the adjusted gross-up basis (AGUB).[72] Assuming a qualified purchase of all of the target's stock, this value would normally be identical to the amount paid by the purchasing corporation for the stock plus the target corporation's liabilities. As discussed below, an S corporation can be a "purchasing corporation" for purposes of Section 338(g).

[a] *Time of Election.*

Purchasing corporation must make the Section 338(g) election within 15th day of 9th month (8½ months) beginning after the month in which the "acquisition date" occurs. For this purpose, the acquisition date is the first date within the 12 month (or less) acquisition period during which the required 80% QSP occurs. The election, once made, is irrevocable.[73]

[b] *Interim Sale of Acquired Target Stock.*

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[70] See Rev. Rul. 90-95, 1990-2 C.B. 67 (reverse cash merger treated as QSP under Section 338 by application of the step transaction doctrine). See Rev. Rul. 78-250, 1978-1 CB 83 (reverse cash merger treated as § 302 redemption where target supplied cash); cf. Rev. Rul. 73-427, 1973-2 CB 301 (reverse subsidiary merger flunked tax-free failed reorganization status treated as taxable purchase of target stock); Reg. § 1.368-1(e)(1)(ii).

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

[72] Reg. §1.338-5.

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

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

[c] *Target Corporation's Ownership of One or More Subsidiary Corporations.*

Where the target owns 80% or more of a subsidiary and provided a Section 338 election is made for the target, the purchasing corporation is deemed to have acquired the subsidiary's stock by purchase on the acquisition date of the target's stock, the analytical framework under Section 338 is that the subsidiary's stock was, along with the target corporation's other assets, sold and repurchased in the hypothetical sale and repurchase of the target corporation's other assets. The election for the target's ownership in each subsidiary corporation results in ignoring the deemed stock sale gain.[74]

[d] *Deemed Asset Sales of Target Affiliates.*

As mentioned, gain or loss, in general, under a deemed-asset sale of the target subsidiary's assets matrix under Section 338, is not recognized on a target's deemed sale of stock to another corporation where: (i) the target subsidiary owns 80% or more (by voting and by value) of the target affiliate; (ii) a Section 338 election is also made for the target affiliate; and (iii) the deemed asset sales of target and target affiliate are reported on a consolidated return. Gain or loss is usually not recognized on a target's deemed sale of stock of another corporation (a target affiliate) if (1) the target directly owns at least 80 percent (by vote and by value) of the target affiliate's stock, (2) a Section 338 election is also made for the target affiliate, and (3) the deemed asset sales of target and target affiliate are reported on a consolidated return.[75] When Section 338 elections are made for all corporations in a chain of corporations, of which the target is the common parent, each corporation recognizes gain or loss only on deemed sales of assets other than stock of all other members of the group. For example, if P purchases all of the stock of T, which owns all of the stock of T1, and makes Section 338 elections for both T and T1, T recognizes no gain or loss on its deemed sale of T1 stock, but T1 recognizes gain or loss in a deemed sale of its assets. In contrast, if P makes a Section 338 election for T but not T1, T recognizes gain or loss on its deemed sale of T1 stock, but there is no deemed sale of T1's assets.[76]

[e] *Domestic Corporation's Ownership of Foreign Target Corporation.*

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

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

[76] As an aside it should be noted that where the target group has filed a consolidated return for prior years, each member of the group is severally liable for the consolidated tax, including deficiencies. Reg. § 1.1502-6(a); Mississippi River & Bonne Terre Ry., 39 BTA 995 (1939); Turnbull, Inc. v. Comm'r, 373 F2d 91 (5th Cir.), cert. denied, 389 US 842 (1967). Therefore, if a subsidiary is sold, the possibility that the subsidiary may be liable for more than its share of the consolidated tax must be the subject of contractual negotiation and resolution.

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

[f] *Example Involving Section 338 and Foreign Target Corporation.*

X (US) and Y(US) own 60% and 40 percent of a foreign corporation, FC. X sells its FC stock to B, a US corporation[77] on 12/31/2022, the last day FC's tax year, and Y sells its FC stock to B on 6/30/2023. X and Y are U.S. shareholders under Section 951(b) of FC on the last day of 2022 and must include their ratable shares of FC's subpart F income for 2022. If B makes a Section 338 election for FC, FC's tax year ends on 6/30/2023, when its shareholders are Y and B, and must report their pro rata share of FC's subpart F income for that short period and including subpart F income generated (and recognized) from the income recognized on the Section 338 sale. Under Section 1248, gains recognized by X and Y on selling shares of FC are dividends to the extent of the earnings and profits attributable to the stock sold. Were X and Y non-U.S. persons, and therefore not described under Section 951(b), FC becomes a CFC only upon B's purchase of 60% of FC on 12/31/2022. B is also taxed on FC's subpart income on 6/30/2023 including subpart F income resulting from the Section 338 sale. Under the TCJA, the gain may not be treated as subpart F income to the extent that the income is described as GILTI income under new Section 951A unless specifically excluded from the definition of "tested income" (and "tested loss") in accordance with Section 951A(c)(2)(A)(i).[78]

[g] *Acquisition Period Requirement.*

The QSP requires that the 80% required ownership must be acquired, by purchase, within a 12 month period. This means that if a corporation purchases 21% of the target's stock in a single transaction and does not purchase the balance of the stock to meet the QSP threshold within the requisite period of 12 months, then as to the 21% stock purchase, Section 338 is unavailable. In such instance, the purchasing corporation must in fact cause the target corporation to issue more shares so that it may meet the QSP requirement with respect to a subsequent purchase or purchases of target corporation stock or cause the redemption of stock from a 21% of the target's existing shareholders.[79] In other words, where 20 percent or less of the stock is owned before the twelve-month period begins, such previously acquired stock is not taken into account and a qualifying purchase can occur only if 80 percent of the stock is later purchased in a twelve-month period. Under Reg. §1.338-8(j)(5), the 12 month acquisition period is extended where, pursuant to an "arrangement", a purchasing corporation purchased 80% by vote and value of the stock of a target corporation over a period that exceeds 12 months.

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[77] See Regs. §§1.338-4(b), 1.338-4T(h)(3).

[78] As enacted into law in 2017 under the TCJA, each person who is a US shareholder per Section 951(b) (as revised) of a CFC is required to include in gross income such shareholder's global intangible low-taxed income (GILTI) for such taxable year. GILTI, as to each US shareholder, is the excess (if any) of—(i) such shareholder's net CFC tested income for such taxable year, over (ii) such shareholder's net deemed tangible income return for such taxable year. The GILTI tax is mitigated, in the case of a U.S. corporate shareholder of a CFC, by the 50% deduction against Section 951A in Section 250 plus the ability to claim the deemed-paid foreign tax credit under Section 960, which is modified by the Act to equal 80% of foreign taxes paid or accrued by the foreign corporation with respect to the income subject to tax under Section 951A.

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

[h] *Purchasing Corporation.*

Only corporations, domestic and foreign, are eligible to make a Section 338 election.[80] For this purpose, stock acquisitions by members of an affiliated group are treated as made by a single corporation. General federal income tax principles apply in determining whether the purchaser is a "corporation". Therefore, an LLC which elects under the check-the-box regulations, to be taxed as an "association" taxable as a corporation, should qualify as a purchasing corporation. Similarly, a purchasing corporation which forms a single member LLC to serve as the acquisition entity, the defective entity result should leave the purchasing corporation eligible to make a Section 338 election. Furthermore, where a corporation forms a new acquisition subsidiary, NewCo, to acquire the target corporation under a reverse subsidiary cash merger, the parent is treated as the true purchaser of target's stock and NewCo is disregarded. On the other hand, a pre-existing corporation should be treated as a purchasing corporation where it engages in a downstream merger into the target corporation after the QSP.[81]

[i] *Section 338 Election Impacts.*

The "old target" corporation is treated as having sold all of its assets at the close of the "acquisition date" at FMV (aggregate deemed sale price (ADSP)) in a single transaction to a "new" and separate "new target" corporation that is treated as having purchased all of the assets as of the day after the acquisition date. Old target, under a straight Section 338(g) election, is treated as owned by the "purchasing corporation on the day of the deemed sale and therefore will economically be responsible for payment of tax on the net gain on the deemed asset sale and liquidation after reduction by available NOLs.[82] The "new target" obtains a new deemed cost basis in its assets on as of the day after the "acquisition date". The tax attributes and history of the "old target" corporation are eliminated as of the day after the acquisition date. The purchasing corporation's basis in the target stock is still the same as the purchase price as ma be further adjusted under the regulations. Note, however, the disappearing basis problem caused by an actual or deemed liquidation. The taxable year of "old target" closes at the end of the acquisition date. Where the purchasing corporation is a part of a consolidated group, including the parent corporation, "old target" will be part of the consolidated return of the purchasing corporation. Therefore, the old target becomes disaffiliated from any group in which it was a member immediately before the deemed sale and its final income tax return is a separate return.[83] From a state law standpoint "old target" is acquired unchanged so that any existing liabilities, contract rights, claims made by or against, etc. carry over despite the deemed asset sale.

[j] *Target Corporation's Deemed Sale Price of Target's Assets.*

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[80] Section 338(d)(3); Regs. §1.338-3(b)(1), -2(e) (as to "foreign purchasing corporations"). See also Section 1371(a)(1).

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

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

[83] In general, "new target" continues to use the same employer identification number. Reg. §1.338-1(b)(3)(iii); 1.338-10(a)(2).

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

[k] *ADSP*.

ADSP is the sum of: (i) the grossed-up amount realized on the sale to the purchasing corporation of the QSP shares plus (ii) old target liabilities assumed or taken subject to.[84] ADSP is initially determined on the day after the acquisition date, and redetermined in such amount as an increase of the purchase price is required under general principles of tax law, for example, subsequent adjustments to the purchase price.[85] The gross up amount realized is reduced by selling costs incurred by the selling shareholders. Target liabilities for this purpose includes liability for tax on gain recognized on the deemed sale.[86] In the new 21% corporate income tax world under the TCJA, the increase to ADSP is reduced by 40% of the tax amount that may have been computed prior to the TCJA of 2017 for regular corporate income tax purposes.

> Example. In Year 1, T, a manufacturer, purchases a customized delivery truck from X with purchase money indebtedness having a stated principal amount of $100,000. P acquires all of the stock of T in Year 3 for $700,000 and makes a section 338 election for T. Assume T has no liabilities other than its purchase money indebtedness to X. In Year 4, when T is neither insolvent nor in a title 11 case, T and X agree to reduce the amount of the purchase money indebtedness to $80,000. Assume further that the reduction would be a purchase price reduction under section 108(e)(5). T and X's agreement to reduce the amount of the purchase money indebtedness would not, under general principles of tax law that would apply if the deemed asset sale had actually occurred, change the amount of liabilities of old target taken into account in determining its amount realized. Accordingly, ADSP is not redetermined at the time of the reduction. See §1.338-5(b)(2)(iii) Example 1 for the effect on AGUB. See Reg. §1.338-4(b), Example.

[l] *AGUB*.

AGUB is the sum of the following: (i) the "gross-up basis" of the purchaser(s) for "recently disposed of stock"; (ii) the purchasers' bases for nonrecently disposed of stock; and (iii) by the corporate target's liabilities.[87] The liabilities of the deemed "new" target re the liabilities of target as of the beginning of the day after the acquisition date (but see Reg. §1.338-1(d) (regarding certain transactions on the acquisition date)). For AGUB purposes, a liability must be a liability of target that is properly taken into account in basis under general principles of tax law if new target had acquired its assets from an unrelated person for consideration that included discharge of the liabilities of that

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[84] Regs. §§1.338-4(b)(1), -4(d)(1). See Schler, "Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10), and More," 43 Tax L. Rev. 605 (1988); Keyes, "The Treatment of Liabilities in Taxable Asset Acquisitions," 50 NYU Inst. on Fed. Tax'n ch. 21 (1992).

[85] Reg. §1.338-4(b)(2).

[86] Reg. §1.338-4(e).

[87] Reg. §1.338-5(c).

unrelated person. It is important to note that liabilities for this purpose includes liabilities for the tax consequences resulting from the deemed sale.[88] For relevant examples see Reg. §1.338-5(g).

[4] Section 338(h)(10).

[a] *In General.*

A Section 338(h)(10) election may be made for a domestic "target" corporation that is: (i) not the parent corporation of an affiliated group of corporations filing a consolidated return; (ii) a member (but not the parent) corporation of an affiliated group which is not currently filing a consolidated return; or (iii) an S corporation. An election may be made under which a target corporation that was a member of the selling consolidated group before the transaction is acquired in a qualified stock acquisition. However, under regulations, the election can also be made for targets that are not members of a selling consolidated group if the stock of the target is sold by a "selling affiliate" or by S corporation shareholders.[89] Where the Section 338(h)(10) election is properly consented to and timely filed, the "old" target corporation is deemed to have sold all of its assets to "new" target corporation and then immediately distributed the sales proceeds to the shareholders of the "old" target corporation which corporation then ceases to exist in a deemed Section 332 liquidation of "old" target into "new" target. This election promotes the avoidance of one level of tax, particularly in a consolidated group context. The Section 338(h)(10) election must be made jointly by the shareholders of "old" target and the purchasing corporation and must be made not later than the 15th day of the 9th month beginning after the month which includes the acquisition date. Once made, the Section 338(h)(10) election is irrevocable. A qualified Section 338(h)(10) election for a target corporation results in a deemed Section 338 election having also been made for the target. Where the (h)(10) election is invalid, the deemed Section 338 election for the target is also not valid per Reg. §1.338(h)(10)-1(c)(5) thereby avoiding a draconian tax impact under Section 338(g) that was not intended.

[b] *Section 338(h)(10) Election Made By Domestic Corporation.*

Unlike a Section 338(g) election, the deemed asset sale under Section 338(h)(10) puts resulting gain recognition derived from the deemed asset sale to the seller's consolidated return, as if the target corporation had actually sold its assets and liquidated upstream to the corporate parent under Section 332. In general, a Section 338(g) election will not be beneficial with respect to a target corporation that is a member of a consolidated group unless the target corporation has substantial net operating losses or unused tax credits since the target company must recognize the entire gain realized on the deemed sale. On the other hand, it may prove beneficial for the selling corporation to make an alternate Section 338(h)(10) election whereby the selling corporation of the target's stock recognizes no gain or loss and instead the target corporation is deemed to have sold its assets at fair market value and then liquidated under Section 332. The Section 338(h)(10) election for S corporation sellers was added by

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[88] Reg. §1.338-5(f)(adjustments by the IRS). This regulation provides that in "connection with the examination of a return, the Commissioner may increase (or decrease) AGUB under the authority of section 338(b)(2) and allocate such amounts to target's assets under the authority of section 338(b)(5) so that AGUB and the basis of target's assets properly reflect the cost to the purchasing corporation of its interest in target's assets. Such items may include distributions from target to the purchasing corporation, capital contributions from the purchasing corporation to target during the 12-month acquisition period, or acquisitions of target stock by the purchasing corporation after the acquisition date from minority shareholders."

[89] Reg. §1.338(h)(10)-1(c)(1).

regulations.[90] The election must be made jointly by both the purchasing corporation and the seller corporation as the seller is liable for the resulting tax liability.[91] The regulations provide that where a Section 338(h)(10) election is made for the target corporation the election is deemed made for the target corporation. On the other hand, if a Section 338(h)(10) election for the target corporation is not valid, the regulations provide that the Section 338 election for the target corporation is also not valid.

[c] *Use by Affiliated Groups.*

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

[d] *Target Corporation as Parent/Subsidiary of Consolidated Group.*

See Form 8023 for Elections under Section 338. Where the target is the parent of a consolidated group, the Form 8883 (asset allocation statement under Section 338) is filed with the group's final consolidated return ending on the acquisition date. Where the old target is a subsidiary of the selling group the Form 8883 must be attached to the group's consolidate return that includes the sale transaction. The same form must also be filed by new target and if new target becomes a member of a consolidated group the form must be attached to the consolidated return that includes the day after the acquisition. When the selling shareholder or shareholders are members of an affiliated group the deemed Section 332 liquidation under the Section 338(h)(10) construct will provide nonrecognition treatment on the deemed liquidation only the target subsidiary will recognize gain or loss on the deemed asset sale.

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

The regulations provide that regardless of the rule set forth in Reg. §1.338-1(c)(1)(i), a Section 338(h)(10) election may be made where the purchase of target stock, viewed independently, constitutes a QSP and, after the stock acquisition, the target corporation merges or liquidates into the purchasing corporation (or another member of the affiliated group that includes the purchasing corporation), regardless the application of the step transaction doctrine or regardless of whether the acquisition of the target corporation stock and subsequent merger or liquidation of the target corporation qualifies as a reorganization under Section 368(a). If a Section 338(h)(10) election is made in a case where the acquisition of the purchasing corporation's stock followed by a merger or liquidation of the target corporation into a purchasing corporation is a reorganization under Section 368(a), it is still treated as a QSP.

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

[91] Reg. §1.338(h)(10)-1(c)(4).

[f] *Consequences of Section 338(h)(10) Election.*

As provided in Reg. §1.338(h)(10)-1(d): (i) the purchasing corporation is deemed (automatically) to have made a gain recognition election for its nonrecently purchased target corporation stock, if any, and includes a taxable deemed sale by the purchasing corporation on the acquisition date of any nonrecently purchased target stock;[92] (ii) the AGUB of "New Target" for its assets is determined under Reg. §1.338-5 and allocated among the acquisition date assets as per the regulations;[93] and (iii) the target corporation remains liable for the tax liabilities of the members of any consolidated group that are attributable to tax year in which those corporation and "old target" corporation joined in the same consolidated return.[94] As to the "old target" corporation, it is treated as transferring all of its assets to an unrelated person in exchange for consideration including the discharge of its liabilities in a single transaction at the close of the acquisition date (but prior to the deemed liquidation). Such gain or loss is included in the consolidated return which includes the acquisition date. Consolidated NOLs and other tax attributes of the selling corporation group (including the target corporation's NOLs) can be used to offset gain on the deemed asset sale.[95] The deemed Section 332 liquidation implicates the deferred intercompany transaction rules of Reg. 1.1502-13. Where the target corporation is the "selling member" the selling consolidated groups takes over the deferred gain or loss with respect to intercompany transactions.[96]

[g] *Section 338(h)(10) Election By Shareholders of Target S Corporation.*

The shareholders of an S corporation may elect, along with the consent of the purchasing corporation, to treat the sale of 80% or more of the S corporation (target) under Section 338(h)(10) as the sale of assets of the target corporation and deemed liquidation of the S corporation.[97] The target S corporation's S election ends (unless the purchasing corporation is an S corporation) as is the case with a straight or regular Section 338(g) transaction.[98] Under the regulations to Section 338(h)(10) the shareholders report the gain or loss on an asset by asset basis and make corresponding adjustments to their outside stock basis. The built-in gains tax can apply if the deemed asset sale occurs with the 5 year recognition period. The deemed liquidation is then tested for its tax effect after the basis adjustments for income or loss are made by the shareholders. The liquidation gain or loss is determined in accordance with Section 331. The "new" target corporation is treated as a new corporation with an AGUB asset base. Where there are shareholders who retain their shares of S stock, they are also treated as purchasing stock of the "new" corporation for FMV on that date.[99] The deemed asset sale overrides the reporting of gain or loss on the sale of stock. The installment sales rules can apply at both the corporate and shareholder levels.[100]

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92 Reg. §1.338-5(d).

93 Regs. §§1.338-6, 1.338-7.

94 Reg. §1.1502-6.

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

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

97 Reg. §1.338(h)(10)-1(c). For the definition of "S corporation target," see Reg. §1.338(h)(10)-1(b)(4). As to the term "S corporation shareholders," see Reg. §1.338(h)(10)-1(b)(5).

98 §1361(b)(1)(B).

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

100 See Reg. §1.338(h)(10)-1(d)(8). See Sections 453(h), 453B(h). See also Reg. §1.338(h)(10)-1(e), Ex. 10. PLR 201530001 (4/22/2015) (permitting late election out of installment reporting Section 453(d)). Where an S

[h] *Single Purchase Transaction.*

The QSP of the S corporation's stock must take place in one transaction or simultaneous transactions. This is because if the QSP was staggered, the first stock purchase to the acquiring corporation may end the target corporation's S election making the S corporation provision in the regulations to Section 338(h)(10) inapplicable. Under the (h)(10) election, a deemed sale of assets occurs causing the target S corporation's S election to terminate in the same manner if a regular or straight Section 338(g) election were made. The regulations to Section 338(h)(10) provide that the final S corporation return includes any gain or loss resulting from the deemed sale, as the target corporation's S status continues through the end of the acquisition date as does the status of any QSUB of the target S corporation making the election.[101] It is critical to note that the resulting gain or loss passes through to the shareholders and increases or decreases their stock basis. The regulations then treat the shareholders as receiving the sale proceeds in a liquidation under Section 331. As the acquired corporation's S status ends, its books are closed. Then the deemed new purchasing corporation comes into play. Where any shareholders of the target corporation retain their stock after the disposition date, they are treated as purchasing stock in the "new" corporation for fair market value on that date.[102]

[i] *Characterization Changes Possible.*

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

[j] *Minority Shareholder Problems.*

Since the Section 338(h)(10) deemed asset sale of a target S corporation requires that K-1s reporting the full amount of the gain or loss to all shareholders is required, the minority shareholders holding onto their shares are still subject to federal income tax on the deemed sale income pass through under Section 1366. In some cases the minority shareholder or group forming the less than 20% of the shareholders of the S corporation target may demand that a premium be paid to sell their shares. Does this constitute a second class of stock if the majority shareholder group (the 80% control group) agrees to make such concession?

[5] Section 336(e).

Under the Tax Reform Act of 1986, which of course is well known for its repeal of the General Utilities doctrine, Section enacted Section 336(e) which authorized the Treasury to issue regulations under which an election may be made to treat the sale, exchange, or distribution of at l80% or more of the voting and value of the stock of a target corporation as constituting the sale of all its underlying assets. Proposed Regulations under Section 338(e) were issued in 2008 but were not finalized

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corporation target holds assets, such as inventory or marketable securities, for which installment reporting is unavailable, the deemed sale of the assets apparently triggers immediate recognition of gain, which passes through to the shareholders.

[101] Reg. 1.338(h)(10)-1(d)(3)(i).

[102] Reg. § 1.338(h)(10)-1(d)(5)(ii). See also Reg. § 1.338(h)(10)-1(e), Exs. 6, 10.

until 2013.[103] Section 336(e) was intended to mimic the results under Section 338(h)(1) in an effort to eliminate one level of tax and without requiring the purchaser to be a "corporation".

[a] *Qualified Stock Disposition ("QSD").*

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

[b] *Greater Access to Deemed Sale Treatment of Subsidiary Assets.*

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

[c] *Limited to Domestic Corporation Targets.*

Like Section 338(h)(10), target corporations eligible for a Section 336(e) election include S corporations and domestic corporations that are members of a consolidated group or that are 80% owned by another domestic corporation. A QSD follows the QSP with regard to the purchase of 80% or more of the voting and value of the target corporation's stock.[104]

[d] *Impact and Consequences of Section 336(e).*

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

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

[104] Harvey, Harris & Kugler, "Deemed Asset Sales and S Corporations," 141 Tax Notes 1057 (2013). Similar issues arise when the target corporation in a "rolling" or "creeping" disposition covered by IRC § 336(e) is a member of a consolidated group. See Geracimos & Holtje, "Treating a Stock Sale as an Asset Sale for Tax Purposes: Old and New Tools," 41 Corp. Tax'n 3, 16–18 (Mar./Apr. 2014); Schnee & Seago, "Maintaining Single Taxation: Sec. 336(e) and S Corporations," 45 Tax Adviser 178 (Mar. 2014).

stock must exercise due diligence on whether the seller intends to make the Section 336(e) election as to the QSD.

[e] *Two Models Potentially Involved.*

Section 336(e) regulations issued in 2013, which was a long time after the authorizing statute was enacted as part of the Tax Reform Act of 1986, to allow a corporation owning 80% or more of the vote and value of the stock of a subsidiary to treat an otherwise taxable distribution for example a distribution of subsidiary stock under Section 311, as the disposition of the subsidiary's assets and thereby elect that it can ignore any gain or loss realized by it on the disposition of the controlled subsidiary's stock.[105] The "sale to self" model with respect to Section 355(d)(2) and Section 355(e)(2) transactions. There is also the basic or general Section 338(h)(10) model. The rules under this area are complex and are not set forth in detail in this outline.[106]

## III. APPLICATION OF SUBCHAPTER S TO SUBCHAPTER C

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

### 3.01. *Background of Section 1371(a)(1) : Subchapter S Revision Act of 1982*[107]

Section 1371(a)(1), which was enacted with the SSRA,[108] provides that except as otherwise provided in the Code and except to the extent inconsistent with the treatment of an S corporation as a flow-through entity for federal income tax purposes, the provisions of Subchapter C will apply to an S corporation and its shareholders. Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge with an S corporation tax-free if all other statutory and non-statutory requirements are satisfied. Furthermore, the Service had recognized both prior and after SSRA that an S corporation may be part of a divisive or non-divisive corporate division under Section 368(a)(1)(D) or Section 355 despite the presence of a subsidiary relationship, at least a momentary one.[109] For example, a distribution of AAA under Section 1368(c)(1)

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[105] See "Report on Section 336(e) by the New York State Bar Association Tax Section Committee on Reorganizations," 55 Tax Notes 539 (Apr. 27, 1992).

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

[107] *P.L*. 97-354.

[108] Prior to SSRA this topic was covered by regulation.

[109] See former Reg. §1.1372-1(c).

effectively overrides Section 301(c)(1). A third and more controversial rule, which serves as a corollary to the "unless otherwise inconsistent" integration principle of Section 1371(a)(2), was contained in Section 1371(a)(2) prior to 1996. This subparagraph provides that where an S corporation owns stock in another corporation, then, with respect to its capacity as a shareholder of such corporation, it is treated as an "individual" for purposes of Subchapter C. The purpose of this rule was to prevent an S corporation from qualifying as a corporation for the dividends received deduction. Thus, for purposes of Section 301, an S corporation shareholder is an "individual." The legislative history unfortunately was silent as to all other applications of Subchapter C where an S corporation is an actor in its shareholder capacity. In 1988, the Internal Revenue Service announced its position that Section 1371(a)(2) is to be applied literally as to liquidations. Thus, the Service took the position that a C corporation may not be liquidated under Sections 337/332 upstream into an S corporation.[110] For purposes of determining whether a corporation remained a small business corporation, transitory ownership of stock in a subsidiary (i.e., stock meeting the Section 1504(a) tests) could be disregarded. In Rev. Rul. 72-320,[111] the Service ruled that momentary ownership of all of the stock in another corporation acquired in connection with a divisive reorganization under Section 368(a)(1)(D) did not terminate the S election of the transferor corporation. The ruling specifically notes that the S corporation never contemplated more than "momentary" control of the newly formed spun-off corporation. In Rev. Rul. 73-496,[112] the Service disregarded a 30-day period during which an S corporation controlled a subsidiary prior to the liquidation of the subsidiary under former Section 334(b)(2). In Haley Bros. Construction Corp. v. Comm'r[113], the Tax Court strongly stated in dictum that the Service's 30-day rule was inconsistent with the statute. The Court expressly reserved its opinion on whether "momentary" ownership would terminate an S election. Despite Haley Bros., the Service, relying on both Rev. Rul. 72-320 and Rev. Rul. 73-496, continued to issue rulings that ignored transitory stock ownership.[114] In 1992, the IRS reversed its position, stating that the prior ruling prohibiting the application of Sections 337 and 332 to the liquidation of a subsidiary of an S corporation, was incorrect.[115]

### 3.02. *Small Business Jobs Protection Act of 1996*[116]

The Small Business Jobs Protection Act of 1996 (the "SBJPA") repealed Section 1371(a)(2) which treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the provision clarifies that the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules, including the provisions of Sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under Section 1374 upon a subsequent disposition. An S corporation also will be eligible to make a Section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses. The repeal of former Section 1371(a)(2) does not disturb the general rule under Section 1363(b), that an S corporation computes its taxable income as an "individual." For example,

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110 See PLR 8818049 (2/10/88).

111 1972-1 C.B. 270.

112 1973-2 C.B. 313.

113 87 T.C. 498 (1986).

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

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

116 *P.L*. 104-188.

it does not allow an S corporation, or its shareholders, to claim a dividends received deduction under Section 246 with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers. Section 1059 requires a corporate shareholder to reduce basis in its stock of another corporation to the extent of any nontaxed portion of an "extraordinary dividend," i.e., a dividend equaling or exceeding a prescribed "threshold percentage" (5% for preferred stock and 10% for other stock) of the underlying stock basis, unless the stock was held for more than 2 years before the "dividend announcement date" or satisfies certain other conditions.[117] Since an S corporation receiving a dividend distribution from a C corporation is not entitled to a dividends received deduction, it generally will fall outside of the scope of Section 1059.

## IV. PRE-CLOSING ELIGIBILITY REQUIREMENTS FOR THE TARGET S CORPORATION

### 4.01. *In General*

Since its enactment in 1958, the electing small business corporation has been limited by entity and owner limitations that have gradually been liberalized over time. Under current law, Section 1361(b)(1) provides that an S corporation is: (i) a domestic corporation; (ii) which does not have more than 100 shareholders; (iii) does not have a shareholder who is not an individual(other than an estate, certain trusts or charitable or tax-exempt organizations); (iv) does not have a nonresident alien as a shareholder;[118] (v) does not have more than one class of stock which is issued and outstanding; and (vi) is not otherwise an ineligible corporation. Accordingly, an entity taxable as a partnership cannot own stock in an S corporation. A regular or C corporation is not permitted to own stock in an S corporation. These limitations not only affect the organization of an S corporation but will greatly impact the structure of the acquisition of or by an S corporation.

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

Where a Section 338(h)(10) election is made, the target corporation recognizes gain or loss as though it sold its assets on the acquisition date, but target shareholders generally recognize no gain or loss on selling target stock to the purchasing corporation as a result of the basis adjustment arising from the pass through of the corporate level gain.[119] The deemed asset sale gives the buyer a cost basis in the assets of the target, subject to depreciation and amortization. In the event the S corporation has a C corporation history, the deemed sale of assets may trigger recognition of built-in gain and the imposition of the corporate level built-in gain tax imposed by Section 1374. Therefore, the history of the S election and the eligibility of the target for S status will need to be scrutinized carefully to ensure both

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[117] *See* Sections 1059(c), 1059(e)(per se extraordinary list).

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

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

the eligibility of the target for the Section 338(h)(10) election and avoidance of liability for any built-in gains tax.

4.02. *S Corporation Shareholder Limitations*

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

(1) have more than 100 shareholders,

(2) have a shareholder who is not an individual, an estate, an eligible trust described in Section 1361(c)(2), or certain exempt organizations,

(3) have a nonresident alien as a shareholder, or

(4) have more than one class of stock.

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

(1) trusts treated as owned 100 percent by an individual who is a citizen or resident of the United States under Sections 673 and 678 (grantor and deemed owner trusts),

(2) qualified subchapter S trusts (QSSTs) that meet the requirements of Section 1361(d),

(3) electing small business trusts (ESBTs) that meet the requirements of Section 1361(e),

(4) grantor trusts for a two year period after the death of the grantor,

(a) testamentary trusts for a two year period after stock is transferred to it under a will,

(b) voting trusts, and

(c) an IRA (or ROTH IRA) with respect to stock in a bank or depository holding company held on October 22, 2004 (the date of enactment of the 2004 Act as amended by the 2005 Act).

4.03. *Family as One Shareholder Rule*

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

removed from the youngest generation of shareholders who would (but for this subparagraph) be members of the family.[120]

4.04. *Single Class of Stock Requirement*

[1] In General.

Where an acquisition or disposition involves an S corporation, the eligibility requirements of Section 1361(b) will be of primary importance since they can significantly restrict the structuring of the transaction. This will be particularly important where the acquiring corporation is an S corporation and wishes to continue to its S status after the acquisition. The Subchapter S rules prohibit the issuance of more than one class of stock, i.e., stock which has a preference on distributions during either the operational or liquidation phase.[121] A corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in common stock voting rights are disregarded.[122] Shareholder covenants contained in buy-sell agreements generally will not result in a second class of stock.[123] This limitation has made it difficult for S corporations to raise funds and venture capital since many lenders seek hybrid forms of payment or "kickers" in addition to receipt of a pure interest stream of payments for the use of borrowed funds.

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

[2] Differences in Voting Rights.

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

[3] Non-conforming Distributions.

The original proposed single class of stock regulations provided that even where all outstanding shares of stock conferred identical rights to distribution and liquidation proceeds, the corporation still would be treated as having more than one class of stock if the corporation made "non-conforming distributions." Non-confirming distributions were defined as distributions which differed with respect to timing or amount as to each outstanding share of stock, with certain limited exceptions. Thus, under the original proposed regulations, excessive or inadequate compensation from an S corporation to a shareholder, shareholder loans, fringe benefits to shareholders, and other constructive distributions

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

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

[122] Section 1361(c)(4).

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

such as excessive rental payments between a shareholder and an S corporation could cause the inadvertent termination of an S corporation's election under the non-conforming distribution rule. Under the final single class of stock regulations, non-conforming distributions will not cause a corporation to be treated as having more than one class of stock, but such distributions (including actual, constructive or deemed distributions) that differ in timing or amount will be given the appropriate tax effect in accordance with the facts and circumstances. Thus, the Service has the power to recharacterize such distributions.[124]

[4] Stock Taken into Account.

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

[5] Governing Provisions.

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

[6] Routine Commercial Contractual Arrangements.

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

[7] State Law Requirements for Payment and Withholding of Income Tax.

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

[124] Reg. §1.1361-1(1)(2)(i).

[8] Distributions that Take into Account Varying Interests.

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

[9] Buy-Sell, Redemption and Other Stock Restriction Agreements.

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

[a] *Agreements Triggered by Death, Divorce, Disability or Termination of Employment.*

A bona fide agreement to redeem or purchase stock at the time of death, divorce, disability or termination of employment will be disregarded in determining whether a corporation's shares of stock confer identical rights to distribution and liquidation proceeds.[125]

[b] *Non-Vested Stock.*

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

[c] *Buy-Sell Agreements, Stock Restriction Agreements and Redemption Agreements.*

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

[d] *Determination of Value.*

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

A determination of book value will be respected if the book value is determined in accordance with GAAP; or the book value is used for any substantial non-tax purpose. Additionally, the

[125] Reg. §1.1361-1(1)(2)(iii)(B).

regulations provide that a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of value was not performed with reasonable diligence.

[e] *Special Rule for Section 338(h)(10) Elections.*

Reg. §1.1361-1(1)(2)(v) provides that if the shareholders of an S corporation sell their stock in a transaction for which an election under Section 338(h)(10) is made, the receipt of varying amounts per share by the shareholders will not cause the S corporation to have more than one class of stock, provided that the varying amounts are determined in arm's-length negotiations with the purchaser. This provision is important because the amount a shareholder is paid per share of stock (and the timing of the payment) often will vary among the shareholders (for example, due to control premiums and minority discounts); this could create a second class of stock concern if the shareholders were viewed as receiving different amounts in the fictional liquidation of the S corporation resulting from the Section 338(h)(10) election.[126]

[10] Use of options and warrants.

Stock options or stock warrants are often important tools in structuring either a taxable or non-taxable acquisition.[127] Under the final regulations to Section 1361, a call option, warrant or similar instrument will constitute a prohibited second class of stock if the option is substantially certain to be exercised by the holder or a potential transferee, and the option has a strike price substantially below the fair market value of the underlying stock on the date that the call option is issued, transferred by a person who is an eligible shareholder to a person who is not an eligible shareholder or materially modified.[128]

[a] *"Not in the Money" Safe Harbor.*

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

[b] *Option Issued to Commercial Lender.*

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

[c] *Option Issued for Services.*

The regulations provide that a call option that is issued to an individual who is either an employee or an independent contractor in connection with the performance of services for the corporation or a related corporation (and that is not excessive by reference to the services performed) is

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126 *See* also PLRs 9821006 and 199918050.

127 Reg. §1.1361-1(l)(4).

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

not treated as a second class of stock under Subchapter S if the call option is not transferable under Reg. §1.83-3(d) and the call option does not have a readily ascertainable fair market value as defined in Reg. §1.83-7(b) at the time the option is issued.

[d] *Safe Harbor Options and Warrants.*

In *Santa Clara Valley Housing Group v. United States*,[129] involving a KPMG tax shelter ("*S Squared*"), the taxpayer sought reconsideration of an earlier ruling that the issuance of warrants resulted in termination of the taxpayer's status as an S corporation.

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

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

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

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

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

> A call option is not treated as a second class of stock if, on the date the call option is issued, transferred by a person who is an eligible shareholder under paragraph (b)(1) of this Section to a person who is not an eligible shareholder under paragraph (b)(1) of this Section, or materially modified, the strike price of the call option is at least 90 percent of the fair market value of the underlying stock on that date. For purposes of this paragraph (l)(4)(iii)(C), a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence to obtain a fair value. Failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock.[130]

[129] 109 AFTR 2nd 2012-360 (N.D. CA 2012).

[130] Reg. §1.1361-1(*l*)(4)(iii)(C).

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

[11] Use of convertible debt.

The regulations provide that convertible debt will be considered a second class of stock if: (i) it would be treated as a second class of equity under general tax principles, i.e., Section 385, and (ii) it embodies rights equivalent to those of a call option that would be treated as a second class of stock under the portion of the regulations pertaining to options. In various instances involving an acquisition, particularly a non-taxable acquisition, the resolution of whether unretired debt, including convertible debt, of the target corporation will have substantial tax implications including (i) possible termination of S status; (ii) debt cancellation income under Section 108; (iii) original issue discount issues; (iv) creation of market discount or bond issue premium; (v) dividend issues under Section 305(5), and (vi) the existence of a taxable sale or exchange.[131]

[a] *Short Term Unwritten Advances.*

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

[b] *Proportionately Held Debt.*

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

[12] Use of straight debt.

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

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

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

As a reform introduced by SBJPA, after 1996 a financial institution now qualifies for holding safe harbor debt provided such institution is actively engaged in the business of lending money.[132] This requirement should not be difficult to satisfy. Still, the non-convertibility requirement of safe harbor debt, as well as the restriction that interest payments not be contingent on profits, remain impediments for achieving transactional neutrality among pass through entities in this area. S corporations remain disadvantaged in this area.

[13] Use of Stock Appreciation Rights and Phantom Stock.

[a] *Stock Appreciation Rights.*

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

[b] *Phantom Stock Plans.*

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

[14] Use of Joint Venture.

Where the Subchapter S limitations concerning the one class of stock requirement or the shareholder eligibility limitations pose a formidable obstacle in structuring a business combination involving an S corporation, consideration should be given to the use of a joint venture. While the Service has backed off to a certain extent its concern that a joint venture involving an S corporation may not be used to end run the Subchapter S limitations, the outer limits of this liberal attitude have not been tested.[133]

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[132] Section 1361(c)(5)(iii).

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

Section 707(a)(2)(A) applies to an allocation and distribution to a partner who has transferred property to a partnership if (1) the allocation and distribution are "related" to the property transfer and (2) the property transfer and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership. The principal targets of this aspect of the provision are situations in which all or a portion of the purchase price of property is paid through partnership allocations in order to give other partners the practical equivalent of immediate deductions for payments of the purchase price. Section 707(a)(2)(B) provides that a partner's transfer of money or other property to a partnership is deemed made in a non-partner capacity if (i) the partnership makes a "related" transfer of money or other property to the partner or another partner and (ii) the transfers of the partner and partnership, "when viewed together, are properly characterized as a sale or exchange of property." This rule is "intended to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a distribution from the partnership and thereby to defer or avoid tax on the transaction."[134] Reg. §1.707-3(c) provides that if within a two-year period, a partner transfers property to a partnership and the partnership transfers money (or other consideration) to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish otherwise. Reg. §1.707-5(b)(1) provides that, for purposes of the disguised sale rules, if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under Reg. §1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability.[135]

[15] Use of "Tax Nothings" or Single Member Entities.

A single member LLC owned by an individual (who otherwise constitutes a permitted S corporation shareholder), disregarded as an entity for federal tax purposes (a "tax nothing"), may own stock in an S corporation[136] much in the same way as a grantor trust is ignored and the grantor is treated as the "owner" of the trust assets for federal income tax purposes.

[a] *Nominee Status.*

Prior to the issuance of the check-the-box regulations (CTB) under Subchapter S that is a nominee is not treated as a shareholder for eligibility purposes. Instead, the shareholder is the beneficial owner.[137] The Service has ruled, for example, that a corporation's S election did not terminate when its stock was held by a non-resident alien under a particular uniform gift to minors act transfer.[138] Thus, if the tax owner of the LLC "tax nothing" is otherwise an eligible shareholder, and such owner acts accordingly for Subchapter S purposes, e.g., signs Form 2553, is indicated as the owner with the Service

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

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

136 PLR 9739014.

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

138 Rev. Rul. 71-287, 1971-2 C.B. 316.

via the K-1, etc., the corporation's S election should be respected notwithstanding the nominee shareholder's state law separate identity.[139]

[b] *CTB Regulations.*

The CTB regulations permitting certain single member controlled entities to be disregarded for federal income tax purposes such as a branch or division.[140] An entity engaged in business operations with two or more members generally will be classified as a corporation or a partnership. Certain entities designated in the regulations will be required to be "per se" corporations. Where there is only one owner, it is treated as either a corporation or a disregarded entity. Where a business entity is unincorporated and has only a single owner, it is a disregarded entity.[141] A business entity with two or more members is classified as either a corporation or a partnership. A business entity with only one owner is classified as either a corporation or a disregarded entity. Thus, a business entity that is not a corporation and that has a single owner is disregarded as an entity separate from its owners-it is a disregarded entity. A business entity that is not a per se corporation and that has at least two members is classified as a partnership absent a reverse default election to be treated as a corporation.[142]

[c] *Tiered Defective Entities.*

Where an entity is owned by disregarded entities, then the upper tier disregarded entity will be disregarded.[143]

[d] *Conversion of Partnership to Disregarded Entity.*

Where an eligible entity classified as a partnership is converted to a single member, the conversion would be treated as a liquidation of a partnership.[144] In Rev. Rul. 99-6,[145] the Service analyzed two situations where one person purchased all of the interests in a multi-person LLC, causing the LLC to change from partnership to a disregarded entity. In each situation, the sellers are treated as selling their partnership interest under Section 741(a) and subject to Section 751(a)("hot assets"). The purchaser in each instance is treated as the purchase of assets which first are distributed in liquidation.[146] Thus, to the sellers, each may recognize gain to the extent that money treated as distributed exceeds the seller's basis in his or her partnership interest immediately before the distribution

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

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

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

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

[143] See PLR 199915030 (1/12/99) (partnership treated as disregarded entity where its "partners" were a corporation and an LLC wholly owned by the same corporation). Accord. PLR 200008015 (11/18/99); PLR 20033407 (5/13/03).

[144] See Reg. §1.708-1(b)(1)(i).

[145] 1999-1 C.B. 432.

[146] See McCauslen v. Comm'r, 45 T.C. 588 (1966); Rev. Rul. 67-65, 1967-1 C.B. 168.

under Section 731(a)(1), and loss is not recognized unless only money and unrealized receivables and inventory items are distributed and the sum of such items exceeds the partners' adjusted basis in his or her partnership interest per Section 731(a)(2). Under Section 732(b), the distributee's basis in the partnership will be the same as his basis in his partnership interest, reduced by any money treated as having been distributed to him, and must be allocated in the manner described in Section 732(c).[147]

[e] *Conversion of Disregarded Entity to Partnership.*

Rev. Rul. 99-5[148] provides that: (1) where original member of single member domestic LLC, holding only capital assets or Section 1231 property, that is disregarded for tax purposes as entity separate from the owner under Reg. §301.7701-3, and converted to partnership when new non related member purchases 50% interest in LLC, recognizes gain or loss from deemed sale of 50% interest in each asset to new member under Section 1001; but under Section 721 partners won't recognize gain or loss as a result of the conversion of the disregarded entity to a partnership (2) where new member's cash contribution to LLC, which converts it from disregarded entity to partnership, is treated as contribution in exchange for ownership interest; and under Section 721(a); partners recognize no gain or loss due to conversion.

In both situations, under Section 722, the new member's basis in the partnership interest is equal to the amount paid for the assets which the new member is deemed to contribute to the newly-created partnership. The original member's basis is equal to his basis in his share of the assets in the LLC. In situation one, under Section 723, the basis of the property treated as contributed to the partnership by both partners is the adjusted basis of that property in their hands immediately after the deemed sale. In situation two, under Section 723, the basis of the property contributed to the partnership by the original member is the adjusted basis of that property in his hands, and the new member's basis is equal to the amount of cash contributed. In both situation one and two, under Section 1223(1), the original member's holding period for the partnership interest received includes his holding period in the capital assets and property described in Section 1231 held by the LLC prior to converting to a partnership. The new partners holding period for the partnership interest begins on the day following the date of his purchase of the LLC interest.

[f] *Conversion of Disregarded Entity to Corporation.*

Upon the conversion of a disregarded entity to corporation status, Section 351 will apply in straightforward fashion.[149]

[g] *Conversion of Corporation to Disregarded Entity.*

The conversion of a corporation to disregarded entity status constitutes a complete liquidation of the corporation pursuant to Sections 331 and 336 and is taxable to the corporation and its shareholders. Exception from taxable treatment is provided where the liquidation meets of the requirements for the liquidation of a controlled subsidiary pursuant to Sections 332 and 337.[150] The

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

148 1999-1 C.B. 434.

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

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

conversion of an eligible entity to a disregarded entity can be accomplished by election. An election should be treated as a distribution of the assets in liquidation of a corporation. In general, the tax consequences of the conversion are deemed to occur at the end of the day preceding the election.

[h] *Mergers Involving Disregarded Entities.*

On May 17, 2000, the Service issued a proposed rulemaking[151] on mergers involving disregarded entities. The proposed regulations revised paragraph (b)(1) of Reg. §1.368-2(b)(1) and adopted the view that a merger involving a corporation and a disregarded entity is not a statutory merger for purposes of qualifying as a tax-free reorganization under Section 368(a)(1)(A).[152] The proposed regulations would have extended to a qualified subchapter S subsidiary or QSUB, a limited liability company (LLC) with a single corporate owner which does not elect to be treated as a separate corporation, or a qualified REIT subsidiary.[153]

Section 368(a)(1)(A), discussed below, requires that a qualifying reorganization constitute a "statutory merger or consolidation."[154] Under the Proposed Regulations, the merger of a disregarded entity ("DRE") (including a QSUB or qualified REIT subsidiary) into a tax corporation would not be a Type A reorganization because the merging entity is not a tax corporation. In Rev. Rul. 2000-5, the Service held that a Type A merger must involve the transfer of the assets of a target corporation to a single transferee corporation ceasing to exist as a result of the "merger" Rev. Rul. 2000-5 implies that a merger of a DRE (single member) owned by a corporation (including a QSUB), cannot be a Type A reorganization because it will be divisive and will not necessarily result in the termination or liquidation of the member. Due to the additional requirements for a Type C ("substantially all of the transferor's assets," no more than 20% boot, including liability assumptions, and "solely for voting stock" requirements) and Type D ("substantially all"/liabilities in excess of basis) reorganization, many of the DRE mergers would constitute taxable transactions under the 2000 proposed regulations.[155]

The final regulations, issued in 2003, retain much of the conceptual background to the proposed regulations, including the definition of a disregarded entity.[156] Examples are set forth in the regulations which apply to disregarded entities, such as a domestic, single member LLC which does not elect to be treated as a corporation for federal income tax purposes, a qualified REIT subsidiary per Section 856(i)(2) and a QSUB per Section 1361(b)(3)(B).[157] Defined terms included the following:

(1) Disregarded Entity; a business entity that is disregarded as an entity separate from its owner for Federal tax purposes;

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151 REG-106186-98, 65 FR 31115-01.

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

153 *See*, Hirschfeld and Wild, "LLCs Provide Broad Tax Planning Possibilities For Corporate Groups in Both Domestic and Cross-Border Transactions," 18 J. Tax'n Investments, 3, 8 (2000).

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

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

156 Reg. §301.7701-2(b)(5).

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

(2) Combining Entity; a business entity that is a corporation that is not a disregarded entity;

(3) Combining Unit; is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such entity for Federal tax purposes;

(4) Transferor Unit; and

(5) Transferee Unit.[158]

Under a Type A reorganization, i.e., a statutory merger or consolidation effected pursuant to the statute or statutes necessary to effect the merger or consolidation, the following events occur simultaneously at the effective time of the transaction; (i) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and (ii) the combining entity of each transferor unit ceases its separate legal existence for all purposes; provided, however, that this requirement will be satisfied even if, under applicable law, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents) may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the requirements of Reg. §1.368-2(b)(1)-(ii)(A).

[i] *Employment Tax Regulations.*

Reg. §301.7701-2(c)(2)(iv), finalized on August 14, 2007 and effective for employment tax purposes on January 1, 2009,[159] provides that a disregarded entity is responsible for withholding employment taxes on wages paid to its employees and satisfying other employment tax obligations such as backup withholding, making timely deposits of taxes, filing returns, and providing wage statements to employees. An individual owner of a single-member LLC who is self-employed and subject to self-employment tax on his net earnings from self-employment with respect to the LLC's activities is not an employee of the LLC for employment tax purposes. The individual would be entitled to deduct trade or business expenses paid or incurred with respect to activities carried on through the LLC, including the employer's share of employment taxes imposed under Sections 3111 and 3301 on his Form 1040, Schedule C.

Similar to the payroll tax regulations, Reg. §§1.34-1, 1.1361-4(a)(8), and 301.7701-2(c)(2)(v) finalized on August 14, 2007 effective for excise tax purposes on January 1, 2008, provide that a disregarded entity itself will be required to pay and report excise taxes, register, and claim any credits (other than income tax credits), refunds, and payments related thereto. As a disregarded entity does not file an income tax return, the Section 46 credit for federal tax paid on fuels will be claimed on

[158] Reg. §1.368-2(b)(1)(i)(C).
[159] T.D. 9356.

the disregarded entity's owner's income tax return with appropriate identification of the disregarded entity and its EIN. The general business credit (including the Section 40 credit for alcohol used as a fuel and the Section 40A credit for biodiesel and renewable diesel used as a fuel) would not be affected by the regulations.

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

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

Section 1361(c)(2)(A)(i) of the Code permits a grantor trust described in Subpart E of Part 1 of Subchapter J of the Code to hold S corporation stock. A revocable inter vivos trust under which income is or may be paid to the grantor during the grantor's life is the most common example of a grantor or "deemed owner" trust. The grantor or deemed owner is treated as the shareholder of the S corporation for all purposes.

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

Any of a number of interests and powers retained by the grantor or vested in the deemed owner may result in a trust being treated as a grantor trust under Sections 671 through 678 of the Code, and accordingly qualify the trust as a permitted shareholder under Section 1361(c)(2)(A)(i). For example, in an early private letter ruling, the Service held that the right of the grantor to substitute property with other property of equivalent value resulted in a trust qualifying to hold S corporation stock as a grantor trust.[160]

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

In order to be treated as a permitted shareholder under Section 1361(c)(2)(A)(i), the entirety of the trust must be treated as owned by a single deemed owner. According to one private letter ruling, the trust may permit the distribution of income and principal to other beneficiaries, provided only one beneficiary is treated as the deemed owner of the entire trust.[161] A general inter vivos power of appointment, exercisable currently, held by a single deemed owner beneficiary, should qualify a trust as a Section 678 trust.

[160] PLR 9227013 (Mar. 30, 1992).
[161] PLR 9037011 (June 14, 1990).

It also appears that a noncumulative annual power, such as a Crummey withdrawal power, will qualify a portion of a trust as a Section 678 trust.[162] In a 1992 private letter ruling, the Service ruled that a beneficiary holding a Crummey withdrawal power would be treated as the owner of the trust, and therefore the trust would be an eligible S corporation shareholder. The Service required the trust to meet the following conditions: (1) no transfer to the trust could exceed the beneficiary's withdrawal power, and (2) the donor could not restrict the beneficiary's withdrawal power with respect to the contribution.[163]

4.06. *The Qualified Subchapter S Trust or QSST*

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

(a) there must be only one income beneficiary during the life of the current income beneficiary,[164]

(b) any corpus distributed during the life of the current income beneficiary must be distributed to such beneficiary,[165]

(c) all income of the trust must be distributed currently (or be required to be distributed currently) to the income beneficiary,[166]

(d) the income interest must terminate on the earlier of the death of the beneficiary or the termination of the trust,[167] and

(e) the trust must distribute all of its assets to the beneficiary upon termination of the trust during the life of the current income beneficiary.[168]

If the trust instrument does not require the distribution of income currently, and the trustee does not in fact distribute all income currently (or during the 65-day grace period provided in Section 663(b)), it will be disqualified on the first day of the following tax year.[169]

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

[163] PLR 9226037 (Mar. 27, 1992).

[164] Section 1361(d)(3)(A)(i).

[165] Section 1361(d)(3)(A)(ii).

[166] Section 1361(d)(3)(a)(iii). For this purpose, "income" means trust accounting income as defined in Section 643(b). It appears that the trust will only have to distribute amounts actually received by the trust from the S corporation. *See* James S. Eustice & Joel D. Kuntz, Federal Income Taxation Of Subchapter S Corporations, ¶ 3.03[11][B].

[167] Section 1361(d)(3)(A)(iv).

[168] Section 1361(d)(3)(B).

[169] Section 1361(d)(4)(B).

A qualified terminable interest property trust (QTIP), a life estate and testamentary general power of appointment trust, a single beneficiary trust providing for the distribution of income currently, or a similar trust may qualify as a QSST. In Rev. Rul. 92-48, the Service ruled that a charitable remainder trust cannot qualify as a QSST.[170] In Rev. Rul. 93-31, the Service ruled that a trust did not qualify as a QSST when the trust instrument authorized the trustee to distribute the trust corpus to someone other than the current income beneficiary of the trust if necessary for such person's health, education, support or maintenance (after taking into account such other person's income).[171] The Service disqualified the trust even though the substantial resources of the other person nearly eliminated the possibility that the trustee would exercise the power to distribute the trust corpus.

In order for a QSST to be a permitted shareholder, the income beneficiary of the QSST must file a QSST election with the Service within two months and fifteen days of the transfer of the shares to the trust.[172] If stock in more than one S corporation is held by the trust, a separate election is required with respect to each S corporation.[173] An individual holding a durable power of attorney with respect to an income beneficiary of a trust may make the QSST election on behalf of the income beneficiary.[174] In the event the income beneficiary is a minor, the QSST election should be filed by a parent or legal guardian. If the QSST income beneficiary either dies or assigns his interest as beneficiary to another U.S. citizen or resident individual, the successor is deemed to have consented to the election unless he files an affirmative refusal to consent within two months and fifteen days after becoming an income beneficiary.[175] A QSST for which the income beneficiary's election has been filed is treated as a Subpart E trust and the income beneficiary is treated as the deemed owner of the shares in the trust for purposes of Section 678(a).[176]

4.07. *Electing Small Business Trusts as Shareholders*

After 1996, as part of the reforms to Subchapter S provided by the SBJPA, an accumulation (domestic) trust, referred to as an electing small business trust ("ESBT") under Section 1361, is permitted to own stock in an S corporation provided that the trustee of the trust files the appropriate election. Special rules are provided in determining the eligible beneficiaries of the ESBT.[177] In contrast to a qualified Subchapter S trust which taxes the individual beneficiary on his or her share of the S corporation's income, the ESBT is treated as the taxpayer and is subject to federal income tax.[178]

[1] Taxation of ESBTs.

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170 1992-1 C.B. 301.

171 1993-1 C.B. 186.

172 Section 1361(d)(2)(D).

173 Section 1361(d)(2)(B)(i).

174 PLR 9314022 (Jan. 7, 1993).

175 Regs. §1.1361-1(j)(9).

176 Section 1361(d)(1)(B).

177 Section 1361(c)(2)(B)(v), as amended by the TCJA, allows a potential current beneficiary of an electing small business trust to be a non-resident alien. The TCJA 2017 added §481(d) for S corporations that revoke their S elections within two years after the TCJA 2017, P.L. No. 115-97 (2017). It added §1371(f) regarding certain distributions of cash by corporations within said two year period.

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

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

[2] Application of Subchapter J.

Section 641(d)(1) provides that the portion of an ESBT that consists of stock in one or more S corporations ("S portion") is taxed as a separate trust. Section 641(d)(2)(c) specifies that the only items of income, loss, deduction, or credit to be taken into account by the S portion ("S portion items") are (i) the items required to be taken into account under Section 1366; (ii) any gain or loss from the disposition of stock in an S corporation; and (iii) to the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii) Section 641(d)(3) provides that the S portion items are excluded for purposes of determining the amount of tax on the portion of the trust that is not treated as a separate trust under Section 641(d)(1) ("non-S portion") and are excluded in determining the distributable net income (DNI) of the entire trust. Because the S portion items are not included in the computation of the ESBT's DNI, they are treated for purposes of determining the treatment of trust distributions in the same manner as any other item that does not enter into the DNI computation (e.g., capital gains and losses allocated to corpus). For example, for the tax year an ESBT has $40 of DNI from the non-S portion and $70 of net fiduciary accounting income from the S portion, if the ESBT makes a distribution of $100, the distribution includes $40 of DNI.[179]

[3] Purchase of S Corporation Stock.

The final regulations provide that interest expenses paid by the trust on indebtedness incurred in connection with the purchase of S corporation stock must be allocated to the S portion of the ESBT.[180] When the regulations were finalized, such interest expenses are not deductible by the S portion because they are not administrative expenses. However, the 2007 Act provides that the interest paid or accrued on indebtedness to acquire S corporation stock is deductible in computing the taxable income of the S portion of an ESBT.[181]

[4] Termination of ESBT Status.

The final regulations provide that except where an ESBT fails to meet the definitional requirements of an ESBT, a trustee must seek the consent of the Commissioner by obtaining a private letter ruling to revoke an ESBT election. Consent of the Commissioner is not required when the trust wishes to convert from an ESBT to a QSST, provided the trust meets all of the requirements to be a QSST and the trustee and the current income beneficiary of the trust sign the QSST election. Similar to the procedures for converting an ESBT to a QSST under Rev. Proc. 98-23, supra, the QSST election must state

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179 See Notice 97-49.

180 Reg. §1.641(c)-1(d)(4)(ii).

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

at the top of the filing that it is a conversion of an ESBT to a QSST pursuant to Reg. §1.1361-1(m) of the regulations and include all information otherwise required for a QSST election under Reg. §1.1361-1(j)(6). A separate election must be made with respect to the stock of each S corporation held by the trust. Finally, to convert from an ESBT to a QSST under the automatic procedure, the trust must not have converted from a QSST to an ESBT within the 36 month period immediately preceding the effective date of the new QSST election.[182]

As noted above, a trust that ceases to meet the ESBT requirements has its ESBT election terminated. The last day the trust is treated as an ESBT is the day before the day on which the trust fails to meet the definition of an ESBT.[183]

The final regulations provide that a trust ceases to be an ESBT on the first day following the day the trust disposes of all of its S corporation stock. However, if the trust is using the installment method to report gain and interest income from the sale or disposition of its stock in S corporation, the ESBT status continues until the day following the day the last installment payment is received by the trust, or the day the trust disposes of the installment obligation, if earlier. Under the special divestiture rule, if a potential current beneficiary is treated as an ineligible shareholder, or if an ineligible shareholder becomes a potential current beneficiary, the trust may dispose of all its S corporation stock within 60 days. The ineligible shareholder is not considered a potential current beneficiary during the 60 day period ending on the date of such disposition.[184]

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

[5] Sale of S Corporation Stock by ESBT.

Reg. §1.641(c)-1(d)(3) requires that the resulting gain or loss from the sale of S corporation stock by an ESBT be reported by the S portion. As mentioned, capital losses are permitted only to the extent of capital gains. Consistent with the final regulations under Section 1361[185] which treat gains on the sale of S corporation stock on the installment basis by a QSST as income of the trust, the final ESBT regulations permit the use of the installment method upon the sale or disposition of stock in an S corporation by an ESBT. The gain recognized under the installment method is taken into account by the S portion of the ESBT.[186] Although the trust no longer holds the S corporation stock, it continues to pay trust-level taxes on the gain as recognized under the installment method. The final regulations provide that the interest on the installment obligation from the sale or disposition of stock in an S corporation is included in the gross income of the non-S portion of the ESBT.[187]

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

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182 Reg. §1.1361-1(m)(7)(i)-(iv).
183 Reg. §1.1361-1(m)(5)(i).
184 Reg. §1.1361-1(m)(5)(iii), cross referencing paragraph (m)(4)(iii).
185 Reg. §1.1361-1(j)(8).
186 Reg. §1.641(c)-1(d)(3)(ii).
187 Reg. §1.641(c)-1(g)(3).

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

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

[6] Distributions with Respect to S Stock.

With respect to distributions from the S corporation, where dividend treatment results under Section 1368(c)(2), Reg. §1.641(c)-1(g)(2) provides that such amount is includable in the gross income of the non-S portion of the trust. Where gain results from a distribution in excess of stock basis, then such gain is allocable to the S portion of the trust. Presumably, this result will apply for a non-dividend-equivalent redemption of the trust's S stock in a particular corporation to the extent such proceeds are not characterized by reference to Section 1368(c)(2).[188]

[7] Tax-Free Reorganizations.

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

4.08. *Removal of Prohibition on Affiliation; Subsidiaries Permitted by SBJPA*

[1] Prior to 1997.

Prior to the SBJPA, an S corporation had not been permitted to own stock in another S corporation, because the second corporation would have had another corporation as a shareholder.[189] A second limitation barred an S corporation from owning 80% or more of the voting and value of the issued and outstanding stock in a C corporation.[190] Still, Section 1361(c)(6) provided that an inactive subsidiary, e.g., one which never has conducted business and merely reserves a corporate name in another state, is permitted.[191] Furthermore, the Service ruled that the "momentary ownership" of a subsidiary will not disqualify the parent corporation's S election.[192] Momentary affiliation may also be the first step in a tax-

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188 Section 302(a), 302(d).

189 See Section 1361(b).

190 See Section 1504(b)(8).

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

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

free division or split-up. The Tax Court has issued a warning on more than momentary affiliations despite the Service's more liberal attitude.[193]

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

[2] Ownership of C Subsidiary Permitted.

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

[3] Repeal of Former Inactive Subsidiary Rule.

As a result of the ability to own a (S or C corporation) subsidiary, the inactive subsidiary exception in Section 1361(c)(6) has been repealed as no longer necessary. Furthermore, the issue of momentary affiliation is substantially reduced in its importance; the only issue being whether momentary affiliations incident to an acquisition or reorganization are to be ignored for federal income tax purposes. Thus, for example, an S corporation may acquire all the stock of a C corporation (and its lower tier subsidiaries) without having to liquidate immediately. Similarly, an S corporation that is purchased by another S corporation no longer will have to be liquidated immediately in order to preserve the application of the flow through rules with respect to its income and losses. Loss of either the purchaser's or the target's S corporation election could have resulted in built-in gains tax, passive investment income, and LIFO recapture tax implications.[194]

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

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[193] Haley Brothers Constr. Corp. v. Comm'r, 87 T.C. 498 (1996).

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

with other C corporations, it is still permitted to file a consolidated return with members of the affiliated group.

Generally, dividends received from a C corporation which are from current or accumulated earnings and profits under applicable rules under Subchapter C, will constitute passive investment income for termination purposes under Section 1362(d)(3) as well as for purposes of the entity termination rule under Section 1375.[195] Again, a dividends received deduction under Section 243 is unavailable. Final regulations dealing with dividends received from affiliated C corporation subsidiaries by an S corporation parent were recently issued.[196]

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

Final regulations issued by the Service address the question of tracing active earnings and profits in a C subsidiary or from a C affiliated group.[197] Under the regulations, earnings and profits of a C corporation derived from the active conduct of a trade or business are the earnings and profits of the corporation derived from activities that would not produce passive investment income under Section 1362(d)(3) if the C corporation were an S corporation. A safe harbor is provided by which the corporation may determine the amount of the active earnings and profits by comparing the corporation's gross receipts derived from non-passive investment income-producing activities with the corporation's total gross receipts in the year the earnings and profits are produced. If less than 10 percent of the C corporation's earnings and profits for a taxable year are derived from activities that would produce passive investment income, all earnings and profits produced by the corporation during the taxable year are considered active earnings and profits. The regulations also provide that a C corporation may treat all earnings and profits accumulated by the corporation prior to the time an S corporation held stock meeting the requirements of Section 1504(a)(2) as active earnings and profits in the same proportion as the C corporation's active earnings and profits for the three taxable years ending prior to the time when the S corporation acquired 80 percent of the C corporation bears to the C corporation's total earnings and profits for those three taxable years. Provisions also address the allocation of distributions from current or accumulated earnings and profits.[198]

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

196 See Reg. §1.1362-8.

197 Reg. §1.1362-8.

198 See Reg. §1.1362-8.

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

[4] Qualified Subchapter S Subsidiary.

Section 1361(b)(3)(B) defines the term qualified subchapter S subsidiary ("QSUB") generally as any domestic corporation that is not an ineligible corporation if, (i) an S corporation holds 100 percent of the stock of the corporation, and (ii) that S corporation elects to treat the subsidiary as a QSUB. An "ineligible corporation includes a financial institution that uses the reserve method of accounting for bad debts; an insurance company subject to tax under Subchapter L; a possessions tax credit entity described in Section 936 or a DISC or former DISC. Except as otherwise provided in regulations, a corporation for which a QSUB election is made is not treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of the QSUB are treated as assets, liabilities, and items of income, deduction and credit of the parent S corporation.[199] Thus, the QSUB rule removes not only the controlled subsidiary impediment, but also serves as an important exception to the prohibition on a corporation from owning stock in an S corporation.[200]

[a] *QSUB as a Disregarded Entity Upon Effective Date of Election.*

Once effective, the QSUB election requires that the assets, liabilities, tax items, tax history, etc., of the QSUB are treated as directly owned and realized by the S corporation parent for federal income tax purposes. This, in general, treats the QSUB as a branch or division of the S corporation subject to a few identified exceptions. As a branch or division, intercompany transactions presumably will be eliminated for federal income tax purposes.[201] A similar rule is contained in Section 856(i), permitting a REIT's ownership of a 100% subsidiary. As to the QSUB, it would no longer add/subtract to its tax history, e.g., earnings and profits, AAA, etc., during the applicable period. There is a carryover of tax basis, which in turn triggers application of Section 1374 with respect to transferred basis assets.[202] Where the subsidiary uses the LIFO method of inventory accounting, the making of the QSUB election triggers the four year LIFO recapture rule. For state law purposes, the QSUB is still recognized as a separate legal or juridical entity.[203] Final regulations to the QSUB rules were issued on January 25, 2000.[204] The final regulations generally apply to taxable years that begin on or after January 20, 2000; however, taxpayers previously could have elected to apply the regulations in whole, but not in part (aside from those Sections with special dates of applicability), for taxable years beginning on or after January 1, 2000, provided the corporation and all affected taxpayers apply the regulations in a consistent manner. To make the QSUB election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. The rules relating to the treatment of banks apply to all taxable years beginning after December 31, 1996.[205] The provision relating

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199 Section 1361(b)(3).

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

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

202 Section 1374(d)(8).

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

204 65 FR 3843.

205 Reg. §1.1361-4(a)(3)(iii).

to transitional relief from application of the step transaction doctrine applies to certain QSUB elections effective on or before the end of calendar year 2000.[206] Reg. §1.1361-5(c)(2), relating to automatic consent for an S or QSUB election made for a corporation whose QSUB election has terminated within the five-year period described in Section 1361(b)(3)(D), applies to certain QSUB elections effective after December 31, 1996.[207]

[b] *Ownership Through Disregarded Entities.*

A corporation may be a QSUB even if all its stock is not actually owned by an S corporation, as long as all of its stock is treated as owned by an S corporation for federal income tax purposes. Therefore, an S corporation can make a QSUB election for a subsidiary which it owns through other entities that are "disregarded" for federal income tax purposes. A chain of QSUB elections can be made for each subsidiary of a tier of C corporations owned by a parent S corporation. The election for lower-tier subsidiaries must be made by the parent S corporation and not by upper-tier subsidiaries. See PLR 202227001 (4/11/2022).[208]

[c] *Debt, Options and Other Instruments, Arrangements.*

While the parent electing QSUB must own all of the stock of the subsidiary, the question is whether there is any disguised equity floating around the QSUB orbit through the issuance of debt, options or other arrangements held by third parties which would violate the QSUB rules.[209] The Regulations do not provide any bright line rules or safe harbors. Instead, general federal tax principles are to be applied, including the safe harbors for options and straight debt instruments under Subchapter S. Instead, the amorphous set of 14 factors would be used to make this determination.[210] Still comment is made on meeting the requirement that the S corporation parent must own 100 percent of the stock of the QSUB under Section 1361(b)(3)(B)(i) with stock for this purpose, being "stock" for federal income tax purposes and "any outstanding instruments, obligations, or arrangements of the corporation which would not be considered stock for purposes of Section 1361(b)(1)(D) if the corporation were an S corporation are not treated as outstanding stock of the QSUB.[211]

The regulations also provide that in applying general tax principles in determining whether the parent owns all of the QSUB stock, arrangements that are not considered to be stock under the one class of stock rules contained in Reg. §1.1361-1(l) will be disregarded. Commentators recommended that, for purposes of determining whether a subsidiary is wholly owned by the parent S corporation, arrangements that are not considered to be stock under the one-class-of-stock rules of Reg. §1.1361-1(l) should be disregarded. The final regulations provide a straight debt safe harbor if the obligation would meet the requirements under Reg. §1.1361-1(l)(5).[212] Similar relief is provided for

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206 See Reg. §1.1361-4(a)(5)(i).

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

208 See Rev. Proc. 2003-43, 2003-1 CB 998, §2.02(2); Rev. Proc. 2013-30, 2013-36 IRB 173, §7.

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

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

211 Reg. §1.1361-2(b). When QSUB status ends, to test for the 80% or more control requirement under § 351, the regulations ignore all instruments, obligations, and arrangements that are not treated as stock of the qualified subchapter S subsidiary for purposes of subchapter S (even if they are equity under general tax principles). Reg. § 1.1361-5(b)(1)(i).

212 Reg.§1.1361-2(b)(2), -2(c).

deemed exercise of an option under Reg. §1.1504-4.[213] An example of the use of straight debt to maintain QSUB status is provided in Reg. §1.1361-2(d).

[d] *Election of QSUB Status.*

Section 1361(b)(3) requires that an S corporation must file a QSUB election for each applicable subsidiary otherwise the particular subsidiary will be treated as a C corporation. The election mechanics are set forth in Reg. §1.1361-3 which provides that a QSUB election may be made by the S corporation parent at any time during the taxable year. The election form, IRS Form 8869, must be signed by the appropriate officer of the corporation under Section 6037. The election is filed with the Service center where the subsidiary filed its most recent tax return, or if a newly organized subsidiary, where the S corporation parent filed its most recent return.[214] The QSUB election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. For this purpose, the definition of the term "month" found in Reg. §1.1362-6(a)(2)(ii)(C) applies. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed. The final regulations further acknowledge that relief is available under the 9100 regulations for a late filing.[215]

An S corporation may revoke a QSUB election under Section 1361 by filing the appropriate statement with the service center where the S corporation's most recent tax return was properly filed. The revocation of a QSUB election, provided the QSUB election has not otherwise terminated for eligibility reasons, is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified.[216] The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

Reg. §1.1361-5 provides that an extension of time to make a QSUB election may be available under the late election relief rule in Reg. §301.9100 by filing a request with the National Office explaining the reason for the failure.[217]

Rev. Proc. 98-55[218] contains relief provisions for late-filed QSUB elections. The Revenue Procedure applies only to a corporation (i) for which a timely QSUB election under Section 1361(b)(3)(B) was not filed for the desired effective date, (ii) for which a QSUB election is filed within 12

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213 See Reg. §1.361-4(a)(2)(v).

214 Reg. §1.1361-3(a)(2).

215 Reg. §1.1361-3(a)(6).

216 Reg. §1.1361-2(b)(2)

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

218 1998-46 I.R.B. 27.

months of the date that an election for the desired effective date should have been filed, and (iii) for which the due date for the S corporation's tax return (excluding extensions) for the first taxable year for which the S corporation desired QSUB status for the subsidiary has not passed. The procedural requirements for this relief are as follows. Within 12 months of the due date for filing a QSUB election to be effective on the desired effective date (but in no event later than the due date for the S corporation's tax return (excluding extensions)) for the first taxable year of the S corporation for which the S corporation intended to treat the subsidiary as a QSUB), the corporation must file with the applicable service center a completed QSUB election. The QSUB election must state at the top the form "FILED PURSUANT TO REV. PROC. 98-55." Attached to the form must be a statement explaining the reason for the failure to file a QSUB election within the time period required for the desired effective date.[219]

Rev. Proc. 2003-43,[220] in superseding the earlier Rev. Proc. 98-55, supra, provides for making a late QSUB election within 2 years of its original due date by filing the form with the service center in the normal manner, but with a statement of reasonable cause attached. If the two-year period has passed, an S corporation may seek 9100 relief by filing a private letter ruling request with the National Office of the Service.[221]

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

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

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

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

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

220 2003-1 C.B. 998.

221 Reg. §1.1361-3(a)(6).

The final regulations confirm that a QSUB election can be effective at any time during its tax year as long as the QSUB eligibility requirements are satisfied at the time that the election is made and for all periods for which the election is to be effective.[222]

[e] *Tax Treatment of QSUB Election.*

Although the relevant statutory language does not specifically provide, the QSUB election is treated as a deemed liquidation of a wholly owned subsidiary into its electing S corporation parent.[223] Under Section 337, no gain or loss is generally recognized by the liquidating subsidiary. Similarly, no gain or loss is recognized by the parent.[224] In accordance with Section 381, the S corporation parent will succeed to the QSUB's entire tax history as well as the adjusted basis in its assets. Where the subsidiary has been a C corporation, the liquidation will cause the parent S corporation to become subject to the built-in gains tax under Section 1374 with respect to the target's assets. If the target C corporation used the LIFO method of inventory accounting, the special recapture rule in Section 1363(d) comes into play. Post-QSUB election problems may also be attributable to inheriting the target's C earnings and profits. Obviously, such will have an impact on characterizing post-QSUB election distributions by a parent S corporation to its shareholders.[225] Where there is a significant amount of passive investment income, the carryover of the target's earnings and profits may result in an entity level tax under Section 1375 and/or eventually pose a termination risk under Section 1362(d)(3).

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

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

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

Section 332(b) requires that the parent must adopt a plan of liquidation when it owns 80% or more of the stock of the liquidating subsidiary. A QSUB election is, by design, a constructive

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

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

224 Section 332.

225 Section 1368(c).

liquidation. Since the subsidiary will not liquidate under state law, the question arises as to whether the adoption of a plan of liquidation is necessary. The timing of the deemed liquidation may also affect its tax consequences. The deemed liquidation is effective at the close of the date prior to the QSUB election is becoming effective.[226] For the conversion of a consolidated group (and its parent corporation), the S corporation/QSUB election deemed liquidation of the QSUBs will be deemed to occur in the last consolidated return year. This means that ELA will be eliminated.[227]

Generally the ordering of the QSUB elections is from the "bottom up" in order to avoid ELA recapture unless the election form designates a QSUB election sequence.[228] For example, if A, an S corporation, owns all of the stock of B and C, and B and C each own 50% of the stock of D, A should specify that the B and C liquidations occur first, in order to qualify the entire set of deemed liquidations.[229]

Where the QSUB election is made after the acquisition of another corporation, the liquidation is deemed to occur immediately after the stock ownership requirement is met.[230]

The deemed liquidation occurs immediately after the deemed asset purchase.[231] The regulations provide that, for purposes of satisfying the requirement of Section 332(b) that the parent corporation own stock in the subsidiary meeting the requirements of Section 1504(a)(2) on the date of adoption of the plan of liquidation of the subsidiary, the plan of liquidation is deemed adopted immediately before the deemed liquidation incident to a QSUB election unless a formal plan of liquidation that contemplates the filing of the QSUB election is adopted on an earlier date.[232] Still if as a result of the application of general tax principles the transactions that include the QSUB election are treated as an asset acquisition, and as further subject to transitional relief, Section 332 is not applicable and this rule has no relevance.

[f] *Criticism Over Application of Step Transaction Doctrine.*

Applying step transaction to the acquisition of stock that precedes a QSUB election can cause the transaction to be recast as an asset acquisition under Section 368 with unfortunate results for the unwary or unsophisticated, which again, is inconsistent with the legislative history to QSUB. Under step transaction principles, for example, if, pursuant to a plan, a shareholder contributes the stock of one wholly owned S corporation (S2) to another wholly owned S corporation (S1), and makes a QSUB election for S2, the transaction generally would be a reorganization under Section 368(a)(1)(D), with the possibility of gain recognition under Section 357(c).[233]

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226 Reg. §1.1361-4(b)(1).

227 Reg. §1.1502- 19(b)(2)(i).

228 Reg. §1.1361-4(b)(2).

229 See Form 8869.

230 Reg. §1.1361-4(b)(3)(i).

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

232 Reg. §1.1361-4(a)(2)(iii), (iv).

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

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

In Bausch & Lomb Optical Co. v. Commissioner,[234] the taxpayer owned 79 percent of the stock of a subsidiary corporation. In order to acquire its assets, the taxpayer issued its stock in exchange for all the assets; the subsidiary then liquidated, distributing the parent's stock pro rata to all of its shareholders. The outside shareholders of the subsidiary thus became minority shareholders of the parent. The various steps were held to constitute a single plan having the effect of a taxable liquidation (to the extent of the assets received in exchange for the parent's 79 percent stock interest), rather than a tax-free Type C reorganization, on the theory that the assets were acquired by the taxpayer in consideration for its stock of the subsidiary rather than in exchange for its own voting stock, as required by Section 368(a)(1)(C).

[g] *Examples of Step Transaction and QSUB Election.*[235]

[i] Qualified Stock Purchase Followed by QSUB Election.

In the first example, a C corporation acquires all of a solvent, target corporation from an unrelated individual for cash and short-term notes. As part of the same plan, the acquiring corporation immediately makes an S election for itself and a QSUB election for the target. The example provides that since the stock purchase is "qualified" per Section 338(d)(3), the deemed liquidation is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under Sections 332 and 337.[236]

[ii] Acquisition of Stock Through Type C Reorganization Followed by QSUB Election for Target Corporation.

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

[iii] Deemed Liquidation Recharacterized as Type D Reorganization.

Another example in the final regulations raises the potential problem under Section 357(c) in connection with a QSUB election. Of course, this problem was removed temporarily under a transactional rule contained in Reg. §1.1361-4(a)(5)(i). Individual A contributes all of the outstanding stock of Y to his wholly owned S corporation, X, and immediately causes X to make a QSUB election for Y. The example concludes that the transaction will be a Type D reorganization, assuming the other conditions for reorganization treatment are satisfied, and

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234 267 F.2d 75 (2d Cir. 1959) cert denied 361 U.S. 835 (1959).

235 Reg. §1.1362-4(a)(2)(ii).

236 See Rev. Rul. 90-95; Reg. §1.338.

consequently, that if the sum of the Y liabilities treated as assumed by X exceeds the total of the adjusted basis of Y's property, Section 357(c) will apply to the transaction and the excess will be gain from the sale of the contributed assets as allocated under relative FMVs.

[h] *QSUB Election Involving Insolvent Subsidiary.*

Despite receiving comments that insolvent subsidiaries should qualify for a deemed 332 liquidation, the final regulations treat insolvent subsidiary liquidations, even as part of a QSUB election, as outside of Section 332. In general, Section 332 does not apply to the liquidation of an insolvent corporation, because the parent corporation does not receive at least partial payment for the stock of its subsidiary. An example is provided in the final regulations.[237] In such instance the tax attributes and adjusted basis of the assets of the subsidiary will not carry over to the parent. As far as transitional relief is concerned, the final regulations provide that for related party acquisitions followed by a QSUB election, the step transaction will not apply provided the QSUB election is made prior to January 1, 2001.[238] Examples are provided in the regulations as to the application of transitional relief.

Negative stock basis or an "excess loss account" (ELA) can arise under the investment basis rules to the consolidated return regulations. When the subsidiary's losses from operations exceed the parent's investment, such excess constitutes an excess loss account (ELA). Reg. 1.1502-19 provides rules requiring, in certain instances, a member (X) of a consolidated group of corporations to include in income its ELA in the stock of another member (Y) of the group. A negative basis or ELA arises where a parent corporation has been funding a subsidiary's operating losses generally involving third party borrowing. An ELA must be included in X's income if X is treated as disposing of Y's stock.[239] A merger or liquidation of X into an S corporation or an S election by X is treated as a disposition that triggers income recognition with respect to an ELA in Y stock. In contrast, X's income or gain in certain cases is subject to any nonrecognition or deferral rules, including Section 332. As a result, if Y liquidates into X in a transaction subject to Section 332 (and the subsidiary is solvent), there is no income recognition with respect to an ELA in Y's stock.[240] This is based on the rationale that the nontaxable liquidation of a member the stock of which has the ELA eliminates the separate entity treatment of the stock of the subsidiary, since the tax basis of the stock is no longer relevant.

Impact of QSUB election on ELAs. Under Reg. 1.1361-4(b)(1), if the common parent of a consolidated group elects S status, the deemed liquidations of the subsidiary members of the consolidated group for which QSUB elections are made (effective on the same date as the S election) occur as of the close of the day before the QSUB elections are effective, while the S electing parent is still a C corporation. As a result, there is no triggering of income with respect to ELAs in the stock of the subsidiary corporations if the liquidations qualify under Section 332. Furthermore, the order of the deemed liquidations for a tiered group of corporations for which QSUB elections are made (effective on the same date) is significant for ELA (and Section 1374 ) purposes. Under the "lowest to highest" liquidations of tiered subsidiaries approach, the deemed liquidation of the common parent follows the deemed liquidation of its subsidiaries. Accordingly, there is no deconsolidation for purposes of Reg. 1.1502-19 and no triggering of ELAs. In other circumstances, however, a top to bottom liquidation of a

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237 Reg. §1.332-4(d), Ex. 5.

238 Reg. §1.1361-4(a)(5)(i).

239 Reg. 1.1502-19(b)(1). See also Reg. §§ 1.1502-19(c)(2) and -75(c).

240 *See* Reg. 1.1502-19(b)(2)(i). *See also Textron, Inc.,* 561 F2d 1023 (1st Cir. 1977); Compare, Norman Scott, Inc., 48 TC 598 (1967); Rev. Rul. 68-602, 1968-2 CB 135.

tiered group of subsidiaries may be preferable. Therefore, the final regulations allow the S corporation to specify the order of the deemed liquidations when QSUB elections are made (effective on the same day) for a tiered group of subsidiaries. In default of an election, the deemed liquidations occur in succession on the effective date of the election, beginning with the lowest tier subsidiary.

[i] *Application to Newly Formed Subsidiaries.*

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

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

[j] *"F" Reorganizations.*

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

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

Citing Rev. Rul. 64-250,[241] the IRS concluded that pursuant to the F reorganization, the S corporation election would continue in effect with respect to the surviving QSUB following the merger. Additionally, citing Rev. Rul. 2004-85,[242] the IRS found that the status of the S corporation's other QSUB would not terminate as a result of the F reorganization.

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[241] 1964-2 CB 333.

[242] 2004-2 CB 189.

Interestingly, the ruling does not address whether the surviving entity should continue to use the federal identification number previously used by the S corporation or the federal identification number of the QSUB into which it was merged. In Rev. Rul. 73-526,[243] the IRS ruled that where an S corporation merges into another corporation in a transaction qualifying as an F reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation. However, more recently in Rev. Rul. 2008-18,[244] discussed further below, the IRS ruled that in the two situations presented in the ruling, which both qualified as F reorganizations within the meaning of Section 368(a)(1)(F), the newly formed corporations would be required to obtain new employer identification numbers and that the existing corporation which became a QSUB would retain its same employer identification number.

[k] *Timing of Deemed Liquidation.*

[i] Where Parent Already Owns 100% of Subsidiary.

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

[ii] Acquisitions by S Corporations of Stock of Target/QSUB Election.

A second rule pertains to acquisitions of target corporations, i.e., where an S corporation does not own all of the subsidiary's stock on the day before the QSUB election is to be effective. In this situation, the regulations provide that the deemed liquidation occurs immediately after the time at which the S corporation's owns 100% of the subsidiary's stock.[245]

[iii] Qualified Stock Acquisitions Under Section 338.

The QSUB election is not effective for the target until the day after the acquisition date. The deemed liquidation resulting from the QSUB election occurs immediately after the date of the deemed asset purchase by the new target corporation under Section 338.[246] Where the S corporation makes an election under Section 338 (without a Section 338(h)(10) election) with respect to a target, the target must file a final or deemed sale return as a C corporation for the deemed sale.[247]

[l] *Effect of QSUB Election on S Corporation's Basis in Subsidiary Stock.*

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243 1973-2 CB 404.
244 2008-1 CB 674.
245 Reg. §1.1361-4(b)(2).
246 Section 338(h)(2). Reg. §1.1361-4(b)(2).
247 Reg. §1.338-10T(a). Reg. §1.1361-4(d), Ex. 3.

Aside from the tax history issues generated by a deemed liquidation, perhaps the most immediate drawback to the QSUB is the disappearing basis problem. Suppose, for example, that an S corporation purchases all of the stock of a target C corporation (in a non-Section 338 transaction) at a purchase price of $2,000x. Assume the target's basis in its assets is $500x. By purchasing all of the target's stock and making the QSUB election (or, alternatively, by immediately liquidating the target into the purchaser), the parent's cost basis in the subsidiary stock, i.e., $2,000x, disappears. The only relevant basis to the parent is the adjusted basis of the subsidiary's assets. The $2,000x basis is not reinstated if there is a termination of the QSUB election because the subsidiary is treated as a newly-formed corporation at that time under Section 1361(b)(3)(C). Again, the inside versus outside value differential will present built-in gains tax problems to the purchaser with respect to the QSUB's assets. The total net unrealized built-in gain is allocated on an asset-by-asset basis including goodwill and going concern value.[248]

[m] *Acquisitions of S Corporations–AAA and Suspended Losses.*

The Treasury Regulations acknowledge that the AAA of a target S corporation which is acquired in a tax-free reorganization or liquidation described in Sections 337/332 will be inherited by the acquiring corporation.[249] Reg. §1.1361-4(c) further provides that suspended losses also carry over where one S corporation acquires the stock of another S corporation referencing Reg. §1.1366-2(c)(1).

[n] *Application of Built-In Gains Tax to QSUB Elections.*

Section 1374 imposes a corporate level tax on the built in gains of an S corporation after it has converted from C corporation status. The tax is imposed on net recognized built-in gains for the subsequent 5 year period following the effective date of a C to S conversion. Section 1374(d)(8) provides the Section 1374 tax carries over with respect to an S corporation's receipt of transferred basis property from another C corporation or S corporation having an unexpired recognition period under Section 1374 from a prior conversion event. Therefore, Section 1374(d)(8) will apply with respect to the purchase of all of the stock of a target corporation and subsequent QSUB election under the deemed liquidation under Section 332 rule. In such case, a separate determination of tax is made with respect to the assets acquired by each particular target corporation. Regulations under Section 1374 provide that the tax attributes of the target, e.g., net operating loss and capital loss carryovers, may only be used against the target's subsequent recognized built-in gains.[250] Furthermore, Section 1374 attributes acquired in one Section 1374(d)(8) transaction may only be used to reduce the tax on the disposition of assets acquired in that transaction. This results in a "Libson Shops" type separate pooling and tracing approach.[251]

[o] *Reorganizations Involving QSUBs.*

QSUBs can be a party to a tax-free reorganization, such as a Section 368(a)(1)(A) merger or consolidation.[252] Provision is made that if a target S corporation that has a QSUB merges into

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

[249] Reg. §1.1368-2(d)(2).

[250] Reg. §1.1374-8(b).

[251] Libson Shops, Inc. v. Koehler, 353 US 382 (1957). But see Maxwell Hardware Co. v. Comm'r, 343 F.2d 713 (9th Cir. 1965).

[252] Reg. §1.368-2(b)(iv) ex. 2.

a disregarded entity which is owned by the acquiring C corporation, the reorganization, taxable or non-taxable, will result in the termination of the QSUB election followed by the deemed contribution of the former QSUB's assets to a new C corporation immediately prior to the merger does not disqualify the merger under Section 368(a)(1)(A).[253] These regulations generally apply to transactions occurring on or after January 23, 2006.[254]

As discussed further above, the Service and Treasury proposed regulations issued by the Treasury and the Internal Revenue Service in January 2005 containing a revised definition of statutory merger or consolidation that allows transactions effected pursuant to the statutes of a foreign jurisdiction or of a United States possession to qualify as a statutory merger or consolidation. Simultaneously with the publication of the 2005 proposed regulations, the IRS and Treasury Department published a notice of proposed rulemaking proposing amendments to the regulations under Sections 358, 367, and 884 to reflect that, under the 2005 proposed regulations, a transaction involving a foreign entity and a transaction effected pursuant to the laws of a foreign jurisdiction may qualify as a statutory merger or consolidation (the foreign regulations). The regulations were finalized in January, 2006.[255]

[p] *Termination of QSUB Election.*

A QSUB election may be terminated: (i) by revocation; (ii) by reason of the parent no longer being an S corporation; or (iii) by the subsidiary's failing to meet the QSUB eligibility requirements. Where a QSUB election is terminated due to a disqualifying event, Reg. §1.1361-5(a)(2) requires the S corporation to attach a statement to its return for the tax year in which the termination occurs, notifying the IRS that a QSUB election terminated. This notification also must include the date of the termination and the names, addresses, and employer identification numbers of both the parent S corporation and the QSUB. Reg. §1.1361-5(a)(3) provides, alternatively, that where a QSUB election terminates because the S corporation becomes a member of a consolidated group (and no election under Section 338(g) is made), principles contained in Reg. §1.1502-76(b)(1)(ii)-(A)(2)(special rules for S corporations joining consolidated groups) apply. This regulation eliminates the "one-day return problem" by providing that an S corporation that is acquired by a consolidated group in a transaction other than a

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

[254] Reg. §1.368-2(b)(1)(v).

[255] TD 918271 FR 4259-01, 2006-7 I.R.B. 422, 2006 WL 173491 (F.R.). Reg. §1.367(a)-3(a)( "if, in an exchange described in section 354 or 356, a U.S. person exchanges stock or securities of a foreign corporation in a reorganization described in section 368(a)(1)(E), or a U.S. person exchanges stock or securities of a domestic or foreign corporation pursuant to an asset reorganization that is not treated as an indirect stock transfer under paragraph (d) of this section, such section 354 or 356 exchange is not a transfer to a foreign corporation subject to section 367(a)"); Reg. §1.367(a)(3)(" if, in a transfer described in section 361, a domestic merging corporation transfers stock of a controlling corporation to a foreign surviving corporation in a reorganization described in sections 368(a)(1)(A) and (a)(2)(E), such section 361 transfer is not subject to section 367(a) if the stock of the controlling corporation is provided to the merging corporation by the controlling corporation pursuant to the plan of reorganization.").

Section 338 transfer, becomes a member of the consolidated group at the beginning of the day on which termination of its S election is effective.[256]

[q] *Effective Date of Termination.*

The final regulations provide that the effective date of a QSUB termination is: (i) on the effective date contained in the revocation statement if a QSUB election is revoked under Reg. §1.1361-3(b); (ii) at the close of the last day of the parent's last taxable year as an S corporation if the parent's S election terminates under Reg. §1.1362-2; or (iii) at the close of the day on which a disqualification event occurs that results in the QSUB not being described under Section 1361(b)(3)(B).[257]

> Example: A terminates its S election effective on January 1, 2006. A wholly owned QSUB B no longer qualifies as a QSUB at the close of December 31, 2016.
>
> Example: A sells 1 share of its QSUB B on December 10, 2006. B is no longer a QSUB at the close of December 10, 2016.
>
> Example: A has a QSUB election for B and C while B owns 100% of C. B transfers all of its C stock to A. No termination occurs since A is already treated as owning all of the C stock through B.
>
> Example: A, an S corporation owns 100% of B a QSUB. Z, the common parent of a consolidated group purchases 80% of the stock of A on June 1, 20106. Z does not make a Section 338 election. A's S election terminates its election as of the close of the preceding date, May 31, 2016. The QSUB election for B is also terminated as of the close of May 31, 2016. Pursuant to Reg. §1.1502-76(b)(1)-(ii)(A)(2), A and B become members of Z's consolidated group as of the start of June 1, 2016. If instead of purchasing 80% of A, Z purchased 80% of B, A's QSUB election terminates as of the close of June 1, 2006 and B becomes a member of the consolidated group at such time.[258]

Under the final regulations, where a tier of QSUBs have their elections terminated on the same day, the formation of any higher tier subsidiary in a deemed Section 351 transaction is

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

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

[258] See Stratton, Kennedy & Lennon, "Whose Deduction Is It Anyway?" Daily Tax Rep. (BNA) No. 220 at J-1 (Nov. 14, 2013); Batter & Sloan, "IRS Addresses Controversial Option Deduction Issue In GLAM 2012-010," 40 Corp. Tax'n 44 (2013); Harris, Hoffenberg & Vogel, "Questioning the IRS's Application of the Next-Day Rule," 145 Tax Notes 235 (Oct. 13, 2014). See Prop. Reg. §1.1502-76(b)(1)(ii)(A)(2).

deemed to have occurred prior to the formation of a lower tier subsidiary, a so-called "top to bottom" approach.[259]

[r] *Effect of Termination of QSUB Election; Sale or Other Disposition of QSUB Stock.*

In the event of a termination of the QSUB's election, the corporation is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the S corporation in exchange for stock of the new corporation immediately before the termination.[260] Without specifically providing that there is a deemed Section 351 transaction, Reg. §1.1361-5(b)(1) provides that the tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Code and general principles of tax law, including the step transaction doctrine. The sale of 100% of the stock of a QSUB is treated as the sale of the assets of the QSUB followed by a Section 351 transfer of the assets to a new corporation by the purchaser (or purchasers).[261]

Prior to the 2007 Act, it was necessary to consider the control requirement (80% transferor group) in Section 368(c) for the termination of a QSUB election, for example upon the sale of some or all of the shares, as well as assessing the potential impact of Section 357(c) and the other potential exceptions to tax free treatment. Under the 2007 Act, if a QSUB election terminates because some or all of the QSUB stock is sold, the sale is treated as a sale of an undivided interest in the assets of the QSUB followed by a deemed Section 351 transfer of the assets to the new corporation by the purchaser (and the seller to the extent of any unsold shares).[262]

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

A termination of QSUB status may result through a revocation by the parent or a consequence of transferring a single share of subsidiary stock to a shareholder or third party. More specifically, Section 1361(b)(3)(c) provides that a upon termination, the QSUB is treated as a new corporation acquiring all of its assets and assuming all of its liabilities from the S corporation parent in exchange for its stock. The former QSUB is prohibited from re-electing S status or QSUB status for 5 years

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259 Reg. §1.1361-5(b)(1)(ii).

260 Section 1361(b)(3)(C).

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

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

unless permission is received from the Service.[263] The final regulations provide some relief. For S and QSUB election s effective after 1996, where a QSUB election terminates, the corporation may, without obtaining IRS consent, make an S election or be subject to a new QSUB election prior to the end of the five year waiting period provided: (i) immediately following the termination, the corporation (or its successor) is otherwise eligible to make an S election or be subject to a QSUB election, and (ii) the relevant election is made effective immediately following the termination of the QSUB election.[264]

> Example: Assume X, an S corporation, owns 100% of Y, a QSUB and distributes all of its Y stock to X shareholders. The distribution terminates the corporation's QSUB election.[265] Assuming Y is otherwise eligible to elect S, Y's shareholders may elect S status without IRS consent within the applicable 5 year period. The same result applies were X to instead sell 100% of its Y stock to an unrelated S corporation, Z, where Z intends to make a QSUB election effective on the date of the acquisition.

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

On July 23, 2014, the Department of the Treasury issued Final Regulations on basis increases for back-to-back loans involving S corporations.[266] The Final Regulations adopt the proposed regulations without substantive change, except for changes allowing a retroactive effective date (which is a positive change to the Proposed Regulations) and minor clarifying revisions. The Proposed Regulations (and now the Final Regulations) constitute a vast improvement over the current state of the law which has applied the "actual economic outlay" test and the "poorer in a material sense concept to determine whether a shareholder is entitled to a basis increase under Section 1366(d)(1)(B). Rather, the Final Regulations allow for a basis increase under Section 1366(d)(1)(B) if the debt running from the S corporation to the shareholder is a "bona fide debt under general Federal tax principles. In view of the uncertainty and inconsistent judicial decisions regarding basis increases with respect to back-to-back loans, the guidance is welcome and the IRS should be applauded for its response to the request for regulations made by the ABA Tax Section, the AICPA and many tax practitioners, and for its abandonment of the "actual economic outlay" test with respect to back-to-back loans. The Final Regulations may be relied on by taxpayers with respect to indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2014.

The preamble to the 2014 Final Regulations state that the "Treasury Department and the IRS continue to study issues relating to stock basis and may address these issues in future guidance."

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

264 Reg. §1.1361-5(c)(2).

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

266 TD 9682, 79 FR 42678 (7/23/2014); Reg. §1.1366-2(a)(2), Ex.(2)("Back -to-back loan transaction. A is the sole shareholder of two S corporations, S1 and S2. S1 loaned $200,000 to A. A then loaned $200,000 to S2. Whether the loan from A to S2 constitutes bona fide indebtedness from S2 to A is determined under general Federal tax principles and depends upon all of the facts and circumstances. See paragraph (a)(2)(i) of this section. If A's loan to S2 constitutes bona fide indebtedness from S2 to A, A's back-to-back loan increases A's basis of indebtedness in S2 under paragraph (a)(2)(iii) of this section). See also TAM 200619021 (5/12/2006); *Meruelo v. Comm'r*, 923 F.3d 938 (11th Cir. 2019), aff'g TC Memo. 2018-16. Compare, *Ruckriegel v. Comm'r*, TC Memo. 2006-78. For a discussion of the *Meruelo* 11th Circuit decision see Klein and Looney, "The Eleventh Circuit Provides a Ray of Sunshine for Back-to-Back Loans", Corporate Taxation (WG&L) 46 WGL-CTAX 38 (2019).

## V. TAX FREE REORGANIZATIONS

### 5.01. *Basic Reorganization Patterns*

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

1. Statutory merger/consolidation. Type A. Section 368(a)(1)(A).[267]
2. Stock "solely" for voting stock. Type B. Section 368(a)(1)(B).
3. All or "substantially all" assets for voting stock. Type C. Section 368(a)(1)(C).
4. All or part of assets transferred to corporation controlled by transferor. Type D. Section 368(a)(1)(D).
5. Recapitalization. Type E. Section 368(a)(1)(E).
6. Place of Organization. Type F. Section 138(a)(1)(F). Mere Change in Form, Identity.
7. Bankruptcy Reorganization. Type G. Section 368(a)(1)(G).

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

### 5.02. *Type A Reorganizations*

#### [1] Application to S Corporations.

In various favorable public and private letter rulings, the Service has permitted an S corporation to be a party to a reorganization which is a qualifying merger between two corporations under state law.[268] Although stock of a surviving S corporation which is transferred momentarily to an acquired corporation could be treated as resulting in an ineligible shareholder, this "foot fault" has been ignored by the Service in a Type A (as well as other types) of tax-free reorganizations.[269]

Two other methods for effectuating Type A treatment but which are treated separately under Section 368 are the forward triangular merger (Section 368(a)(2)(D)) and the reverse triangular merger (Section 368(a)(2)(E)), each having separate requirements. A forward triangular merger under Section 368(a)(2)(D) involves the merger of the target into a wholly owned subsidiary of the acquiring corporation. The target must transfer "substantially all" of its assets[270] and no shares of the subsidiary corporation can be used. It is not necessary for all of the assets be acquired solely for voting stock, and any other consideration is satisfactory as long as continuity of interest is met. A reverse triangular merger under Section 368(a)(2)(E) involves the merger of a subsidiary of the acquirer into the target corporation, with the target continuing as the surviving corporation. The target corporation must retain "substantially all" of its assets and the shareholders of the target corporation must exchange 80% or more of the target stock for voting stock of the acquiring corporation or its parent company in exchange for voting stock of the acquiring company or parent.

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[267] See also Sections 368(a)(2)(D), 368(a)(2)(E).

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

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

[270] Generally, "substantially all" means that the merger subsidiary must acquire 90% of the net assets and 70% of the gross assets of the target corporation.

With the revisions in SBJPA permitting ownership of C subsidiaries, an S corporation can be an acquiring corporation in a forward or reverse triangular merger. Where a QSUB is involved, the S corporation parent is treated as a party to the reorganization based on the "tax nothing" status of the QSUB.[271]

[2] Impact on Subchapter S Status.

[a] *Acquiring S Corporation.*

The S election of an acquiring S corporation in a Type A reorganization will not terminate, per se, as a direct result of receiving the assets (and assuming the liabilities) of the merged or target corporation.[272]

The question will be whether the shareholders of the target corporation are each eligible to own stock in the acquiring S corporation, whether the permitted number of shareholder requirement and the other ineligible shareholder rules will be triggered. In such instances, consideration should be given to taking out ineligible shareholders of the target with cash payments or notes without violating the continuity of interest requirements.[273] However, a proprietary interest in the target corporation is not preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or the stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved. For purposes of the continuity of interest requirement, a mere disposition of stock of the target corporation prior to a potential reorganization to persons not related to the target corporation or to persons not to the issuing corporation is disregarded and a mere disposition of stock of the issuing corporation received in a potential reorganization to persons not related to the issuing corporation is disregarded).

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

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[271] Reg. §301.7701-2(b)(5).

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

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

The issuance of stock in the corporation to shareholders of the target may give the target shareholders the power to revoke the corporation's S election, such as where the target shareholders receive more than 50% of the acquiring corporation's stock.[274]

Where the election of an acquiring S corporation is terminated as a result of a Type A merger, it presumably will not be able to reelect S status for a succeeding period of 4 years after the year in which the terminating event took place unless early consent is received by the Service.[275] This rule applies to the corporation and any "successor corporation." A successor corporation is defined as any corporation: (i) of which 50 percent or more of its stock is owned, directly or indirectly, by the same persons who, on the date of termination, owned 50 percent or more of the stock of the S corporation whose election was terminated, and (ii) which acquires a "substantial portion" of the assets of such small business corporation, or a "substantial portion" of the assets of which were assets of such small business corporation.[276] Generally, a corporation will not be a successor to a terminated S corporation unless there is both a continuity of shareholder interest of at least 50 percent and the new corporation acquires the assets of the S corporation or a substantial portion of the assets it holds are the former S corporation's assets.[277]

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

[b] *S Corporation Acquired.*

Where an S corporation is a target corporation and is acquired or consolidated with a C corporation, its S status will end because the corporation ceases to exist and its taxable year will end on the date that it transfers its assets.[278] The Service has ruled that the termination of S status does not occur "with respect to" the corporation's final taxable year.[279] This means the S corporation will continue its S status through the last day of its existence. Where it is important to preserve the target corporation's S election, consideration should be given to structuring the acquisition as a "reverse merger" so that the target S corporation is the surviving corporation. Where an S corporation and its target form a new entity in a consolidation, the S corporation elections of both entities terminate as a practical matter but the Service views this as not resulting in a termination of either election. The new entity should be allowed to make a new S election without regard to the waiting period of Section 1362(g) based on an outstanding ruling.[280]

[3] Allocation of Income and Loss in Reorganization.

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[274] Section 1361(d)(1).

[275] Section 1362(g).

[276] Reg. §1.1362-5(b).

[277] See PLRs 199918031, 94190010, 9340047. See also IRS INFO 2002-0163, 2002 WL 31991721.

[278] Section 381(b)(1).

[279] Rev. Rul. 64-94, 1964-1 (Part 1) C.B. 317, 318; Rev. Rul. 70-232, 1970-1 C.B. 177, 178. See PLR 20021817 discussed in 4 Bus. Entities 54 (WG&L) (July/August 2002).

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

[a] *Acquiring S Corporation's Election Remains in Effect.*

If the acquiring corporation's S election does not terminate as a result of the merger, income will be allocated in the same manner as if the acquisition had not occurred, i.e., on a per-share/per-day basis.[281] Pre-acquisition income (loss) of the acquiring S corporation, A, may be shifted to the target T shareholders. Post-acquisition income (loss) attributable to T's assets may be shifted to A's shareholders. With respect to income generated by the acquired assets, only post-acquisition income would be included in A's income.[282] If a shareholder terminates his interest as a result of the merger, consideration should be given to closing the corporation's books as of the date of termination.[283] Reg. §1.1368-1(g)(2) provides that where there is a "qualifying disposition" of S stock, the corporation can elect to treat the tax year as if it consisted of separate taxable years with the first ending at the end of the day in which the qualifying disposition occurs. For this purpose, a "qualifying disposition" is (i) disposition of stock of 20% or more of the issued and outstanding stock of the corporation during any 30 day period during the corporation's tax year; (ii) a redemption treated as an exchange per Sections 302(a) or 303 of 20% or more of the outstanding share of stock again within the applicable 30 day period; or (iii) the issuance of stock at least equal to 25% of the previously outstanding stock to one or more shareholders.[284]

[b] *Acquiring S Corporation's Election Terminates.*

If the acquiring corporation's S election does terminate as the direct result of being acquired or through a termination by revocation or three years of excess passive investment income, i.e., and an S termination year occurs, income for the S termination year is allocated on a per-share/per-day basis between the short S and short C years.[285] Accordingly, only the acquiring S corporation's pre-merger shareholders will be allocated its income or loss on a per-share/per-day basis. However, A's shareholders can elect to close the books on the date of termination.[286] The pro rata method, however, can not apply to a Section 338 transaction involving a qualified acquisition of S stock.[287] If there is a 50 percent or more change in ownership of A in the S termination year, A is required to close

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281 Section 1377(a)(1).

282 Section 381(b)(1).

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

284 See Reg. §1.1368-1(g)(2)(i).

285 Section 1362(e)(2).

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

287 Reg. §1.1362-3(b)(3).

it books unless the issuance of its stock in the reorganization is not considered a sale or exchange under Section 1362(e)(6)(D).[288]

Under Section 1366(d), the excess of a shareholder's pro rata share of corporate loss and deductions over basis in stock and debt is carried over indefinitely, subject to other applicable limitations, including Sections 465 and 469. See also the "draconian" Section 461(1) a product of the TCJA 2017.[289] The carryover of the excess loss retains its character through a pro rata rule contained in the regulations.[290] Thus, excess losses can be used, for example, in reporting gain from the sale of assets or deemed sale under Section 338(h)(10) by a shareholder of a target S corporation. Stock and debt are carried forward to future years, where it is deductible to the extent of the shareholder's basis in those years. Suspended losses, with limited exception, are "personal" to the shareholder who was allocated the deductions and losses in the prior year(s). Where a shareholder retains a portion of his or her S stock, the excess losses will remain intact until the shareholder disposes all of the remaining shares. Where stock is transferred to a spouse per Section 1041, however, the transferee succeeds to any carryover with respect to the transferred stock.[291]

Where, for example, the acquiring S corporation's election terminates as part of an acquisition, its shareholders' losses which were suspended under Section 1366(d)(2) will be treated as incurred on the last day of the post-termination transition period.[292] The losses will be deductible to the extent of the shareholder's basis in the stock on such date.[293] However, if an S corporation acquires the assets of another S corporation in a transaction to which Section 381(a)(2) applies, a post-termination transition period does not arise.[294]

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

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

[289] See Hodaszy, "The Curious Case of Section 461(L): Why This Unclear And Unwise New Rule Should Be Construed As Narrowly As Possible", 73 Tax Lawyer 61 (Fall, 2019). But see Wallace, "The Troubling Case of the Unlimited Pass-Through Deduction: Section 2304 of the CARES Act", Univ. of Chicago Law Review Online, (6/29/2020) WESTLAW.

[290] Reg. §1.1366-2(a)(5).

[291] Section 1366(d)(2)(B) (applicable for taxable years beginning after 2004).

[292] Section 1366(d)(3).

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

[294] See Reg. §1.1368-2(d)(2) (for the treatment of the acquisition of the assets of an S corporation by another S corporation in a transaction to which Section 381(a)(2) applies). See Reins-Schweer, "The Power of "Except As Otherwise Provided": Carry Forward of Passive Activity Losses From A Closely Held C Corporation to An S Corporation", 28 Univ. of Iowa Jrnl of Corp. Law (Winter, 2003) WESTLAW.

St. Charles Investment Company v. Commissioner[295] involved a closely held C corporation under Section 469(j)(1). During years in which it engaged in real estate rental activities, it had PALs which were suspended and carried forward under Section 469(b). St. Charles, in 1991, converted to S status and in accordance with Section 469(g)(1)(A), claimed a deduction against gains from the sale of several rental properties after the conversion occurred. The Service disallowed the deduction for the suspended PALs per Section 1371(b)(1) which prohibits S corporations from carrying forward PALs created in its C years to S years. The Tax Court agreed that Section 1371(b)(1) prevailed over the PAL carryover rule. The Tenth Circuit, however, reversed the Tax Court and held that Section 469(b) permits St. Charles to use its C year PALs to offset income in its post-conversion gains based on its finding that Congress did not expressly want Section 469(b) to be preempted by Section 1371(b)(1).

[c] *Impact on Acquired S Corporation.*

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

[4] Tax Attributes.

[a] *Net Operating Losses.*

The acquiring corporation will generally succeed to the tax attributes of the target corporation, T, under Section 381. However, the acquiring S corporation will be precluded from using any net operating loss carryovers of the target in computing its taxable income as long as it continues to be an S corporation.[296] In addition, Section 1371(b)(1) prevents any carryover between an S year and C year at the corporate level, although it is unclear whether Section 1371(b)(1) applies only to attributes generated by the acquiring corporation itself or those inherited from a target corporation under Section 381. An S corporation which is acquired generally will not have net operating or capital loss carryovers, although it could have such items from pre-Subchapter S years or from other prior acquisitive transactions.

[b] *Built-in Gains Tax.*

In the case of the Section 1374 built-in gains tax, Section 1374(b)(2) provides that a net operating loss carryover arising from the taxable year for which the S corporation was a C corporation can be used to offset net recognized built-in gains.[297] If Section 382 applies to the net operating loss carryforward on the first day of the recognition period, such limitation will continue to apply in limiting the utilization of the net operating loss carryforward in computing the Section 1374 tax.[298]

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[295] 232 F.3d 773 (10th Cir. 2000), rev'g 110 T.C. 46 (1998).

[296] Sections 1363(b)(2), 703(a)(2)(D).

[297] See Reg. §1.1374-5.

[298] See also Reg. §1.1374-6 for utilization of credit carryforwards.

An S corporation's Section 1374 tax attributes when it became an S corporation may only be used to reduce the tax imposed on the dispositions of such assets of the S corporation held at that time.

The regulations require an acquiring S corporation to individually account for separate asset acquisitions for Section 1374 purposes. Accordingly, an acquiring S corporation may only apply Section 381 attributes of a target corporation when computing the built-in gains tax on such acquired corporation's assets and not against any built-in gain in other assets of the acquiring corporation.[299]

[c] *Earnings and Profits from C Years.*

If the target corporation is a C corporation with earnings and profits, T's earnings and profits will carry over to the S acquiring corporation under Section 381. Accordingly, the S corporation may be subject to restrictions on passive investment income.[300] Moreover, post-acquisition distributions will be tested for dividend status under Section 1368(c) rather than Section 1368(b).

[d] *LIFO Recapture.*

A transfer of a C corporation's LIFO inventory to an S corporation results in LIFO recapture under Section 1363(d) even though the transaction is otherwise generally non-taxable to the transferor (C corporation).[301]

[5] Distributions.

[a] *Pre-Merger.*

Pre-merger distributions generally should be governed by Section 1368 unless it can be established that the acquiring corporation funding the pre-merger distributions.[302] Where the target is an S corporation and its election is terminated as a result of being acquired by a C corporation, pre-merger distributions of the target of AAA should be made. Otherwise, the AAA account will evaporate as a result of the reorganization unless the acquiring corporation is an S corporation on the date of the reorganization. Still, the regulations allow for a post-termination transition period distribution to the target shareholders of the now acquiring corporation in accordance with Section 1371(e).[303] On the other hand, if the acquiring corporation provides the consideration for the distributions, the reorganization distributions rules should apply.

[b] *Distributions as Part of Tax-Free Reorganization.*

In the case of distributions made, pursuant to the plan of reorganization, it is unclear whether such distributions are governed by Section 356 or Section 1368. Under Section 356, boot distributions could result in the recognition of gain by a shareholder of the target S corporation. Section

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299 See Reg. §1.1374-8(b).

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

301 Reg. §1.1363-2(a)(2).

302 Cf. Rev. Rul. 71-266, 1971-1 C.B. 262. See August, "Mergers And Acquisitions of S Corporations—Part 2", 9 No. 3 Bus. Entities 18 (WG&L) (May/June 2007).

303 See Section 1377(b)(1).

356 generally treats gain as a dividend if the exchange "has the effect of the distribution of a dividend."[304] Alternatively, Section 1368 generally would allow an S corporation to make a tax-free distribution to the extent of the target shareholder's basis in the corporation's stock or, if the corporation has earnings and profits, its accumulated adjustments account.

[c] *Post-merger Distributions.*

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

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

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

After AAA is adjusted for the year, then the tax impact to any distributions is assessed.[305] Where distributions exceed AAA, AAA is applied pro rata to the distributions made during the year.[306] Under a recent change in the law, distributions may be made from AAA to the extent of the ending AAA for the prior year where there is a net loss during the current year.[307] Redemptions are charged against AAA based on whether the redemption is treated as an exchange under Sections 302(a) or 303(a) or a dividend equivalent redemption.

Prior to the issuance of regulations under SSRA, and although not specifically identified under Section 381(c), the Service has consistently ruled that an acquiring S corporation's and target S corporation's AAA are combined after the merger.[308] Reg. §1.1368-2(d)(2), provides that in the case of a Type A merger, the acquiring corporation succeeds to and merges its AAA with the AAA of the target. Accordingly, the AAA of an acquiring S corporation following a Type A merger with a target S corporation will be the sum of the AAAs of the respective corporations immediately prior to the reorganization.[309] The regulations further provide for the carryover of a negative AAA account of the

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

[305] Section 1368(d)(2).

[306] Reg. §1.1368-2(b).

[307] Section 1368(c)1)(C).

[308] See, e.g., PLR 9115059, 9115029 and 9002051.

[309] Reg. §1.1368-2(d)(2).

acquired corporation.[310] If the acquiring C corporation makes an S election effective for its tax year that includes the date of the reorganization, the AAA of the target S corporation carries over in that both corporations are S corporations at the time of the transaction but only for purposes of permitting shareholders of the target S corporation to receive qualifying distributions from AAA during the post-termination transition period. In a spin off transaction, the AAA of the distributing corporation is allocated in a manner similar to the method by which earnings and profits are allocated in such transaction under the regulations.

5.03. *Type B Reorganization*

[1] In General.

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

[a] *S Corporation as the Acquiring Corporation.*

If the S corporation is the acquiring corporation, it can immediately make a QSUB election with respect to the purchased target which arguably recasts the transaction into a Type C reorganization.[311]

[b] *S Corporation as the Acquired Corporation.*

Where an S corporation is acquired in a Type B reorganization, the target corporation's S status will terminate because of the presence of an ineligible corporate shareholder.[312] The taxable year is divided into two years, the first of which is subject to the rules applicable to Subchapter S.[313] The same rules apply with respect to the allocation of income and loss as with respect to a tax-free acquisition of assets.

[2] Tax Attributes.

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

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

[311] See Reg. §1.1361-4 Ex. 2. See August and Looney, "Tax Planning For S Corporations: Mergers And Acquisitions Involving S Corporations (Part 3)", Practical Tax Lawyer (Summer 2016) WESTLAW

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

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

5.04. *Type C Reorganization*

[1] In General.

A Type C reorganization entails the issuance by an acquiring corporation of its voting stock to another corporation in exchange for substantially all of the assets of the acquired corporation. The acquiring corporation may also transfer a small amount of boot (cash or other property, and/or assumption of liabilities of the target) as long as 80 percent of the value of the assets of the target is acquired solely in exchange for voting stock.[314] The stock and other consideration, as well as any assets retained, must generally be distributed to the shareholders of the target corporation in complete liquidation unless the Services waives the requirement.[315] Based on the authority set forth in GCM 39768, S corporations may act as either acquiring corporations or target corporations in a Type C reorganization.

[a] *S Corporation as Acquiring Corporation.*

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

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

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

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

[b] *S Corporation as Target Corporation.*

Since the Service's position is that an S corporation may engage in a Type C reorganization, the target S corporation does not forfeit its S election as a consequence, its existence

[314] Section 368(a)(2)(B).

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

merely terminates. This will result in an acceleration of income or loss attributable to the target S corporation's short taxable year.[316]

[c] *Momentary Affiliation.*

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

[d] *Regulatory Repeal of Bausch & Lomb Doctrine; Prior Stock Ownership of Target.*

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

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

[316] Section 381(b)(1).

Example: Integrated Steps Cause Failure to Qualify as a Type C Reorganization. The facts are the same as in Example 1 except that P purchased the 60 shares of T for $60x in cash in connection with the acquisition of T's assets. The transaction does not satisfy the solely for voting stock requirement of paragraph (d)(2)(ii) of this Section because P is treated as having acquired all of the T assets for consideration consisting of $70x of cash, $10x of liability assumption and $30x of P voting stock, and the sum of $70x of cash and the assumption by P of $10x of liabilities exceeds 20% of the value of the properties of T.

[e] *Tax Attributes.*

A Type C reorganization results in a carryover of the basis of the assets acquired from the target as well as the tax history and attributes of the subsidiary, including its earnings and profits account. Accordingly, an S corporation acquiring a target in a Type C reorganization may have passive investment income issues as well as falling into the three tier distribution system under Section 1368(c)(3) if the target has C earnings and profits. A target C corporation presumably would be subject to the LIFO recapture rule were it acquired by a S corporation in a Type C reorganization.[317] The regulations divide the liability resulting on the LIFO recapture tax between the C corporation target and the acquiring S corporation.[318]

5.05. *Type D Reorganization*

[1] Acquisitive Type D Reorganization.

In an acquisitive (nondivisive) D reorganization, a corporation (transferor) transfers substantially all of its assets to another corporation (transferee) in exchange for stock of the transferee.[319] This stock, along with any other consideration received and all retained assets, is then distributed in complete liquidation to the shareholders of the transferor.[320] The shareholders must then be in control (50 percent of the voting power or 50 percent of the value test set forth in Section 304(c), using modified Section 318 attribution rules). The transfer of assets may be accomplished through either a statutory merger or C reorganization structure. In the latter instance, Section 368(a)(2)(A) provides that where a Type C and Type D reorganization overlap, the transaction is controlled by Section 368(a)(1)(D). Where the transfer is effectuated through a statutory merger or consolidation, the transaction may overlap with a type A reorganization.[321] There does not appear to be anything in Subchapter S which is inconsistent with permitting an S corporation to engage in a Type D reorganization.[322] Prior to SBJPA, Section 1371(a)(2), which treated an S corporation as an "individual" in owning stock of another corporation, suggested that an S corporation could not technically engage in a Type D reorganization or Section 355 transaction unless its ownership of the subsidiary was momentary. Still several revenue rulings and GCM 39786 provided authority for spin-off and split-off transactions by S corporations.[323]

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317 Reg. §1.1363-2(a)(2).

318 Reg. 1.1363-2(b).

319 §368(a)(1)(D).

320 §354(b)(1)(B).

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

322 §1371(a)(1); GCM 39768 (12/1/88); PLR 9108059.

323 Rev. Rul. 72-320, 1972-2 C.B. 270 (momentary affiliation in a Type D reorganization did not terminate S corporation status of a distributing corporation under Section 355); Rev. Rul. 73-496, 1973-2 C.B. 312 (similar result

[a] *Similarity to Type A Reorganization.*

The tax consequences to an acquisitive Type D reorganization should have the same effects as a Type A, including the carryover of tax attributes in accordance with Section 381. A critical exception is that in a Type D reorganization Section 357(c) will trigger gain recognition to the transferor corporation where the aggregate amount of liabilities transferred are in excess of the aggregate adjusted basis of the assets transferred.[324] Such Section 357(c) gain, in certain instances, could also fall within the built-in gains tax if the transferred assets were subject to Section 1374.

[2] Divisive Type D Reorganization.

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

[3] Business Purpose.

If the transaction is to qualify as a tax-free reorganization, it must satisfy the business purpose test; it must have one or more real and substantial non-federal tax corporate business purpose.[325] Eligibility for an S election alone will not qualify as a requisite business purpose.[326] Reduction in non-federal taxes will not satisfy the business purpose if: (i) both federal and state taxes are reduced, and (ii) the federal tax reduction is greater than the reduction in any state taxes.[327] A distribution solely to make an S election to save state income or other taxes may be a valid business purpose.[328] Close scrutiny to business purpose is given by the Service.[329] To ensure a tax-free transaction, the shareholders will need to identify a business purposes other than Newco's S corporation election.

When a valid non-tax corporate business purpose does exist, a subsequent S election by either the distributing corporation or controlled corporation may be viewed by the Service as tantamount to tax avoidance, possibly triggering the Service's "no ruling" policy.[330] This no ruling position will not

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in Kimbell-Diamond type acquisition/precursor to Section 338 involving momentary affiliation of 30 days or less). But see Haley Brothers Construction Corp., 87 T.C. 498 (1966).

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

[325] Reg. §§1.355-2(b)(1) and (2).

[326] See Reg. §1.355-2(b)(2).

[327] Reg. §§1.355-2(b)(2) and (5) (Ex. 7). See Martin, "Buying, Selling, or Merging A Professional Practice", ALI-CLE (2/18/1993) WESTLAW. See also Rizzi, "Business Purpose in Spin-Offs Involving Public Companies", 31 Corporate Taxation 27 (WG&L) (Sept/Oct 2004).

[328] PLR 8825085.

[329] Reg. §1.355-2(b)(1). Rev. Proc. 96-30, 1996-1 C.B. 696 superceded by Rev. Proc. 1017-52, 2017-41 IRB 283, etc. (succeeding years).

[330] See Rev. Proc. 92-3, I.R.B. 1991-1, 55.

apply, however, where the distributing corporation already has an S election in place, since an S election by the spun-off corporation merely represents a continuation of the distribution corporation's S status.[331]

[4] Allocation of Income or Loss in Year of Division.

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

[5] Distributions.

Generally, pre-divesture distributions should be governed by Section 1368, although any distribution that bears a close connection in time or planning to the division may be analyzed by the Service as having been paid by the acquiring corporation or "deemed paid" by the acquiring corporation under the boot rules of Section 356.[332] In the case distributions pursuant to the divisive reorganization, the application of Section 356 to boot distributed in a Section 355 transaction requires a different analysis from that applicable to boot distributed in other acquisitive reorganizations. In such cases, as required for Section 1368 to apply, there would be a distribution "made by an S corporation with respect to its stock." Moreover, in a pro-rata spin-off transaction, Section 356(b) would apply to characterize the boot as a distribution to which Section 301 applies. This Section 301 characterization would necessarily implicate Section 1368(a) treatment.

[6] Built-in Gains Tax /Section 1374.

The Service has consistently ruled that Section 1374 will not apply to the spun-off corporation if it elects S status effective on the first day of its existence and the assets received from the distributing corporation would not have been subject to Section 1374 in the hands of the distributing corporation. Accordingly, Section 1374 should apply to the spun-off control corporation only to the extent that Section 1374 would have applied to the distributing corporation.[333] A spun-off corporation that does not elect S status for its first year will face exposure to Section 1374 upon its subsequent Subchapter S election.

[7] Tax Attributes.

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

[331] See, e.g., PLR 9230028; PLR 9117062; PLR 9117054.

[332] For commentary in this issue see Crowley, "Finishing The Job On Section 356(A)(2): Closing Loopholes And Providing Consistent Treatment To Boot In Tax-Free Reorganizations", 2015 BYU L Rev. 471 (2015)(WESTLAW).

[333] See, e.g., PLR 9202028; PLR 9151998; PLR 9140054.

corporation under Section 312(h). Under such rules, earnings and profits are generally allocated in proportion to the relative value of the assets transferred and retained by the distributing corporation.[334]

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

A Type E reorganization involves a recapitalization of a corporation and contemplates a reshuffling of the capital structure within the framework of an existing corporation. A tax free Type E reorganization involves the exchange of stock and/or "securities" of the issuing corporation. Rights issued to a party to a reorganization to acquire stock are treated as securities.[335] Notably, the continuity of business and continuity of interest requirement do not apply to Type E recapitalizations.[336] A Type E recapitalization may be the first step in a two-step, two company Type A, B, C, D, F or G reorganization.[337]

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

A Type F reorganization occurs where there is a "mere change in identity, form, or place of organization of one corporation, however effected." There are various overlap issues between a Type F and a Type A, Type C or Type D reorganization. For example, both a Type F and a Type A reorganization may occur when a corporation merges into a corporation newly created in another state by the same shareholders.[338] An application of an F reorganization would be where an S corporation merges into a QSUB.[339] A similar application would be where an S corporation transfers its assets to a newly organized corporation. If this is a Type F reorganization, the "new" corporation is simply a continuation of the old S corporation which has merged into Newco.[340]

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

Citing Rev. Rul. 64-250,[341] the IRS concluded that pursuant to the F reorganization, the S corporation election would continue in effect with respect to the surviving QSUB following the merger.

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334 See Reg. §1.312-10(a).

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

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

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

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

339 Reg. §1.1361-5(b)(3), Ex. 8.

340 See PLR. 8843026 (Aug. 1, 1988).

341 1964-2 CB 333.

Additionally, the IRS found that the status of the S corporation's other QSUB would not terminate as a result of the F reorganization.

In Rev. Rul. 2008-18,[342] the IRS ruled that in the two situations presented in the rulings, which both qualified as F reorganizations within the meaning of Section 368(a)(1)(F), the S election of the existing corporations did not terminate (and were carried over to the newly formed corporations), but that the newly formed corporations would be required to obtain new employer identification numbers.

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

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

The ruling first cites Rev. Rul. 64-250,[343] which provided that when an S corporation merges into a newly formed corporation in a transaction qualifying as a reorganization under Section 368(a)(1)(F) and the newly formed surviving corporation also meets the requirements of an S corporation, the reorganization does *not* terminate the S election, and as such, the S election remains in effect for the new corporation (without the new corporation being required to file a new S election). The ruling then cites Rev. Rul. 73-526,[344] in which the IRS concluded that where an S corporation merged into another corporation in a transaction qualifying as an F reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation.

Rev. Rul. 2008-18 provides, however, that since the publication of Rev. Rul. 73-526, the Code has been amended to provide the classification of certain wholly-owned subsidiaries of S corporations as QSUBs and the regulations under Section 6109 have been amended to address the effect of QSUB elections under Section 1361. Specifically, Reg. §301.6109-1(i)(1) provides that any entity that has a federal employer identification number will retain that employer identification number if a QSUB election is made for the entity under Reg. §1.1361-3 or if a QSUB election that was in effect for the entity terminates under Reg. §1.1361-5. Additionally, Reg. §301.6109-1(i)(2) provides that, except as otherwise provided in regulations or other published guidance, a QSUB must use the parent S corporation's employer identification number.

Additionally, for tax years beginning after December 31, 2004, Section 1361(b)(3)(E) was amended to provide that except to the extent provided by the IRS, QSUBs are not disregarded for purposes of

342 2008-13 IRB 674.
343 1964-2 C.B. 333.
344 1973-2 C.B. 404.

information returns. Further, QSUBs are not disregarded for certain other purposes as provided in the regulations. For example, Reg. §1.1361-4(a)(7) provides that a QSUB is treated as a separate corporation for purposes of employment tax and related employment requirements effective for wages paid on or after January 1, 2009. Because a QSUB is treated as a separate corporation for certain federal tax purposes, the QSUB must retain and use its employer identification number when it is treated as a separate corporation for federal tax purposes.

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

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

Rev. Rul. 2008-18 applies to F reorganizations occurring on or after January 1, 2009.[345] For F reorganizations occurring on or after March 7, 2008 and before the effective date of the ruling, taxpayers may rely on Rev. Rul. 2008-18. The ruling acknowledges that the IRS is aware that prior to the effective date of the ruling, S corporations have undergone F reorganizations in a manner similar to those described in situations 1 and 2 in which the acquiring corporation continued to use the transferor corporation's employer identification number consistent with Rev. Rul. 73-526. In those cases, the IRS provides that the acquiring corporation should continue to follow Rev. Rul. 73-526 and use the transferor corporation's employer identification number and that after the F reorganization, the transferor QSUB should use the parent's employer identification number until such time as the QSUB is otherwise treated as a separate corporation for federal tax purposes or until such time as the QSUB terminates. At such time, the QSUB must obtain a new employer identification number. The IRS also states in the ruling that for an F reorganization occurring prior to January 1, 2009, it may be prudent for the acquiring corporation to make a protective S election.

Rev. Rul. 2008-18 is consistent with a number of prior rulings issued by the IRS to the extent that the newly formed corporation making a QSUB election for the existing (transferor) corporation is not required to make a new S election. On the other hand, Rev. Rul. 2008-18 reverses the holdings in a number of prior rulings which provided that the newly formed corporation should use the employer identification number of the existing corporation (which becomes a QSUB).[346] The ruling does state, however, that in

[345] See Casey S. August and Paul A. Gordon, "Know Your Roll, Planning for Taxable Acquisitions of S Corporations Involving Equity Rollover For Sellers," 18 No. 4 BUSENT 4 (July/August 2016) WESTLAW; Rizzi, "F Reorganizations and S Corporations: The QSUB Transaction", 48 Corp. Tax'n 44 (Sept/Oct. 1021).

[346] See, e.g., Ltr. Ruls. 200701017 and 200725012.

situations not involving a QSUB, such as the specific situation set forth in Rev. Rul. 73-526 involving the merger of one S corporation with and into another corporation that constitutes an F reorganization, the surviving corporation in those circumstances would use the employer identification of the transferor corporation.

In EEC 200941019, dated October 9, 2009, the IRS issued email guidance to a taxpayer providing that the taxpayer could rely on Rev. Rul. 2008-18.[347] In the email advice, C owns all of the stock of Z, an S corporation with an existing employer identification number. In year 1, Z forms Newco, which in turn forms Mergeco. Pursuant to a plan of reorganization, Mergeco merged with and into Z with Z surviving and C receiving solely Newco stock in exchange for Z stock. Newco meets the requirements for qualification as a small business corporation and timely elects to treat Z as a QSUB effective immediately following the transaction.

The email advice provides that the taxpayer may rely on the principles set forth in Rev. Rul. 2008-18, and consequently, Z's original S election will *not* terminate but will continue for Newco, but Newco will be required to obtain a new employer identification number and Z will retain its existing employer identification number even though a QSUB election is made for it. Additionally, the IRS provided in the email advice that Z would *not* file a final Form 1120S, but rather that Newco would report all of Z's and Newco's income on its Form 1120S.[348]

5.08. *The "Substantially All" Requirement – A Momentary Concept*

The "substantially all" test for certain tax-free reorganizations under Section 368(a) (e.g., C, acquisitive D, and triangular A reorganizations) generally refers to the quantity of assets that must be transferred (or held) to qualify a transaction as a reorganization. As noted above, for IRS ruling purposes, "substantially all" means 90% of the net assets and 70% of the gross assets, while courts have applied a facts-and-circumstances test focused on operating assets.

Regardless of the amount of assets that must be transferred, final regulations dealing with continuity of business enterprise (COBE)[349] and post-acquisition transfers[350] appear to indicate that "substantially all" is only a momentary concept. Immediately after a reorganization, as part of a plan, the acquiring company may distribute, transfer, or sell acquired assets, provided certain requirements are met. These new rules may give taxpayers certain flexibility in relocating assets within their corporate structure for business reasons while maintaining the tax-free nature of the initial reorganization.

5.09. *Section 351 Transactions and National Starch*

Under Section 351, an acquisition may be structured to give selling shareholders stock tax free in a transaction that may not meet the continuity of interest requirements. Under Section 351, eligible shareholders may transfer property to a corporation in exchange for stock (and boot) of such corporation

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347 2008-13 IRB 674.

348 With respect to potential transferee liability when the QSub is converted to an LLC and the membership interests are purchased after a drop-and-check F reorganization, based on state law providing that a conversion of a corporation to an LLC is a continuation of the same entity, *See "Drop-and-Check Reorganizations and Transferee Liability"* by Michael P. Spiro, Tax Notes September 28, 2020

349 Reg. §1.368-1(d).

350 Reg. §1.368-2(k).

and immediately after the exchange, the transferor(s) must be in control of the corporation within the meaning of Section 368(c).

Section 351(g) treats nonqualified preferred stock issued to a shareholder in a Section 351 transaction as boot. This places some restrictions on the National Starch structure inspired by Letter Ruling 7839060.[351] In this structure, the purchaser (P), and the selling shareholder or shareholders desiring tax free treatment (A) contribute cash and stock in the target (T) to a new corporation (New S) in exchange for stock in New S. New S can either purchase the remaining shares from the shareholders desiring cash, or in the event the remaining shareholders are not cooperative, a subsidiary (D) can be formed to merge with the target, and merge with T forcing out the remaining shareholders.

In the National Starch ruling, the Service ruled that (i) A did not recognize gain or loss on the exchange of T voting shares for New S shares, and (ii) under Rev. Rul. 73-427,[352] the formation of D and the merger of D into T will be disregarded, and the transaction is viewed as a purchase by S for cash of the remaining stock in T held by shareholders other than T.

Two years later, the Service reversed its approach in two published rulings, Rev. Ruls. 80-284[353] and 80-285.[354] In 1984, however, the Service revoked the 1980 published ruling in Rev. Rul. 84-71,[355] and readopted the position in the National Starch ruling, concluding that the fact that the larger acquisitive transaction failed to meet the continuity of interest requirements for a tax free reorganization, does not preclude the applicability of Section 351 to transfers that may be described as part of such larger transactions, but also, either alone or in conjunction with other transactions, meet the requirements of Section 351(a).

As noted above, the nonqualified preferred stock rules result in the taxation of the shareholder receiving preferred stock in a National Stock transaction, precluding the use of the redemption and call provisions involved in the National Starch ruling. Preferred stock would not be permissible if the acquisition vehicle is an S corporation. Otherwise, as the transferee corporation in a National Starch structure, an S corporation will qualify as the new acquisition vehicle under Section 351. No gain or loss will be recognized on the transfer of its stock under Section 1032. Still, Section 351 transfers are problematic for S corporations, not only for the control requirement under Section 368(c) and liability in excess of basis issues, but in order to maintain eligibility. In particular, the one class of stock requirement places a strait jacket on the type of consideration that can be issued by an S corporation in exchange for its stock. Where an S corporation is a transferor in a Section 351 transfer, the normal rules applicable to Section 351 will apply.[356]

An alternative structure is the "horizontal double-dummy" or "top hat" approach for the combination of two corporations wholly or partly tax free, when not otherwise permitted by the reorganization provisions. A new corporation ("Newco") is formed along with two wholly owned subsidiaries, S1 and S2. The target is merged into S1 and the acquirer (or other target) is merged into S2,

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[351] June 23, 1978.

[352] 1973-2 C.B.301.

[353] 1980-2 C.B. 117.

[354] 1980-2 C. B. 119.

[355] 1984-1 C.B. 106.

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

with the shareholders of each target receiving stock in Newco and other consideration, including boot and convertible debentures. Newco, S1 and S2 file a consolidated federal income tax return, with the interest on the convertible debentures deductible in computing taxable income. The target shareholders generally receive shares of Newco stock and boot (cash or other property) and the buyer's shareholders receive solely Newco common stock. This transaction generally qualifies under Section 351.[357]

If the boot in the transaction, including the debentures, exceeds 20% of the consideration to the shareholders of either transaction, it would not qualify as a reverse subsidiary merger under Section 368(a)(2)(E). However, the two simultaneous reverse triangular mergers should qualify as a Section 351 transaction so long as the mergers are not interdependent.[358] The former target shareholders, taken as a group, are in control of Newco within the meaning of Section 368(c) immediately thereafter.[359] Only the shareholders receiving debentures or other boot will recognize taxable gain in the transaction.

## VI. TAXABLE ASSET ACQUISITIONS AND STOCK PURCHASES AND DISPOSITIONS TREATED AS ASSET ACQUISITIONS

### 6.01. *The Acquiring S Corporation*

Where an S corporation purchases the assets of another corporation or business entity, the tax impacts are substantially the same as with any other asset purchase. The acquiring corporation gets a cost basis in the acquired assets, which includes any liabilities which are assumed or to which the purchased assets are subject. Gain, including recapture gain is taxable to the selling entity in the year of sale, subject to potential application of the installment sales rules for qualifying deferred payment obligations of eligible sellers. The consideration paid for the assets is allocated in accordance with Section 1060 and the regulations issued thereunder. Cost recovery deductions for tangible personal property and rules applicable to the amortization of purchased intangibles, including goodwill and going concern value, permit annual deductions for depreciation and amortization.[360]

#### [1] Taxable Merger.

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

#### [2] Buyer's Basis in Purchased Assets.

##### [a] *Direct Asset Acquisition.*

Where the target's assets are purchased in a taxable transaction, the buyer's aggregate basis in the purchased assets will equal: (1) cash and value of property paid; and (2) liabilities

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[357] See Rev. Rul. 76-123, 1976-1 C.B. 94; but see Rev. Rul. 68-349, 1968-2 C.B. 143; Rev. Rul. 84-44, 1984-1 C.B. 105.

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

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

[360] See Sections 168, 197, 263 and the regulations thereunder.

assumed or taken subject to.[361] Interest, including OID, is not added to basis. Thus, the principal amount of any fixed payment obligations is included in basis even if the seller is reporting under Section 453. For contingent payments, generally basis is not established until the amount of the contingency is determined and resolved.

[b] *Regular Section 338 Election.*

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

[c] *Section 338(e) Election; Section 338(h)(10) Election.*

Where a deemed asset sale occurs pursuant to a Section 336(e) election or a Section 338(h)(10) election, both discussed further below, the new target's basis is adjusted under the same rules as a regular Section 338 election except: (i) basis of assets to new target does not include any liability for tax arising out of the deemed asset sale (i.e., since the consolidated group of the seller will be bearing the tax liability); and (ii) a basis step-up is made with respect to nonrecently purchased stock.[362]

[d] *Allocation of Basis Among Purchased or Deemed Purchased Assets.*

As mandated by Section 1060, the residual method of valuation is required to allocate the purchase price in actual asset sales as well as deemed asset sales under Section 338.[363] Sellers will tend to allocate to assets that produce long term capital gain, or, on the other hand, ordinary loss. As to purchased goodwill and similar items, Section 197 eliminates the issues of whether an intangible's useful life can be estimated with reasonable accuracy and, if so, the length of that useful life; if an intangible is covered by Section 197(a) its cost is amortized over 180 months, regardless of the period during which the intangible is expected to be useful in the business. In order to trigger application of Section 1060, the acquisition must involve the purchase of any "active trade or business" (per Section 355 definition) or any other group of assets where "goodwill or going concern value could under any circumstances attach to such group."[364] Under Section 1060, the allocation of the purchase price is to be made upon the following classes, in the following order:

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

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

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

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361 Section 1012.

362 See Reg. §1.338(b)-1(e)(3)(ii).

363 See Section 1060(c)(definition of "applicable asset acquisition").

364 Reg. §1.1060-1T(b)(2).

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

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

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

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

[e] *Purchase of Section 197 Intangibles.*

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

[i] Definition of Section 197 Intangible.

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

[ii] Use of Separate Company to Purchase Intangibles.

As part of the acquisition, consider use of a holding company with the acquisition subsidiary acquiring the business assets and the holding company purchasing the licenses and similar intangibles which it then leases to its subsidiary. This planning strategy may avoid state income tax on the royalty payments.[365]

[iii] Consideration for Covenant Not to Compete.

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

[365] See Sections 446(b), 482.

[iv] Anti-churning Rules.

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

[v] Non-Section 197 Intangibles.

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

[vi] Information Reporting Requirements.[366]

Buyers and sellers are not required to agree on asset allocations, but once an agreement is made, both buyer and seller (but not the Service) are generally bound. The allocation is reported on IRS Form 8594.[367]

[vii] Allocation to Non-Corporate Assets.

In trying to avoid double tax for an asset or deemed asset, sale of a corporation, note cases providing that non-corporate assets, include covenants not to compete from key shareholders, and, possibly, customer relationships or goodwill retained by shareholders are not corporate assets.[368] In Howard v. U.S.,[369] the court denied the taxpayer's motion for a summary judgment and granted the government's motion for summary judgment in finding that goodwill in connection with the sale of a dental practice was corporate goodwill rather than personal goodwill.

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

366 See Section 1060(e).

367 See also Form 8023 (Section 338 transactions).

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

369 2010 WL 3061626 (E.D. Wash.) (July 30, 2010).

compete with the acquiring personal service corporation. The selling corporation itself received $47,100 for its assets.

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

The government, citing *Furrer v. Comm'r*,[370] *Martin Ice Cream v. Comm'r*,[371] *Norwalk v. Comm'r*,[372] and *MacDonald v. Comm'r*,[373] found that the goodwill was an asset of the corporation and not of the taxpayer personally because of the contractual obligation of the taxpayer under the Employment Agreement to continue to work for and not to compete against his corporation. In granting summary judgment in favor of the government, the court found no merit in the taxpayer's argument that Washington state dissolution case law supported the proposition that professional goodwill is a community property right in dissolution cases, and as such, is of a personal nature.

6.02. *The Selling S Corporation*

Where a selling S corporation never has had a C history, the impact of an asset sale is rather straightforward. The decision of whether it is more advantageous and to what extent the target should sell its assets or its stock will require consideration of four tax issues: (i) the comparison of inside (asset) basis versus outside (stock) basis; (ii) the character of gain differential between an "inside" sale versus an "outside" sale (long term capital gain); (iii) whether a corporate-level tax will be imposed because of the sale; and (iv) whether (and to what extent) the installment method of reporting is available. Where the target has been a qualified electing small business corporation for its entire history and has not acquired the assets of a C corporation within the past 10 years in an exchanged basis transaction, then the corporate level gain from an asset sale is, for federal (and most state) income tax purposes, passed through to the shareholders and results in a single level of tax. The amount realized is allocated among the basis of the individual assets in accordance with the residual method of valuation in accordance with Section 1060 and Section 338 regulations, to the extent applicable. Allocated gain or loss is characterized by reference to the nature of the corporation's purpose in holding the particular asset sold, e.g., depreciable real property used in a trade or business or Section 1231 property, inventory, depreciation subject to recapture, or property held for investment, including corporate goodwill. Where the corporation has acquired assets in a C corporation in a tax-free reorganization within the past 10 years and/or otherwise converted to Subchapter S within the past 10 years (7 years in for sales of assets occurring in 2009 and 2010, and 5 years for sales occurring in 2011 through 2014, discussed further

370 566 F.2d 1115 (9th Cir. 1977).
371 110 TC 189 (1998).
372 TCM 1998-279.
373 3 TC 720 (1944).

below), then there is a special corporate level tax on the corporation's built-in gains (and losses) to the extent of such unrealized built-in gain (or loss) on the effective date of the conversion (exchange).

Prior to the enactment of the American Recovery and Reinvestment Act of 2009 (the "2009 Recovery Act"),[374] the "recognition period" for built-in gains under Section 1374 was generally defined as the 10-year period following the first day of the tax year for which the corporation was an S corporation.

As a way to provide relief to small businesses faced with the need to dispose of assets to satisfy debts, the 2009 Recovery Act amended Section 1374(d)(7) to reduce the "recognition period" from ten years to seven years for sales of assets occurring in 2009 and 2010.[375] Section 1374(d)(7) provides that for the 2009 and 2010 taxable years, "no tax shall be imposed on the net recognized built-in gain of an S corporation if the 7th taxable year in the recognition period preceded such taxable year." For property acquired from a C corporation in a carryover basis transaction, the recognition period is reduced to 7 years from the date the property is acquired, for sales occurring in 2009 and 2010.[376]

The Small Business Jobs and Credit Act of 2010[377] further reduced the Section 1374 recognition period to 5 years for sales occurring in 2011. The American Taxpayer Relief Act of 2012[378] extended the 5 year rule for dispositions occurring in 2012 and 2013. The Section 1374 recognition period reverted to 10 years for the 2015 tax year and future years, in the absence of further legislation.

[1] Allocation of Income.

In the year of sale, the normal pro rata allocation rules under Section 1377(a)(1) will generally continue to apply. Even in a taxable merger, the corporation will retain its S status through the close of the final S year, which will not constitute an S termination year.[379] The character and amount of the gain will generally be determined at the corporate level. The corresponding gain or loss is then passed through to the shareholders and increases or reduces outside basis in stock (and, in some instances, shareholder debt previously reduced for losses and other deductions).

[a] *Recharacterization*.

A controversial provision was inserted in the final regulations to Section 1366 which permits the Service to recharacterize capital gain or Section 1231 gain allocable to a "dealer" type shareholder with respect to such property.[380]

[b] *Built-in Gains Tax per Section 1374.*

For the S corporation, gain from the sale of assets will result in the pass through of gain and loss to the shareholders in accordance with their proportionate stock interests. Alternative tax impacts are accounted for at the shareholder level. Where the corporation has converted to S status within the past 10 years (7 years for sales occurring in 2009 and 2010 and 5 years for sales occurring in

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374 *P.L.*111-5 (February 17, 2009).
375 *See* Section 1374(d)(7), as amended by the 2009 Recovery Act, Section 1251.
376 Section 1374(d)(8)(B)(i). Joint Committee on Tax'n Report on P. L. 111-5 (February 17, 2009).
377 *P.L*. 111-240 September 27, 2010.
378 *P.L*. 112-240 (January 2, 2013).
379 See Rev. Rul. 66-94, 1964-1 C.B. 317; Rev. Rul. 70-232, 1970-1 C.B. 178.
380 Reg. §1.1366-1(b)(2).

2011 through 2014, as explained above), Section 1374 may apply. Thus, an asset sale by an S corporation, with a prior C history, could result in a forced double tax to the extent of its recognized built-in gains. The Section 1374 tax also applies to operating and liquidating distributions. Tax history is used in determining the taxable income or loss of the corporation in the year of sale. Where the corporation does not liquidate, then the seller may need to carefully consider the potential impacts of the accumulated earnings tax under Section 531, or, alternatively, the personal holding company tax under Section 541. There are also alternative minimum tax impacts as well.

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

[a] *Regular Section 338 Election.*

In order for an acquiring corporation to be eligible to make a Section 338 election, it must satisfy the requirement of a "qualified stock purchase," i.e., any transaction or series of transactions in which stock (per Section 1504(a)(2), i.e., 80% or more voting and value) of 1 corporation is acquired by another corporation by purchase during the 12 month acquisition period.[381] If target makes a Section 338 election, then a stock sale by the target's shareholders will be deemed to have sold all of its assets, subject to liabilities, to a deemed newly formed corporation in a fully taxable transaction, which is then immediately followed by the deemed liquidation of the target. Unless the target has substantial net operating losses or capital loss carryovers, a regular Section 338 liquidation is generally undesirable.[382]

[b] *Section 336(e) Election.*

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

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

Final Section 336(e) regulations were published in the Federal Register on May 15, 2013.[383] Despite many similarities with the Section 338(h)(10) regulations, the two regulatory regimes differ in several important respects. First, although both require the transfer of an affiliated interest in target stock by a corporation or S corporation shareholders, Section 338(h)(10) looks to the purchase of that stock interest, while Section 336(e) focuses on its disposition. Thus, the Section 338(h)(10) regulations (as do the Section 338 regulations generally) consider what is purchased, while the Section 336(e)

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

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

383 78 Fed. Reg. 28467 (May 15, 2013).

regulations measure what is sold, exchanged, or distributed. Second, for Section 338(h)(10) to apply to a non-S corporation target, on the date that the affiliated interest in the target is first acquired by purchase (the "acquisition" date), the target must be a member of the consolidated group or affiliated with a selling domestic corporation. On the other hand, under the Section 336(e) regulations, a Section 336(e) election may be made for the target even if it is not affiliated with the selling corporation or a member of the selling consolidated group on the corresponding date (the "disposition" date). Finally, if a Section 338(h)(10) election is made, a gain recognition election is required, while a gain recognition election for a purchaser may not be required following a Section 336(e) election.

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

(1) The transferee's basis in the stock is determined in whole or in part by reference to the transferor's basis;

(2) The transferee's basis in the stock is determined under Section 1014;

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

(4) The stock is transferred to a related person.[384]

If a qualified stock disposition of a target is also a qualified stock purchase for which a Section 338 election can be made, a Section 336(e) election can generally not be made for the disposition. There is an exception where the target is a subsidiary of another corporation and the target's qualified stock disposition is a result of the deemed sale of the other corporation's assets pursuant to a Section 336(e) election.[385]

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

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

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384 Reg. §1.336-1(b)(5)(i).

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

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

(3) The old target is deemed to distribute its assets (*i.e.*, the proceeds from the deemed sale) to the seller or S corporation shareholders. Except as otherwise provided, the federal income tax consequences of the deemed events are the same as if the parties had actually engaged in the transactions that are deemed to occur.[386]

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

The old target is treated as selling its assets for the aggregate deemed asset disposition price ("ADADP") while the seller or the S corporation shareholders still own the old target stock. If the old target is an S corporation target, the old target's S election continues in effect through the close of the disposition date. The ADADP is allocated among the target assets using the seven-tier residual method described in Reg. §1.338-6, an allocation that determines the amount realized for each asset in the deemed sale.[387]

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

[c] *Section 338(h)(10) Election.*

Section 338(h)(10) sets forth an advantageous method of converting a qualified "purchase" of 80% or more of the target stock by a corporation into an asset purchase on an elective basis. This election may only be made for a target that is a domestic corporation that before the sale of

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386 Reg. §1.336-2(b)(1)(i).

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

its stock, is a member of an affiliated group of corporations (whether or not the group files consolidated returns) or is an S corporation. Where a Section 338(h)(10) election is made, the target corporation recognizes gain or loss as though it sold its assets on the acquisition date, but target shareholders generally recognize no gain or loss on selling target stock to the purchasing corporation. The S status of the target corporation remains in effect through the close of the acquisition date, including the time of the deemed asset sale and liquidation.[388] If the gain inherent in the target shareholders' stock is similar in amount to the gain inherent in the target's assets, Section 338(h)(10) may provide a step-up in asset basis at a tax cost not significantly greater than would be incurred with no election. Regulations further provide for deemed asset sale treatment for shareholders of an S corporation target provided all shareholders of the target consent.

[d] *Section 336(e) and Section 338(h)(10) Election Mechanics.*

The Section 336(e) election is made by an S corporation by having the target and all S corporation shareholders, whether or not they dispose of stock in the qualified stock purchase, enter into a written, binding agreement to make a Section 336(e) election on or before the due date (including extensions) of the federal income tax return for the target that includes the disposition date. The target must retain a copy of that agreement and it must attach the return (including extensions) for taxable year that includes the disposition date.

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

(1) The name, address, taxpayer identification number, taxable year, and state of incorporation (if any) of the target, each seller, any common parent of a seller, each S corporation shareholder, any 80-percent purchaser, and any purchaser that holds nonrecently disposed target stock;

(2) The disposition date;

(3) The percentage of target stock that was disposed of by each seller or S corporation shareholder in the qualified stock disposition;

(4) The percentage of target stock that was disposed of by each seller or S corporation shareholder in the qualified stock disposition on or before the disposition date;

(5) The percentage of target stock that was retained by each seller or S corporation shareholder;

(6) A statement about whether the target realized a net loss on the deemed asset sale:

(i) If the target realized a net loss, a statement about whether any stock of the target (or a higher-tier corporation for which a § 336(e) election was made) was distributed during the 12-month disposition period; and

[388] Reg. §1.338(h)(10)-1(d)(3).

(ii) If the target realized a net loss and such a distribution was made, a statement about whether any stock of the target (or a higher-tier corporation for which a § 336(e) election was made) was actually sold or exchanged in a qualified stock disposition;

(7) When required, the name, address, and taxpayer identification number of each purchaser that made a gain recognition election; and

(8) A statement that each of the sellers or S corporation shareholders and the target have executed a written, binding agreement to make a Section 336(e) election. The old target and new target must also report the information concerning the deemed sale and purchase of the target assets, each filing a Form 8883. Because Form 8883 describes asset allocations for a Section 338 election, appropriate adjustments must be made in completing that form to accommodate a Section 336(e) election. Note that if a Section 336(e) election is made for a qualified stock disposition to which Section 335(d)(2) or (e)(2) applies, the old target must file two Forms 8883, one in its capacity as the buyer and one in its capacity as the seller. Note that a separate Section 336(e) statement must be filed for each target subsidiary for which a Section 336(e) election is made.

The Section 338(h)(10) election is made on Form 8023 jointly by the purchasing corporation (or its common parent) or the common parent of a target subsidiary, affiliate of a nonconsolidated subsidiary or with respect to an S corporation, by unanimous consent of all S shareholders, regardless if some shareholders do not agree to sell their shares.[389] The Section 338(h)(10) election must be made no later than the 15th day of the 9th month after the month in which the acquisition date occurs.[390] Once made the election is irrevocable.[391] Consistency rules are provided under the Section 338(h)(10) regulations.[392]

[3] Allocation of Consideration for Multiple Asset Sales.

The consideration received from the sale of a going concern must be itemized into separate sales of each asset. This allocation is performed in accordance with the residual method of allocation under Section 1060. This allocation is critical not only in computing the amount of gain or loss and its character, but also in determining which part of the sale may qualify for installment sale reporting. This allocation is made on Form 8333.[393]

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

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389 Reg. §1.338(h)(10)-1(c)(2).

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

391 Reg. §1.338(h)(10)-1(c)(3).

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

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

A taxable asset sale, including deemed asset sale under Section 338(g) or Section 338(h)(10), is generally less desirable to the target, in comparison with a stock sale, because it would result in a double tax, first to the target on the sale of its assets and second to the target shareholders on the distribution of the after-tax proceeds. Deferred intercompany transactions are accelerated.[394] While the purchaser may want a step-up in basis for the price paid for goodwill and other assets having a tax basis less than fair market value on the seller's books, the amortization and cost recovery allowances to the buyer will not mitigate the double tax cost to the seller.[395] However, it is important for a buyer to note that in a Section 338(g) or Section 338 (h)(10), the deemed "New" T remains liable for the tax liabilities of the old T (including the tax liability for the deemed sale tax consequences). For example, New T remains liable for the tax liabilities of members of any consolidated group that are attributable to taxable years in which those corporations and Old T joined in the same consolidated return.[396]

[5] Mitigation of Target Corporation's Tax Cost on Asset Sale by Presence of Favorable Tax Attributes.

A taxable asset acquisition may lighten the impact of the double tax effect where the target has net operating loss and/or capital loss carryovers which can be used to reduce taxable income on the realized gain. Any unused losses disappear and may not be used by the target unless it continues to hold back income producing assets from being distributed to the shareholders. The tax attributes of the seller, including NOLs and CNOLs, are not portable.[397]

[6] Where Target Corporation Is an S Corporation.

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

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

Where the corporation has acquired assets in a C corporation in a tax-free reorganization within the past 10 years (7 years in 2009 and 2010, 5 years in 2011) and/or otherwise converted to Subchapter S during such period, there is a special corporate level tax on the corporation's built-in gains

394 Reg. §1.1502-13(c)(2).
395 As to T subsidiaries, see Section 338(h)(8). Reg. §1.338-3(b)(4).
396 See Regs. §§1.1502-6(a), 1.338(h)(10)-1(d)(2).
397 See Section 381(a).

(and losses) to the extent of such unrealized built-in gain (or loss) on the effective date of the conversion (exchange).

[7] Avoidance of Step-Transaction Doctrine.

A fundamental, judicially-created, doctrine of Federal income taxation is the "step-transaction" doctrine which has been frequently applied in the corporate income tax area. Basically, the step transaction, which has several rules of construction or standards which the courts have each spared over with the Service, requires that in addition to the form of the transaction taken by the taxpayer, the IRS and the courts will look to the substance of the transaction in assessing its tax impacts. Therefore, where a planned or integrated series of "steps" are part of a single transaction, the steps will be collapsed in order to determine the type and consequences of the transaction.[398] Prior to the enactment of Section 338, the long standing rule, which was the product of the step-transaction doctrine, was where a corporation purchased the stock of a target and immediately liquidated the target in order to acquire its assets, the transaction would be treated for tax purposes as an asset sale for both the buyer and the seller. This particular setting for application of the step transaction to recast a stock sale into an asset purchase, by application of Section 334(b)(2), was known as the Kimbell-Diamond doctrine.[399]

[a] *Enactment of Section 338.*

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

[b] *Step Transaction Doctrine Broken in Section 338(d)(3) Qualified Stock Purchase.*

In Rev. Rul. 90-95,[400] the Service ruled that the step transaction doctrine does not apply to treat a QSP followed by the immediate liquidation of the target into the acquiring corporation as an asset purchase. The rationale for the Service's position was that Section 338 overrode the Kimbell-Diamond doctrine.[401]

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

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

400 1990-2 C.B. 67.

401 See CCA 200230026 (4/15/02).

In Rev. Rul. 2001-46,[402] the Service ruled that, under certain circumstances, such as the qualification for a statutory merger under Section 368(a)(1)(A), step transaction principles apply to characterize the transaction prior to the determination of whether a QSP has been made. In such cases, Rev. Rul. 90-95 will not apply and there will be no QSP.

In July 2003, Service issued final and temporary regulations that permit taxpayers to turn off the step transaction doctrine and to make a Section 338(h)(10) election in certain multi-step transactions, as set forth in Rev. Rul. 2001-46.[403] The regulations are effective for stock acquisitions occurring on or after July 8, 2003. The notion is that where a Section 338 election is made by the parties, then the transaction will be treated as a deemed asset sale and the step transaction doctrine will not apply even though the target corporation is immediately liquidated into the acquisition subsidiary or acquiring corporation.[404] If the Section 338(h)(10) election is not made, Rev. Rul. 2001-46 will continue to apply so as to recharacterize the transaction as a reorganization under Section 368(a).[405]

[8] Redemptions of Target Stock.

Where the purchasing corporation (P) purchases less than 80% of the T stock and as part of the same transaction T redeems stock sufficient to increase P's holdings to more than 80%, the regulations provide that redemptions from persons unrelated to P will generally count towards the 80% qualified stock purchase requirement.[406]

[9] Going Public/Section 338 Transaction.

Although beyond the scope of this outline, it is possible, at least conceptually, to use a Section 351 template to structure an asset purchase as part of an IPO transaction provided there is: (i) a binding commitment to have the target shareholders sell at least 80% of their stock; and (ii) the Section 351 transaction has an unrelated party acquiring part of the stock prior to the IPO.[407]

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

When the acquiring corporation (or a wholly owned subsidiary of the acquiring corporation) is merged into the target corporation (a "reverse merger") and the former shareholders of the target receive cash consideration, the transaction is treated as a qualified stock purchase eligible for treatment as a deemed asset sale under Section 338(h)(10).[408] The gain from the deemed asset sale is passed through to the cashed out shareholders of the S corporation.

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

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402 I.R.B. 2001-42.

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

404 See Reg. §1.338(h)(10)-1(c)(2).

405 Reg. §1.338(h)(10)-1(e) Ex. 11.

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

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

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

The same tax consequences resulting from a Section 338(h)(10) election may be accomplished if the target company is acquired through a forward merger of the target into the acquiring corporation, where the selling shareholders receive cash and no stock (a "cash merger"), in which event the transaction is treated as an asset sale.[409] Similarly, the forward cash merger of the target corporation into a LLC taxable as a partnership or disregarded as an entity separate from its sole owner is treated as a deemed asset sale, with the buyer obtaining a basis in the assets equal to the purchase price. The transaction is treated as if the assets were sold by the target and the proceeds distributed to the selling shareholders in a liquidating distribution.[410]

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

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

Rev. Rul. 2008-18[411] held that the new QSUB retains the employer identification number of the former S corporation and there is no need for S election by the Newco.[412] Newco, as successor to the target, continues the target's taxable year. The QSUB target is treated as a disregarded entity.

Upon the sale of the QSUB, Newco recognizes and passes through to its shareholders the gain on the asset sale, similar to effect of Section 338(h)(10) but without the deemed liquidation.[413] The purchaser is treated as purchasing the assets of the target and contributing the assets to a new corporation.

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

The typical steps involved in a pre-acquisition F reorganization of an S corporation is summarized as follows:

Step 1: Shareholders form Newco. Newco can be a state law corporation or LLC. A new EIN should be obtained for Newco.

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409 Rev. Rul. 69-6, 1969-1 C.B. 104.

410 PLR 2006 28008 (March 28, 2006).

411 2008-1 C.B. 674.

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

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

Step 2: Shareholders contribute Target to Newco and Target makes a QSub election on Form 8869 on behalf of Target [414]

Step 3: Target files a Form 8832 election to be treated as a disregarded entity.

As a result of the above steps:

- The Shareholders, collectively, hold 100% of the equity interests in Newco.
- Newco is the successor entity to Target and succeeds to Target's S election.
- Newco owns 100% of the equity interests Target.
- Target is treated as a disregarded entity for tax purposes.
- The purchaser may acquires some or all of the membership interests in the Target LLC, in a transaction treated as an asset sale for tax purposes.

A pre-acquisition F reorganization may be used to avoid the risks to the buyer of an invalid S election disqualifying the transaction from Section 338(h)(10) treatment. The first structure (transfer of stock to Newco followed by QSUB election for target and sale) should be accompanied by a protective Section 338(h)(10) election reflecting Newco as the seller of target. If the S election is later challenged by the Service, the target would still qualify for the Section 338(h)(10) election as the subsidiary of a C corporation parent. However, if the S election is invalid, the new target may be liable for the old target's federal income tax liabilities, including the tax liability for the sale.[415] In the second structure, the sale of membership interests in an LLC should be treated as an asset sale regardless of the validity of the S election of the target prior to the transaction.

6.03. *Target Shareholders*

[1] In General.

Where the proceeds of an asset sale are distributed to the shareholders then the shareholder-distributees must report income (or loss) under the distribution rules contained in Subchapter C or such portion of Subchapter S, i.e., Section 1368, which may apply. Thus, depending on the facts and circumstances, a distribution of sales proceeds will be treated as a dividend, a return of capital or capital gain.[416] Where the distribution of sales proceeds is accomplished by redemption of part of the stock of the target corporation, the shareholder level tax treatment may be a dividend equivalent or produce sale or exchange treatment in accordance with Sections 302 and 303.[417] The acquisition could also be structured as a "bootstrap" redemption or "Zenz" redemption.

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[414] The Qsub election and filing of Form 8869 would be unnecessary if the IRS modified Rev. Rul. 2008-18 and added Situation 3 as proposed by the ABA Tax Section *Comments on Guidance on S Corporation F Reorganizations with a State Law Limited Liability Company* (July 2, 2024).

[415] See Reg. §§1.381(b)(3)(i) and 1.1502-6(a).

[416] See also Sections 243-246, 1059.

[417] See also Section 304 (redemptions of stock through related corporation).

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

Generally, the normal allocation of tax items per share per day will apply under Section 1377(a)(1). The character of the gain or loss is determined at the corporate level. The tax items of gain or loss are passed through to the shareholders with gain increasing basis (or first restoring a previously reduced basis in debt) and loss reducing basis, including debt basis under Section 1367(b). If a Section 338(h)(10) election is made, the S status of the target corporation remains in effect through the close of the acquisition date, including the time of the deemed asset sale and liquidation.[418]

Attention should be given to outstanding stock options that are "in the money" on the date of the sale and intended to be "cashed out" at the closing. Provided the options are exercised on the closing date, and the Section 338(h)(10) election is made, the employer deduction is passed through to the selling shareholders (rather than accruing to the buyer). The options may then be cashed out with the proceeds of the sale, subject to tax withholding. The exercise of the options does not cause the holders to be treated as owners of stock on the closing date for purposes of the pass through of the gain from the sale or any portion of the related compensation deduction.[419]

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

If buyer funds the compensation payments on behalf of the target, and the required employee payments exceed 20% of combined payments to stockholders employees, the question may arise as to whether 80% of the stock has been acquired by purchase as required for a valid Section 338(h)(10) election.[420]

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

[3] Impact of Installment Sales by S or C Corporation Targets.

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

[a] *Exceptions to Installment Sale Treatment in General.*

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418 Reg. §1.338(h)(10)-1(d)(3).

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

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

Whether the seller corporation is an S (or C) corporation, a deferred payment taxable asset sale may trigger more immediate gain recognition than a stock sale would. First, under Section 453(b)(2), installment method reporting is not available on the sale of inventory or dealer dispositions. Second, under Section 453(i), recapture income is recognized in the year of sale. Third, under Section 453A, interest may be charged on nondealer installment sales (i.e., casual sales) of property used in a trade or business or held for the production of income if (i) the sales price exceeds $150,000, and (ii) the face amount of all such obligations held by the taxpayer for the taxable year exceeds $5 million. Fourth, a pledge of an installment obligation arising from such a sale may be treated as a payment.[421]

[b] *Distribution of ISO in Complete Liquidation.*

A shareholder that is a "qualifying shareholder" receiving an installment obligation in a complete liquidation (provided no "election out" is made) may treat the payments under the obligation instead of the obligation itself, as the consideration received in exchange for her stock.[422] In order to qualify for installment reporting, the installment obligation (ISO) must: (i) be acquired in respect to a sale or exchange of the target corporation's assets within 12 months after the corporation adopted a plan of complete liquidation; and (ii) the liquidation is completed within that 12-month period.[423] Exception is made for installment sales of depreciable property to certain related parties, recapture items, certain sales of inventory, and ISOs attributable to certain tax avoidance transactions.[424] The limitation on a shareholder's use of Section 453 for reporting gain on complete liquidation for the portion attributable to inventory property is inapplicable (and therefore Section 453 reporting is permitted) if a bulk sale requirement is met.[425]

Under Section 453B(h), a distribution by an S corporation of an ISO with respect to which the shareholder is entitled to report his stock gain on the installment method is not treated as a disposition of the obligation by the S corporation. Under Section 453B(h), when a liquidating distribution includes an ISO and cash, the shareholder's stock basis must be apportioned between the ISO and cash (and any other property) distributed, in the manner appropriate to installment reporting, rather than the upfront basis recovery otherwise contemplated under Section 331.[426] Thus, the shareholder is allowed to report gain over the same period of years that it could have been reported if the nonrecognition rules for 12-month liquidations had not been repealed. This rule does not apply, however, with respect to the built-in gains tax or for purposes of determining the corporation's tax liability. Thus, except for purposes of determining the tax on certain built-in gains or on passive investment income, an S corporation-distributee shareholder is also permitted to defer the recognition of gain on the distribution of a qualifying ISO in complete liquidation. As a result, gain will be recognized and taxed to the shareholders only as payments are received. Whether the sale is effectuated by a stock sale with a Section 338(h)(10) election, the same principles apply.[427]

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421 See Section 453A(d).

422 Section 453(h).

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

424 See also Reg. §1.453-11(c)(2).

425 Reg. §1.453-11(c)(4)(i).

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

427 PLR 20060317 (10/7/05).

[c] *Planning Considerations—the "One Day Note."*

Unfortunately, Section 453(h) will accelerate the tax liability of the shareholders in many cases. Section 453(h), originally designed to apply to liquidating distribution from a C corporation, treats the distributed installment obligation as arising, not on the asset sale by the corporation, but rather on a sale of stock by the shareholders. Whether the liquidation of the corporation is accomplished in one year or two, the shareholder's tax basis in the stock must be apportioned between the installment note, any cash, and any property distributed by the corporation in the manner appropriate to installment reporting.[428] This method is illustrated in Reg. §1.338(h)(10)-1(e), Example (10), and contrasts with the more favorable "up front" basis recovery method that normally applies when proceeds of sale are distributed to shareholders under Section 331.

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

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

The adverse tax consequences to the selling shareholders of these "basis recovery" rules may be avoided if *only* installment obligations are distributed to the shareholders and no cash or property is distributed at closing. This may be accomplished by distributing any accumulated or surplus cash to the shareholders prior to the sale and liquidation, and selling the assets solely in exchange for installment notes, with no cash down payment at closing. The cash portion of the transaction can be payable a day or so later in satisfaction of the "one day note." The stock basis allocation contemplated by Section 453(h) does not come into play. The gross profit allocated to the notes is recognized ratably as the payments are received, based on the gross profit ratio, resulting in more deferral for the taxpayer. The one day note can be backed up by a standby letter of credit or otherwise secured.[429]

Since the one day note strategy can be used to avoid gain recognition that would result if the S corporation were acquired with a combination of cash and an installment note, as opposed

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[428] See Reg. §1.453-11(a)(3) (requiring the shareholder to "reasonably estimate" the gain attributable to distributions received during the year and anticipated aggregate distributions).

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

to only installment notes, the strategy may raise questions under the economic substance doctrine, as discussed further below.[430]

[4] Complete Liquidation of Target Corporation.

Where the target corporation completely liquidates as part of the acquisition, the general characterization rule at the shareholder level will be Section 331, or as to a controlling corporate distributee, will qualify for nonrecognition under Section 332.[431]

[a] *Downstream Merger.*

As an alternative to liquidating the target corporation, the acquiring S corporation may merge downstream into the target, with the target surviving.[432] If the downstream merger is made immediately after the stock acquisition, the target conceivably would not be prevented from making an immediate S election due to the existence of a transitory corporate shareholder (assuming all other requirements under Section 1362 are met). In addition, the acquiring S corporation's election presumably would not be terminated by the transitory affiliation with target. The target could then freely elect S corporation status without Section 1362(g) applying.[433] If the acquiring S corporation's election terminates, Section 1362(g) will prevent a subsequent election until the close of the prescribed five-year waiting period. This strategy also had potentially adverse tax consequences with respect to the built-in gains tax and LIFO recapture provisions.

[b] *Direct Asset Purchase and Liquidation.*

In some instances there will be liabilities of the target, either contingent, or known or unknown, which were not assumed by the buyer. There may also be other assets that are retained to pay additional claims. In such cases, a liquidating trust may be required. In such instance, it is essential that the trust be treated as such for tax purposes and not be viewed as an association taxable as a corporation.[434]

Generally, the corporation will recognize gain or loss on the distribution of property in liquidation.[435] Under Section 336(d)(1), the corporation is not permitted to recognize loss on the distribution of assets to a related person if the distribution is non-pro rata or the distribution consists of "disqualified property" (i.e., assets acquired in a Section 351 transaction or contribution to capital in the preceding 5 years). A second loss disallowance rule applies where a principal purpose of the transaction in which property was contributed to corporation in advance of liquidation was to recognize loss to offset corporate-level gain.[436]

[c] *Reverse Merger of Acquiring Corporation into Target Corporation Treated as Qualified Stock Purchase.*

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

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

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

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

434 See Reg., §301.7701- 4(d).

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

436 Section 336(d)(2).

As noted above, when the acquiring corporation (or a wholly owned subsidiary of the acquiring corporation) is merged into the target corporation (a "reverse merger") and the former shareholders of the target receive cash consideration, the transaction is treated as a qualified stock purchase eligible for treatment as a deemed asset sale under Section 338(h)(10), provide the purchaser is a corporation.[437] The gain from the asset sale is passed through to the cashed out shareholders of the S corporation.

[d] *Forward Merger of Target into Acquiring Corporation Treated as Asset Sale.*

The same tax consequences resulting from a Section 338(h)(10) election may be accomplished if the target company is acquired through a *forward merger* of the target into the acquiring corporation, where the selling shareholders receive cash and no stock (a "cash merger"), in which event the transaction is treated as an asset sale.[438] Similarly, the forward cash merger of the target corporation into a LLC taxable as a partnership or disregarded as an entity separate from its sole owner is treated as a deemed asset sale, with the buyer obtaining a basis in the assets equal to the purchase price.[439] The transaction is treated as if the assets were sold by the target and the proceeds distributed to the selling shareholders in a liquidating distribution. This may be a preferable method for acquiring the assets of a target subsidiary to avoid technical legal issues generated through the transfer of assets and assignment of leases, contract rights, licenses, etc. In certain instances, a forward merger may qualify as a non-taxable Type A or Type C reorganization.

[e] *Forward Triangular Merger.*

Same as forward merger but through use of a subsidiary, i.e., newly formed acquisition subsidiary. Where a portion of the consideration consists of stock or debt of the parent, the transaction may qualify for nonrecognition treatment.[440] Shareholders of the target corporation may be offered the option of receiving shares of the purchasing corporation (or parent) or cash. Continuity of interest guidelines need to be addressed, i.e., % of consideration in purchasing corporation stock.

[f] *Section 338(h)(10) Election: Target C Corporation.*

Where a C corporations is the seller of target subsidiary stock and both corporation are members of an affiliated group, the buyer and seller may consent to an (h)(10) election. In such instance the stock sale is treated as an asset sale followed by the (tax-free) complete liquidation of the target. The deemed sale occurs while the target is still a member of the affiliated (seller) group. In contrast, a regular Section 338 election results in the deemed sale taking place after the target stock is sold and is included in a one-day short year return.[441] The benefits of the Section 338(h)(10) election include the possible avoidance by the parent (seller) of liquidation gain per Section 332. Target gain, i.e.,

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437 See Rev. Ruls. 73-247 and 90-95, supra.
438 Rev. Rul. 69-6, 1969-1 C.B. 104.
439 PLR 200628008 (March 28, 2006).
440 See Sections 368(a)(1)(C), 368(a)(2)(D).
441 Section 338(h)(9).

on the deemed asset sale, can be sheltered by any favorable tax attributes of the rest of the consolidated group.[442]

[g] *Impact of State and Local Taxes.*

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

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

Where S corporation shareholders are sellers of target S corporation stock, the corporation and all shareholders, as well as the purchasing corporation, may elect to treat the stock sale as an asset sale for federal income tax purposes. This results in shareholder level gain or loss on the deemed liquidation. Note that the character of the gain may change significantly where the target has ordinary income assets, or recapture items and may be required to accelerate ordinary operating income in the year of the sale. There also is the gross up in the purchase price for liabilities assumed or taken subject to. Thus, in various instances, a straight up sale of stock for the equity value may produce a more favorable result to the seller shareholder(s). Regulations endorse the use of the installment sale method for Section 338(h)(10) elections made by S corporation target shareholders.[443]

## VII. CONVERSION OF TYPE OF ENTITY AND DISREGARDED ENTITIES

### 7.01. *Overview*

During the latter part of the prior century, new business entity alternatives became available such as the limited liability company, the limited liability partnership, and the limited liability limited partnership. Such "unincorporated" creatures of statutory creation were designed to provide businesses with corporate characteristics, particularly limited liability for investors, combined with pass through treatment under the federal tax law like partnerships.[444] The limited liability company found itself recognized in the United States by the State of Wyoming in 1977.[445] In a landmark type ruling, Rev. Rul. 88-76, 1988-38 IRB 360, obsoleted IRS RRU (August 10, 1998), the Service ruled that an unincorporated organization operating under the Wyoming Limited Liability Company Act is classified as a partnership for

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

[443] Reg. §1.338(h)(10)-1(d)(8).

[444] Under the long-standing "Kintner regulations," the determination was to be made whether a business entity was taxable as a corporation (or "association") or instead as a partnership. Four characteristics were relevant: centralized management, free transferability of interests, continuity of existence, and limited liability. An entity with three or more of those characteristics was taxed as a corporation, while one with two or fewer was a partnership. Reg. §301.7701-1, -2(a) to -2(e) (repealed in 1996). The regulations were promulgated in response to US v. Kintner, 216 F.2d 418 (9th Cir. 1954).

[445] Wyo. Stat. Ann. §§17-15-102 to -144 (Michie 1999) (1977); The statute was enacted as special legislation to assist a mineral company, providing limited liability to all owners and pass-through tax treatment. Id. The IRS issued a private letter ruling classifying the company as a partnership for tax purposes. PLR 8106082 (Nov. 18, 1980).

federal income tax purposes under Reg. §301.7702. After the revenue ruling the LLC entity gain widespread attention and by 1996 had become enacted by all states.[446]

The process of combining business organizations of different species, whether incorporated or unincorporated, was somewhat awkward, in many instances cumbersome and therefore, by definition, expensive. As an illustration, before the states enacted entity merger or conversion statutes, a corporation could not be combined with an existing LLC for lack of statutory grant. However, the corporation could sell its assets to the LLC in exchange for membership interests with the subsequent dissolution of the corporation and distribution of membership interests to its shareholders as a distribution in complete liquidation. Such "long form" conversions of business entities of different species was reassessed. States decided to grant authority by statute to authorize more direct and efficient means of effectuating the conversion by a single step involving only the converting entity in a "short form" or "short cut" manner. For example, a partnership can convert into a corporation or an LLC without benefit of a short form statute via four alternatives: (i) the partnership dissolves, distributing its net assets in cash or in kind to the former partners. The former partners then transfer the assets to a newly organized corporation or LLC in exchange for stock or LLC membership interests; (ii) the partnership sells its assets to a newly organized corporation or LLC in exchange for the corporation's stock or LLC's membership interests. The partnership then dissolves, distributing its only asset, the stock, to the former shareholders; (iii) the partners transfer their partnership interests to a newly organized corporation or LLC in exchange for stock or membership interests. The corporation or LLC, which has become the sole "partner," dissolves the partnership, acquiring the partnership's assets; or (iv) the possible cross-entity merger but not conversion where partners organize a corporation and then merge the partnership into the corporation.[447]

Therefore, in adapting to the new set of business organization alternatives, and to ease conversions and mergers of such diverse entities with one another for state law purposes, nearly all states have enacted statutes that allow business entities to convert from one type of entity to another type of entity by merely filing a form (such as articles of conversion) with the secretary of state (state law formless conversion statutes). As mentioned, many states have also enacted statutes allowing one type of business entity to merge into a different type of business entity, such as the merger of a corporation into an LLC (state law cross-entity merger statutes). The effect of such statutes is that title to the assets of the entities is automatically owned by the converted or surviving entity, and correspondingly liabilities automatically become liabilities of the converted or surviving entity.

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

The advent of state law formless conversion statutes and the cross-entity merger statutes, combined with the somewhat elective tax status available under the check-the-box regulations can have significant non-tax and state tax law advantages, including:

1. the possible avoidance of non-transferability, acceleration, due on sale, and similar clauses contained in various contracts;

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[446] See Art, "Conversion and Merger of Disparate Business Entities", 76 Washington L. Rev. 349 (2001).

[447] See, e.g., Del. Code Ann. tit. 8, § 266 (2001); Iowa Code Ann. § 490A.304 (West 2001); Or. Rev. Stat. § 70.515 (2001); N.C. Gen. Stat. § 55-11A-12 (2003); Okla. Stat. Ann. tit. 18, § 2054.1 (West 1999).

2. avoiding application of transfer fees, sales taxes, documentary stamp taxes, etc.; and

3. simplicity.

There are essentially five types of entity conversion transactions: (i) juridical or "formless", New York LLC converts to a New York corporation; (ii) merger into a newly organization shell entity, New York LLC merges with and into a newly organized New York shell corporation (which was commonly used before statutory conversion statutes were enacted); (iii) tax conversion only, such as by filing IRS Form 8832 or by certain ownership change which can be tricky, such as the LLC electing S corporation status per Reg. §301.7701-3(c)(1)(v)(C); (iv) dissolution and reformation transactions which frequently may involve substantial tax costs; or (v) pure-redomestication transactions, such as converting a New York LLC into a Florida LLC, Florida corporation or converting a Georgia corporation into a Delaware corporation. However, the ease of converting an entity from one type of entity to another type under state law formless conversion statutes, state law cross-entity merger statutes and the check-the-box regulations can present significant tax pitfalls and a trap for the unwary as a result of the federal tax consequences resulting from changing the tax classification of the entity for federal income tax purposes.

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

[1] In General.

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

[2] General Incorporation Rules.

[a] *Recognition of Gain or Loss to Shareholder.*

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

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

A corporation may be classified as an "investment company" if more than 80% of its assets are held for investment and constitutes stock, securities, money, etc.[448]

Even if the 80% test is met, the company will not be classified as an "investment company" unless it results in "diversification." Diversification does not occur if each of the transferors conveys identical assets to the newly organized corporation. Additionally, diversification does not occur if not more than 25% of the portfolio of stock and securities conveyed by each transferor constitutes stock and securities of any one issuer, and not more than 50% of such portfolio is in the stock and/or securities of five or fewer issuers.[449]

[b] *Receipt of Boot.*

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

Rev. Rul. 68-55,[450] provides that in determining gain recognized under Section 351(b)(1), where several assets are transferred, each asset must be considered transferred separately in exchange for a portion of each category of consideration received. Each category of consideration received by the transferor is separately allocated to the transferred assets in proportion to their relative fair market values.

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

[c] *Property Requirement.*

Section 351(d) provides that for purposes of Section 351, stock issued for: (1) services, (2) indebtedness of the transferee corporation which is not evidenced by a security; or (3) interest on indebtedness of the transferee corporation which is accrued on or after the beginning of the transferor's holding period for the debt, is *not* considered as issued in return for property. Under such circumstances, ordinary income could be realized to the extent that any stock received in the transaction is not attributable to the contribution of "property."

[d] *Liabilities.*

[i] General Rules.

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

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

450 1968-1, C.B. 140.

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

[ii] Liabilities in Excess of Basis.

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

[iii] "Nasty Purpose Liabilities."

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

[e] *Control*.

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

[i] Binding Commitment Test.

The binding commitment test is relatively straight forward. If, at the time the parties commence the first transaction, they are under a binding commitment to undertake the subsequent transactions, then all transactions will be integrated into one transaction.

[ii] Mutual Interdependence Test.

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

[iii] End Results Test.

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

[f] *Basis for Stock.*

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

[g] *Holding Period for Stock.*

The holding period for the stock received in the exchange will receive "tacking" of the holding period of any assets transferred to the corporation, provided, however, ordinary income assets (assets other than a capital asset as defined in Section 1221 or property described in Section 1231) are not entitled to tacking and the holding period for the stock begins on the date following the date of the exchange.[451]

[h] *Nonrecognition of Gain or Loss to Corporation.*

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

[i] *Basis of Property Contributed to Corporation.*

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

[j] *Holding Period of Property Contributed to Corporation.*

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

[3] Tax Consequences to the Shareholder.

[a] *Recognition of Gain or Loss to Shareholder.*

Subject to the rules discussed above regarding the receipt of boot, the "property" requirement, liabilities in excess of basis and "nasty purpose" liabilities and the control requirement, under Section 351(a), no gain or loss is recognized to the shareholder if property is transferred to a

[451] Section 1223(1).

corporation solely in exchange for stock in such corporation and immediately after the exchange such person is in control of the corporation.

[b] *Basis of Stock to Shareholder.*

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

[c] *Holding Period of Stock.*

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

[4] Tax Consequences to the Corporation.

[a] *Nonrecognition of Gain or Loss to Corporation.*

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

[b] *Basis of Property Contributed to the Corporation.*

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

[c] *Holding Period of Property Contributed to Corporation.*

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

[5] Other Considerations.

[a] *Employer Identification Number.*

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

[b] *S Corporation.*

[i] Election of S Status.

Regardless of whether the transaction involves the incorporation of a sole proprietorship, the election by a disregarded entity under the check-the-box regulations to be treated as an association taxable as a corporation, the conversion of a disregarded entity such as a single-member LLC under the applicable state law formless conversion statute, or the merger of a disregarded entity into a corporation under the applicable state law cross-entity merger statute, if the corporation desires to be taxed as an S corporation, an S election will need to be filed for the corporation within two months and fifteen days of the incorporation, election to be treated as a corporation, conversion or merger, as the case may be.[452]

[ii] Deemed Election as Association by Filing Form 2553.

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

[6] From QSUB to Association Taxable as a Corporation - Termination of QSUB Election

The termination of a QSUB election is effective: (a) on the effective date contained in the revocation statement if a QSUB election is revoked; (b) at the close of the last day of the parent S corporation's last taxable year as an S corporation if the parent's S election terminates; or (c) at the close of the day on which an event occurs that renders the subsidiary ineligible for QSUB status.[453]

In the event of a termination of the QSUB's election, the corporation is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the S corporation in exchange for stock of the new corporation immediately before the termination.[454] Without specifically providing that there is a deemed Section 351 transaction, Reg. §1.1361-5(b)(1) provides that the tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Code and general principles of tax law, including the step transaction doctrine. The sale of 100% of the stock of a QSUB is treated as the sale of the assets of the QSUB followed by a Section 351 transfer of the assets to a new corporation by the purchaser (or purchasers).[455]

Prior to the 2007 Act, it was necessary to consider the control requirement (80% transferor group) in Section 368(c) for the termination of a QSUB election, for example upon the sale of some or all of the shares, as well as assessing the potential impact of Section 357(c) and the other potential exceptions to tax free treatment. Under the 2007 Act, if a QSUB election terminates because some or all of the QSUB stock is sold, the sale is treated as a sale of an undivided interest in the assets of the QSUB

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452 Sections 1362(a) and (b).

453 *See* Reg. §1.1361-5(c).

454 Section 1361(b)(3)(C).

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

followed by a deemed Section 351 transfer of the assets to the new corporation by the purchaser (and the seller to the extent of any unsold shares).[456]

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

A termination of QSUB status may result through a revocation by the parent or a consequence of transferring a single share of subsidiary stock to a shareholder or third party. More specifically, Section 1361(b)(3)(c) provides that a upon termination, the QSUB is treated as a new corporation acquiring all of its assets and assuming all of its liabilities from the S corporation parent in exchange for its stock. The former QSUB is prohibited from re-electing S status or QSUB status for 5 years unless permission is received from the Service.[457] The final regulations provide some relief. For S and QSUB elections effective after 1996, where a QSUB election terminates, the corporation may, without obtaining IRS consent, make an S election or be subject to a new QSUB election prior to the end of the five year waiting period provided: (i) immediately following the termination, the corporation (or its successor) is otherwise eligible to make an S election or be subject to a QSUB election, and (ii) the relevant election is made effective immediately following the termination of the QSUB election.[458]

> Example: Assume X, an S corporation, owns 100% of Y, a QSUB and distributes all of its Y stock to X shareholders. The distribution terminates the corporation's QSUB election.[459] Assuming Y is otherwise eligible to elect S, Y's shareholders may elect S status without IRS consent within the 5 year period. The same result applies were X to instead sell 100% of its Y stock to an unrelated S corporation, Z, where Z intends to make a QSUB election effective on the date of the acquisition.

Rev. Rul. 2004-85[460] addresses whether a QSUB election terminates when the QSUB is transferred pursuant to a reorganization under Section 368. In a Section 368(a)(1)(F) transaction where an S corporation merges into a sister S corporation (having identical stock ownership), the QSUB election for a QSUB owned by the merging S corporation does not terminate. However, in transactions qualifying as reorganizations under Sections 368(a)(1)(A), (C) or (D), a QSUB election for a subsidiary that is transferred as part of the transaction to an acquirer S corporation will terminate as of the date of transfer unless the acquirer S corporation makes a QSUB election for the subsidiary effective immediately following the termination. If this new election is not made effective immediately following the

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

[457] Section 1361(b)(3)(D). See Reg. §1.1361-5.

[458] Reg. §1.1361-5(c)(2).

[459] See also Sections 368(a)(1)(D), 355, 311.

[460] 2004-33 I.R.B. 189.

termination, the subsidiary will not be eligible to be treated as a QSUB or as an S corporation before the expiration of the waiting period under Section 1361(b)(3)(D).[461]

The final regulations provide that the effective date of a QSUB termination is: (i) on the effective date contained in the revocation statement if a QSUB election is revoked under Reg. §1.1361-3(b); (ii) at the close of the last day of the parent's last taxable year as an S corporation if the parent's S election terminates under Reg. §1.1362-2; or (iii) at the close of the day on which a disqualification event occurs that results in the QSUB not being described under Section 1361(b)(3)(B).[462]

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

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

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

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

Under the final regulations, where a tier of QSUBs have their elections terminated on the same day, the formation of any higher tier subsidiary is deemed to have occurred prior to the formation of a lower tier subsidiary, a so-called "top to bottom" approach.[463]

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

If a QRS ceases to meet the requirements to be a QRS, or upon an election to be treated as a taxable REIT subsidiary ("TRS"), the former QRS will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the REIT parent in exchange for stock.[464] The deemed transfer of assets to a new corporation will qualify for nonrecognition if the requirements of Section 351 are satisfied, similar to the termination of a QSUB election.

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

[1] In General.

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

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

463 Reg. §1.1361-5(b)(1)(ii).

464 Section 856(i)(3).

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

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

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

[2] Tax Consequences to the Corporation.

[a] *Recognition of Gain or Loss.*

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

[b] *Treatment of C Corporation Versus S Corporation.*

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

[c] *Beware of Section 1239.*

Because Section 336(a) provides that the property is treated as sold to the distributee at its fair market value, any gain attributable to depreciable property distributed to a shareholder owning more than 50% of the stock of the corporation may be subject to ordinary income, rather than capital/Section 1231 gain. Although this may not be important in the C corporation context since C corporations do not enjoy special capital gain rates, Section 1239 can have a significant impact on S corporations since the gain would flow through to the shareholders as ordinary income rather than as capital gain, and could cause a mismatching of ordinary income against capital loss. This poses a significant trap for the unwary.

[d] *Deductibility of Loss on Liquidation.*

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

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

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

[3] Tax Consequences to the Shareholder.

[a] *Recognition of Gain or Loss.*

In addition to corporate-level gain or loss, under Section 331(a), the shareholder will recognize gain or loss to the extent the fair market value of the assets distributed to the shareholder exceeds such shareholder's basis in the stock of the corporation or loss to the extent the shareholder's adjusted tax basis in the stock of the corporation exceeds the fair market value of the property distributed to the shareholder. Any shareholder-level gain will constitute capital gain or loss if the shareholder has held his stock for more than one year.[465]

[b] *C Corporation Versus S Corporation.*

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

[465] Section 1222.

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

[c] *Qualified Subchapter S Trusts.*

Another possible mismatching of gain and loss could occur in the case of the sale of S corporation stock by a qualified subchapter S trust (QSST), if the gain passing through from the S corporation is taxable to the current income beneficiary, whereas the loss on liquidation is taxable to the trust itself. However, the IRS has made it clear that both the loss and the corresponding gain in such situations should be reported by the QSST.[466]

[4] From Corporation to QSUB Status – the QSUB Election.

Once effective, the QSUB election requires that the assets, liabilities, tax items, tax history, etc., of the QSUB are treated as directly owned and realized by the S corporation parent for federal income tax purposes. All intercompany transactions presumably will be eliminated for federal tax purposes.[467] A similar rule is contained in Section 856(i), permitting a REIT's ownership of a 100% subsidiary. As to the QSUB, it would no longer add/subtract to its tax history, e.g., earnings and profits, AAA, etc., during the applicable period. There is a carryover of tax basis, which in turn triggers application of Section 1374 with respect to transferred basis assets.[468] Where the subsidiary uses the LIFO method of inventory accounting, the making of the QSUB election triggers the four year LIFO recapture rule. For state law purposes, the QSUB is still recognized as a separate legal entity.[469]

Final regulations to the QSUB rules were issued on January 25, 2000.[470] The final regulations generally apply to taxable years that begin on or after January 20, 2000; however, taxpayers previously could have elected to apply the regulations in whole, but not in part (aside from those Sections with special dates of applicability), for taxable years beginning on or after January 1, 2000, provided the corporation and all affected taxpayers apply the regulations in a consistent manner. To make the election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. The rules relating to the treatment of banks apply to all taxable years beginning after December 31, 1996.[471]

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

*Debt, Options and Other Instrument and Arrangements Involving QSUBs*. While the parent electing QSUB must own all of the stock of the subsidiary, the question is whether there is any disguised

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

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

468 Section 1374(d)(8).

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

470 65 FR 3843.

471 Reg. §1.1361-4(a)(3)(iii).

equity floating around the QSUB orbit through the issuance of debt, options or other arrangements held by third parties which would violate the QSUB rules.[472]

The final regulations provide that arrangements that are not considered to be stock under the one class of stock rules set forth in Reg. §1.1361-1(l) will be disregarded. The final regulations provide a straight debt safe harbor if the obligation would meet the requirements under Reg. §1.1361-1(l)(5).[473] Similar relief is provided for deemed exercise of an option under Reg. §1.1504-4.[474] An example of the use of straight debt to maintain QSUB status is provided in Reg. §1.1361-2(d).

*Election of QSUB Status*. Section 1361(b)(3) requires that an S corporation must file a QSUB election for each applicable subsidiary otherwise the subsidiary will be treated as a C corporation. The election mechanics are set forth in Reg. §1.1361-3 which generally follows the rules set forth in the proposed regulations including the provision that a QSUB election may be made by the S corporation parent at any time during the taxable year. The election form, which is still to be prescribed by the IRS, must be signed by the appropriate officer of the corporation under Section 6037. The election is filed with the Service center where the subsidiary filed its most recent tax return, or if a newly organized subsidiary, where the S corporation parent filed its most recent return.[475] The QSUB election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing. For this purpose, the definition of the term "month" found in Reg. §1.1362-6(a)(2)(ii)(C) applies. If an election form specifies an effective date more than two months and 15 days prior to the date on which the election form is filed, it will be effective two months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed. The final regulations further acknowledge that relief is available under the 9100 regulations for a late filing.[476]

An S corporation may revoke a QSUB election under Section 1361 by filing the appropriate statement with the service center where the S corporation's most recent tax return was properly filed. The revocation of a QSUB election, provided the QSUB election has not otherwise terminated for eligibility reasons, is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified.[477] The effective date specified on the revocation statement cannot be more than two months and 15 days prior to the date on which the revocation statement is filed and cannot be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than two months and 15 days prior to the date on which the statement is filed, it will be effective two months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

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472 See Reg. §1.1361-1(l)(4)(ii)(B), (iii)(B), (iii)(C) (safe harbor rules for certain debt and option arrangements).
473 Reg.§1.1361-2(b)(2), -2(c).
474 See Reg. §1.361-4(a)(2)(v).
475 Reg. §1.1361-3(a)(2).
476 Reg. §1.1361-3(a)(6).
477 Reg. §1.1361-2(b)(2).

Reg. §1.1361-5 provides that an extension of time to make a QSUB election may be available under the late election relief rule in Reg. § 301.9100 by filing a request with the National Office explaining the reason for the failure.[478]

Rev. Proc. 98-55[479] contains relief provisions for late-filed QSUB elections. The Revenue Procedure applies only to a corporation (i) for which a timely QSUB election under Section 1361(b)(3)(B) was not filed for the desired effective date, (ii) for which a QSUB election is filed within 12 months of the date that an election for the desired effective date should have been filed, and (iii) for which the due date for the S corporation's tax return (excluding extensions) for the first taxable year for which the S corporation desired QSUB status for the subsidiary has not passed. The procedural requirements for this relief are as follows. Within 12 months of the due date for filing a QSUB election to be effective on the desired effective date (but in no event later than the due date for the S corporation's tax return (excluding extensions)) for the first taxable year of the S corporation for which the S corporation intended to treat the subsidiary as a QSUB), the corporation must file with the applicable service center a completed QSUB election. The QSUB election must state at the top the form "FILED PURSUANT TO REV. PROC. 98-55." Attached to the form must be a statement explaining the reason for the failure to file a QSUB election within the time period required for the desired effective date.[480]

Rev. Proc. 2003-43,[481] in superseding the earlier Rev. Proc. 98-55, supra, provides for making a late QSUB election within 2 years of its original due date by filing the form with the service center in the normal manner, but with a statement of reasonable cause attached. If the two-year period has passed, an S corporation may seek 9100 relief by filing a private letter ruling request with the National Office of the Service.[482]

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

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

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

479 1998-46 I.R.B. 27.

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

481 2003-1 C.B. 998.

482 Reg. §1.1361-3(a)(6).

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

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

The final regulations confirm the rule set forth in the proposed regulations which provide that a QSUB election can be effective at any time during its tax year as long as the QSUB eligibility requirements are satisfied at the time that the election is made and for all periods for which the election is to be effective.[483]

*Tax Treatment of QSUB Election.* Although the relevant statutory language does not specifically provide, the QSUB election is treated as a deemed liquidation of a wholly owned subsidiary into its electing S corporation parent.[484] Under Section 337, no gain or loss is generally recognized by the liquidating subsidiary. Similarly, no gain or loss is recognized by the parent.[485] In accordance with Section 381, the S corporation parent will succeed to the QSUB's entire tax history as well as the adjusted basis in its assets. Where the subsidiary has been a C corporation, the liquidation will cause the parent S corporation to become subject to the built-in gains tax under Section 1374 with respect to the target's assets. If the target C corporation used the LIFO method of inventory accounting, the special recapture rule in Section 1363(d) comes into play. Post-QSUB election problems may also be attributable to inheriting the target's C earnings and profits. Obviously, such will have an impact on characterizing post-QSUB election distributions by a parent S corporation to its shareholders.[486] Where there is a significant amount of passive investment income, the carryover of the target's earnings and profits may result in an entity level tax under Section 1375 and/or eventually pose a termination risk under Section 1362(d)(3).

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

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

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

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

485 Section 332.

486 Section 1368(c).

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

Section 332(b) requires that the parent must adopt a plan of liquidation when it owns 80% or more of the stock of the liquidating subsidiary. A QSUB election is, by design, a constructive liquidation. Since the subsidiary will not liquidate under state law, the question arises as to whether the adoption of a plan of liquidation is necessary. The timing of the deemed liquidation may also affect its tax consequences. The deemed liquidation is effective at the close of the date prior to the QSUB election becoming effective.[487] For the conversion of a consolidated group (and its parent corporation), the S corporation/QSUB election deemed liquidation of the QSUBs will be deemed to occur in the last consolidated return year. This means that ELA (excess loss account) will be eliminated.[488]

Generally the ordering of the QSUB elections is from the "bottom up" in order to avoid ELA recapture unless the election form designates a QSUB election sequence.[489] However, an election may be made to change the ordering of the QSUB election from top to bottom. For example, if A, an S corporation, owns all of the stock of B and C, and B and C each own 50% of the stock of D, A should specify that the B and C liquidations occur first, in order to qualify the entire set of deemed liquidations.[490]

Where the QSUB election is made after the acquisition of another corporation, the liquidation is deemed to occur immediately after the stock ownership requirement is met.[491]

The deemed liquidation occurs immediately after the deemed asset purchase.[492] The regulations provide that, for purposes of satisfying the requirement of Section 332(b) that the parent corporation own stock in the subsidiary meeting the requirements of Section 1504(a)(2) on the date of adoption of the plan of liquidation of the subsidiary, the plan of liquidation is deemed adopted immediately before the deemed liquidation incident to a QSUB election unless a formal plan of liquidation that contemplates the filing of the QSUB election is adopted on an earlier date.[493] Still if as a result of the application of general tax principles the transactions that include the QSUB election are treated as an asset acquisition, and as further subject to transitional relief, Section 332 is not applicable and this rule has no relevance.

*Application of Step Transaction Doctrine*. Applying step transaction to the acquisition of stock that precedes a QSUB election can cause the transaction to be recast as an asset acquisition under Section 368 with unfortunate results for the unwary or unsophisticated, which again, is inconsistent with the legislative history to QSUB.[494]

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487 Reg. §1.1361-4(b)(1).

488 Reg. §1.1502- 19(b)(2)(i).

489 Reg. §1.1361-4(b)(2).

490 See Form 8869.

491 Reg. §1.1361-4(b)(3)(i).

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

493 Reg. §1.1361-4(a)(2)(iii), (iv).

494 See generally, Rev. Rul. 67-274 (1967-2 C.B. 141) (which treats as a Type C reorganization, and not as a reorganization under §368(a)(1)(B)(Type B reorganization) an acquisition of the stock of one corporation by another corporation, solely in exchange for voting stock of the acquiring corporation, followed by a liquidation of the target

The regulations provide that general principles of tax law, including the step transaction doctrine, will apply to determine the tax consequences of the transactions that include a QSUB election. The regulations provide examples illustrating the results of applying step transaction in the context of a QSUB election. It should be noted that in Rev. Rul. 67-274, supra, the Service "forced" the transaction to meet the requirements for a tax-free reorganization under the "second" or "stepped" form of reorganization. Both Type B and Type C reorganizations have restrictions on whether any "boot" can be received and Type C's have the "substantially all" requirement as well as a separate boot limitation rule. The conversion of a two-step transaction into a single transaction in this manner continues to be applied by the Service in characterizing multi-step acquisitions of corporations, including S corporations and their shareholders.[495]

In *Bausch & Lomb Optical Co. v. Commissioner*,[496] the taxpayer owned 79 percent of the stock of a subsidiary corporation. In order to acquire its assets, the taxpayer issued its stock in exchange for all the assets; the subsidiary then liquidated, distributing the parent's stock pro rata to all of its shareholders. The outside shareholders of the subsidiary thus became minority shareholders of the parent. The various steps were held to constitute a single plan having the effect of a taxable liquidation (to the extent of the assets received in exchange for the parent's 79 percent stock interest), rather than a tax-free Type C reorganization, on the theory that the assets were acquired by the taxpayer in consideration for its stock of the subsidiary rather than in exchange for its own voting stock, as required by Section 368(a)(1)(C). Liability was successfully asserted by the IRS against the parent corporation for gain on liquidation of its subsidiary since Section 332 was unavailable to insulate the parent corporation for gain on the liquidation of its subsidiary.[497]

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corporation pursuant to a plan). Consider the same exchange of target stock for voting stock of parent acquisition company and then a liquidation of target into parent but prior to the closing of the transaction, target distributes unwanted assets to target shareholders in a tax-free spin-off transaction under §355. See Helvering v. Elkhorn Coal Co., 96 F.2d 732 (4th Cir. 1938), cert. den. 305 US 605 (1938). This would cause testing under the "substantially all" requirement under §368(a)(1)(C) to fail since parent acquisition company would not be acquiring substantially all of target's assets. This would make the transaction a taxable asset purchase to target and provide acquisition company with a cost basis in its assets. For a defense of the Service's application of the step transaction doctrine to the deemed liquidation resulting from the making of a QSub election see Anderson, "Re-examining the Qualified Subchapter S Subsidiary–Years Later," 40 Tax Mgt. Mem., No. 24 (Nov. 22, 1999). See also Kwall and Maynard, "Dethroning King Enterprises", 58 Tax Lawyer 1 (2004); August, "Mergers and Acquisitions of S Corporations—Part 3", 9 No. 6 Bus. Entities 6 (2007).

[495] See Rev. Rul. 79-130, 1978-1 CB 114, revoked by Rev. Rul. 2015-9, 2015-21 IRB 972. In Rev. Rul. 2015-9, the service ruled that where: (i) a domestic corporation transfers all of the stock of its foreign operating subsidiary to its foreign holding company subsidiary in exchange for additional stock; (ii) the foreign operating subsidiary and three foreign subsidiaries of the foreign holding company transfer substantially all of their assets to a newly-formed foreign subsidiary of the foreign holding company in exchange for stock of the new subsidiary; (iii) the subsidiaries that transfer their assets are liquidated, the transfer of the foreign operating subsidiary's stock is an exchange governed by § 351 followed by reorganizations under § 368(a)(1)(D). See also Rizzi, "Doubling Down on Multiple Drops: Rev. Ruls. 2015-10 and 2015-9", 42 J. Corp. Tax'n 20 (2015); 42 WGL-CTAX20 (2015). Cf. Rev. Rul. 2017-9, 2017-21 IRB 1244 (application of step-transaction doctrine to so-called "north-south" transactions. See Rizzi, "A New 'Purpose Test': Step-Transaction Analysis In North-South Ruling", 44 Corp. Tax. 33 (2017) WESTLAW 44 WGL-CTAX 33.

[496] 267 F.2d 75 (2d Cir. 1959) cert denied 361 U.S. 835 (1959). August, "Benefits and Burdens of Subchapter S In A Check-the-Box World", 4 Fla. Tax Rev. 287 (1999). But see Rizzi "Through a Lens Darkly: Darkly: Proposed "C" Reorganization Regulations Clear Up The Bausch & Lomb Problem", 27 J. Corp. Tax'n 3 (Spring 2000).

[497] See Seplow, "Acquisition of Assets of a Subsidiary: Liquidation or Reorganization?", 73 Harv. L. Rev. 494 (1960).

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

> Example: X is an S corporation which operates retail and manufacturing divisions. In January 2015, X contributes the retail operations, subject to liabilities, which liabilities exceed the adjusted basis of the retail assets, to a newly formed corporation Y in exchange for all of Y's stock and makes a QSUB election effective as of the date of formation of Y. If Section 332 applied, the liquidation would be taxable since Y is insolvent. Similarly, Section 357(c) should not apply since there is no Section 351 transaction. Reg. §1.1361-1(a)(2) applies step transaction analysis to ignore the deemed liquidation under Sections 337 and 332 and treat the transaction simply as the formation of a newly organized subsidiary.

Another example of the application of the step transaction doctrine in the context of a QSUB election is a qualified stock purchase under Section 338(d)(3) which is immediately followed by the acquisition corporation's making a QSUB election with respect to the target corporation.[498] This may occur where the acquisition corporation is a C or an S corporation. In the first example of the Regulations, a C corporation acquires all of a solvent, target corporation from an unrelated individual for cash and short-term notes. As part of the same plan, the acquiring corporation immediately makes an S election for itself and a QSUB election for the target. The example provides that since the stock purchase is "qualified" per Section 338(d)(3), the deemed liquidation is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under Sections 332 and 337.[499] Other examples are discussed below under Disregarded Entities in Corporate Reorganizations.

*Timing of Deemed Liquidation.* Under Reg. §1.1361-4(b), rules are set forth for the date on which the deemed liquidation resulting from a QSUB election occurs. Where the S corporation parent owns all of the subsidiary stock prior to the effective date of the QSUB election, the regulations provide that the deemed liquidation occurs at the close of the day prior to the effective date of the QSUB election. Thus, if a C corporation elects to be treated as an S corporation and makes a QSUB election effective on the same date, the liquidation occurs immediately prior to the S election becomes effective, while the S electing parent is still a C corporation. This timing rule has significant implications for consolidated groups which convert to S corporation and QSUB status. For example, where the parent S corporation wants to file a set of QSUB elections for a tiered group of subsidiaries on the same date, the parent corporation is permitted to specify the order of the deemed liquidations. Where no order is set forth in the filing with the Service, the regulations provide that the constructive liquidations are deemed to occur from a "bottom-up" approach starting with the lowest tier subsidiary.[500] Where the acquisition S corporation does not acquire 100% of the stock of the target C subsidiary or group on the day before the QSUB election is effective, the deemed liquidation occurs at the time when the S corporation first owns 100% of the target subsidiary stock.[501]

A second rule pertains to acquisitions of target corporations, i.e., where an S corporation does not own all of the subsidiary's stock on the day before the QSUB election is to be effective. In this

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498 Reg. §1.1362-4(a)(2)(ii). See discussion of step-transaction with respect to S corporation acquisitions in August, "Mergers And Acquisition of S Corporations", Part 1, 9 No. 2 Business Entities 96 (March/April 2007)

499 See Rev. Rul. 90-95; Reg. §1.338.

500 Reg. §1.1362-4(b)(1).

501 Reg. § 1.1361-4(b)(3)(i).

situation, the regulations provide that the deemed liquidation occurs immediately after the time at which the S corporation's owns 100% of the subsidiary's stock.[502]

The QSUB election is not effective for the target until the day after the acquisition date. The deemed liquidation resulting from the QSUB election occurs immediately after the date of the deemed asset purchase by the new target corporation under Section 338.[503] Where the S corporation makes an election under Section 338 (without a Section 338(h)(10) election) with respect to a target, the target must file a final or deemed sale return as a C corporation for the deemed sale.[504]

*Effect of QSUB Election on S Corporation's Basis in Subsidiary Stock*. Aside from the tax history issues generated by a deemed liquidation, perhaps the most immediate drawback to the QSUB is the disappearing basis problem. Suppose, for example, that an S corporation purchases all of the stock of a target C corporation (in a non-Section 338 transaction) at a purchase price of $2,000x. Assume the target's basis in its assets is $500x. By purchasing all of the target's stock and making the QSUB election (or, alternatively, by immediately liquidating the target into the purchaser), the parent's cost basis in the subsidiary stock, i.e., $2,000x, disappears. The only relevant basis to the parent is the adjusted basis of the subsidiary's assets. The $2,000x basis is not reinstated if there is a termination of the QSUB election because the subsidiary is treated as a newly-formed corporation at that time under Section 1361(b)(3)(C). Again, the inside versus outside value differential will present built-in gains tax problems to the purchaser with respect to the QSUB's assets. The total net unrealized built-in gain is allocated on an asset-by-asset basis including goodwill and going concern value.[505]

*Acquisitions of S Corporations–AAA and Suspended Losses*. The Regulations acknowledge that the AAA of a target S corporation which is acquired in a tax-free reorganization or liquidation described in Sections 337/332 will be inherited by the acquiring corporation.[506] Reg. §1.1361-4(c) further provides that suspended losses also carry over where one S corporation acquires the stock of another S corporation referencing Reg. §1.1366-2(c)(1).

*Application of Built-In Gains Tax to QSUB Elections*. Section 1374 imposes a corporate level tax on the built in gains of an S corporation after it has converted from C corporation status. The tax is imposed on net recognized built-in gains for the subsequent 5-year period following the effective date of a C to S conversion. Section 1374(d)(8) provides the Section 1374 tax carries over with respect to an S corporation's receipt of transferred basis property from another C corporation or S corporation having an unexpired recognition period under Section 1374 from a prior conversion event. Therefore, Section 1374(d)(8) will apply with respect to the purchase of all of the stock of a target corporation and subsequent QSUB election under the deemed liquidation rule. In such case, a separate determination of tax is made with respect to the assets acquired by each particular target corporation. Regulations under Section 1374 provide that the tax attributes of the target, e.g., net operating loss and capital loss carryovers, may only be used against the target's subsequent recognized built-in gains.[507] Furthermore, Section 1374 attributes acquired in one Section 1374(d)(8) transaction may only be used to reduce the

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[502] Reg. §1.1361-4(b)(2).

[503] Section 338(h)(2). Reg. §1.1361-4(b)(2).

[504] Reg. §1.338-10(a)(3). Reg. §1.1361-4(d), Ex. 3.

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

[506] Reg. §1.1368-2(d)(2).

[507] Reg. §1.1374-8(b).

tax on the disposition of assets acquired in that transaction. This results in a "Libson Shops" type separate pooling approach.[508]

7.04. *Conversions of a Disregarded Entity into a Partnership and a Partnership into a Disregarded Entity*

[1] In General.

The acquisition of a disregarded entity by a single buyer is treated for federal income tax purposes as the sale of assets by the owner of the disregarded entity which neither elected or converted to association status. The check-the-box regulations do not address a change in tax status caused by a change in number of members, but this subject has been addressed by the IRS in two well-known rulings.[509]

[2] Conversion of a Disregarded Entity into a Partnership: Increase from One Member to Two (or More) Members.

In Rev. Rul. 99-5, *supra,* two scenarios involving the conversion of a disregarded entity into a partnership are discussed. In both cases, A owns 100% of the interests in an LLC valued at $10,000 and B purchases a 50% interest from A.

(a) In situation one, B acquires the interest from A for $5,000. The transaction is treated as a sale of one-half of each asset to B, followed by a contribution of all of the assets by A and B to a new partnership. A recognizes gain or loss on the sale of each asset held by the LLC.

(b) In situation two, B acquires a new 50% interest in the LLC from the LLC for $10,000 and the proceeds of the sale are retained in the business of the LLC. The transaction is treated as a transfer of all of the assets by A to a new partnership for an interest in the partnership, and a transfer of cash by B to the new partnership. No gain or loss, in general, is recognized by either party under Section 721.

(c) What if A transfers an interest in the LLC to B, but A contributes the cash to the business, so that their interests were 2/3 to A and 1/3 to B? Would the form of the transaction be followed, resulting in gain to A on an asset sale to B, or would the transaction be treated as a subscription by B to a 1/3 interest in the resulting partnership, resulting in nontaxable Section 721 treatment to A?[510]

(d) What if B purchases his interest directly from the LLC but cash is distributed to A? Presumably, the disguised sales rules under Section 707(a)(2)(B) would apply. This result could also occur if A caused new liabilities to be assumed by the new entity.

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[508] See Anderson and Looney, "Pesky S Corporation M&A Issues", 2016 ABA TAX-CLE 0129092 (1/29/2016).

[509] Rev. Rul. 99-5, 1999-1 C.B. 434 (increase in number of owners of disregarded entity from one to two or more), and Rev. Rul. 99-6, 1999-1 C.B. 432 (sale of membership interest in a partnership to a single purchaser resulting in the conversion to a disregarded entity).

[510] See Monte A. Jackel, "New Rulings Address One-to-Two and Two-to-One Entity Conversions", 82 Tax Notes 1167 (Feb. 22, 1999); Spiro, "Assumptions of Deferred Revenue Liabilities in Rev. Rul. 99-6 Transactions" 125 JTax'n 149 (2016).

(e) *Other Consequences*. Each scenario will have a varying outcome with respect to: (i) basis; (ii) holding period; (iii) Section 704(c) attributes and possibly with respect to Section 197.

[3] Conversion of a Partnership into A Disregarded Entity: Purchase of All of the Interests in an LLC Taxable as a Partnership by One Buyer.

In Rev. Rul. 99-6, the IRS addressed the purchase of all of the interests in an LLC taxed as a partnership by a single purchaser, resulting in a conversion to a single-member LLC.

(a) In situation one, A and B are each equal 50% owners of an LLC. B purchases A's interest in the LLC for 10X and continues to operate the business as a single-member LLC. The ruling concludes that: (i) the partnership terminates under Section 708(b)(1)(A); (ii) A, under Section 741, is treated as selling his partnership interest to B; and (iii) B, however, is treated as if the LLC first made a liquidating distribution of all of its assets to A and B and then B acquired the assets deemed distributed to A for full monetary consideration paid. B would therefore have a carryover basis in 1/2 of the assets (his pre-purchase share and tacking of holding period for his interest) and a fair market value purchase price basis in 1/2 of the assets deemed purchased from A with a new holding period.

(b) In situation two, C and D are equal partners in CD, an LLC. C and D sell their entire interests in CD to E, an unrelated person, for $10X each. The business is continued by the LLC, which is owned solely by E. The IRS concluded: (i) the CD partnership terminates under Section 708(b)(1)(A); (ii) C and D must report gain or loss under Section 741; (iii) the CD partnership is deemed to make a liquidating distribution of its assets to C and D; and (iv) immediately thereafter, E is deemed to acquire, by purchase, all of the former partnership's assets. E has a cost basis of $20X in the assets and a new holding period. Compare Rev. Rul. 84-111,[511] which determines the tax consequences to a corporate transferee of all interests in a partnership in a manner consistent with McCauslen v. Comm'r,[512] and holds that the transferee's basis in the assets received equals the basis of the partnership interests, allocated among the assets in accordance with Section 732(c).

[4] AICPA Proposes that Rev. Rul. 99-6 be Revoked or Clarified.

In a letter dated October 1, 2013, the American Institute of CPAs (AICPA) provided comments on Rev. Rul. 99-6 relating to the conversion of partnerships to disregarded entities. In the letter, the AICPA proposes that Rev. Rul. 99-6 be revoked, and that a sale which results in a partnership being converted into a disregarded entity be treated as the sale of a partnership interest by the selling partner or partners, and likewise that the purchaser be treated as acquiring the seller's partnership interest followed by a liquidating distribution of all of the assets of the partnership to the purchaser.

The letter goes on to provide that if Rev. Rul. 99-6 is not revoked, the following clarifications should be made to Rev. Rul. 99-6:

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[511] 1984-2 C.B. 88 (Situation 3).

[512] 45 TC 588 (1966). See Palm Canyon X Investments, LLC v. Comm'r, TC Memo. 2009-288, aff'd 2018 WL 1326394 (D.C.Cir. 2018).

(a) Limit the amount of liabilities assumed by the buyer from the seller to the seller's share of liabilities immediately before the transaction.

(b) Determine the partnership's distribution of gross assets to the seller and buyer by adding each partner's share of liabilities under Section 752 immediately before the transaction to the value of their equity.

(c) Clarify that neither the purchasing partner nor the partnership will recognize gain or loss as a result of the extinguishment of the partnership's debt to the purchasing partner resulting from the deemed liquidation of the partnership in Situation 1 of Rev. Rul. 99-6.

(d) Clarify that Sections 704(c)(1)(B) and 737 will not apply to the purchasing partner in the constructive distribution of partnership assets in Situation 1 of Rev. Rul. 99-6.

(e) Clarify that Section 751(b) does not apply to the purchasing partner in Situation 1 of Rev. Rul. 99-6.

(f) Provide that the tax consequences of nontaxable and partially taxable transfers not described in Rev. Rul. 99-6 that result in a partnership having a single owner and, therefore, becoming a disregarded entity for tax purposes (e.g., transfers to corporations, gifts, and bequests), have the same construct for basis and holding period as is adopted for Situation 1 of Rev. Rul. 99-6, except for those transfers resulting in a partnership merger.

(g) Provide that the tax consequences of the conversion of two or more partnerships into one partnership should be determined under the partnership merger rules of Reg. § 1.708-1(c) rather than Rev. Rul. 99-6.

## VIII. USE OF DISREGARDED ENTITIES IN M&A TRANSACTIONS

### 8.01. *Disregarded Entities in Corporate Reorganizations*

#### [1] Proposed and Final Regulations on Mergers involving Disregarded Entities.

On May 17, 2000, the Service issued a proposed rulemaking[513] on mergers involving disregarded entities. The proposed regulations revised paragraph (b)(1) of Reg. §1.368-2(b)(1) and adopted the view that a merger involving a corporation and a disregarded entity is not a statutory merger for purposes of qualifying as a tax-free reorganization under Section 368(a)(1)(A).[514] The proposed regulations would have extended to a qualified subchapter S subsidiary or QSUB, a limited liability company (LLC) with a single corporate owner which does not elect to be treated as a separate corporation, or a qualified REIT subsidiary. Section 368(a)(1)(A), discussed below, requires that a qualifying reorganization constitute a "statutory merger or consolidation."[515] Under the Proposed Regulations, the merger of a disregarded entity ("DRE") (including a QSUB or qualified REIT subsidiary) into a tax corporation would not be a Type A reorganization because the merging entity is not a tax corporation. In

[513] REG-106186-98, 65 FR 31115-01.

[514] See also Rev. Rul. 2000-5, 2000-5 IRB 1.

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

Rev. Rul. 2000-5, the Service held that a Type A merger must involve the transfer of the assets of a target corporation to a single transferee corporation ceasing to exist as a result of the "merger" Rev. Rul. 2000-5 implies that a merger of a DRE (single member) owned by a corporation (including a QSUB), cannot be a Type A reorganization because it will be divisive and will not necessarily result in the termination or liquidation of the member. Due to the additional requirements for a Type C ("substantially all of the transferor's assets," no more than 20% boot, including liability assumptions, and "solely for voting stock" requirements) and Type D ("substantially all"/liabilities in excess of basis) reorganization, many of the DRE mergers would constitute taxable transactions under the 2000 proposed regulations.[516]

The final regulations, issued in 2003, retain much of the conceptual background to the proposed regulations, including the definition of a disregarded entity.[517] Examples are set forth in the regulations which apply to disregarded entities, such as a domestic, single member LLC which does not elect to be treated as a corporation for federal income tax purposes, a qualified REIT subsidiary per Section 856(i)(2) and a QSUB per Section 1361(b)(3)(B).[518] Defined terms included the following:

(a) Disregarded Entity; a business entity that is disregarded as an entity separate from its owner for Federal tax purposes;

(b) Combining Entity; a business entity that is a corporation that is not a disregarded entity;

(c) Combining Unit; is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such entity for Federal tax purposes;

(d) Transferor Unit; and

(e) Transferee Unit.[519]

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

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

[517] Reg. §301.7701-2(b)(5).

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

[519] Reg. §1.368-2(b)(1)(i)(C).

actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the requirements of Reg. §1.368-2(b)(1)-(ii)(A).

The final regulations can be viewed as consistent with rulings previously issued by the Service. In Situation 1 of Rev. Rul. 2001-46,[520] an acquirer purchased a target corporation by means of two consecutive mergers. First, all of the target's outstanding stock was acquired in a reverse triangular merger (the "Acquisition Merger"), in which the merger consideration consisted of 30% cash and 70% stock. Next, the target, a wholly owned subsidiary of the acquirer, was merged upstream into the acquirer (the "Upstream Merger"). The Service held that the two steps should be integrated and treated as an asset acquisition under Rev. Rul. 67-274. Because Section 338 policies do not dictate otherwise, this transaction is treated as an A reorganization.[521]

In Situation 2 of the Ruling, the facts are the same as in Situation 1 except that in the Acquisition Merger the target shareholders receive solely voting stock in the acquirer in exchange for their target stock, so that the Acquisition Merger, if viewed independently of the Upstream Merger, would qualify as a reorganization under 368(a)(1)(A). The Service held that the difference in consideration (all stock, no cash) does not change the result in Situation 1.

Because Section 368(a)(1)(A) does not contain a 20% boot limitation (or a "substantially all" requirement), Rev. Rul. 2001-46 sanctions the use of a second step upstream merger to avoid the limitations of a reverse triangular merger under Section 368(a)(2)(E). The same consequences would apply if the target was converted or merged into a disregarded entity owned 100% by the acquirer, treated as an A reorganization under the final regulations dealing with mergers involving disregarded entities.

[2] Reorganizations Involving QSUBs.

QSUBs can be part of a tax-free reorganization, such as a Section 368(a)(1)(A) merger or consolidation.[522] Provision is made that if a target S corporation that has a QSUB merges into a disregarded entity, the termination of the QSUB election followed by the deemed contribution of the former QSUB's assets to a new C corporation immediately prior to the merger does not disqualify the merger under Section 368(a)(1)(A).[523] These regulations generally apply to transactions occurring on or after January 23, 2006.[524]

As discussed further above, the Service and Treasury proposed regulations in January 2005 containing a revised definition of statutory merger or consolidation that allows transactions effected pursuant to the statutes of a foreign jurisdiction or of a United States possession to qualify as a statutory merger or consolidation. Simultaneously with the publication of the 2005 proposed regulations, the IRS and Treasury Department published a notice of proposed rulemaking proposing amendments to the

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520 2001-42 I.R.B. 1(September 25, 2001).

521 See *King Enterprises, Inc. v. U.S.,* 418 F.2d 511 (CT. CL. 1969); Rev. Rul. 67-274.

522 Reg. §1.368-2(b)(iv) ex. 2.

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

524 Reg. §1.368-2(b)(1)(v).

regulations under Sections 358, 367, and 884 to reflect that, under the 2005 proposed regulations, a transaction involving a foreign entity and a transaction effected pursuant to the laws of a foreign jurisdiction may qualify as a statutory merger or consolidation (the foreign regulations). The regulations were finalized in January, 2006.[525]

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

*Deemed Liquidation Recharacterized as Type D Reorganization*. Another example in the final regulations raises the potential problem under Section 357(c) in connection with a QSUB election. Of course, this problem was removed temporarily under a transactions rule contained in Reg. §1.1361-4(a)(5)(i) and was removed permanently by the 2004 Act which amended Section 357(c) so that it is only applicable to *divisive* D reorganizations involving Section 355. Prior to the 2004 amendment to Section 357(c), assume Individual A contributes all of the outstanding stock of Y to his wholly owned S corporation, X, and immediately causes X to make a QSUB election for Y. The example concludes that the transaction will be a Type D reorganization, assuming the other conditions for reorganization treatment are satisfied, and consequently, that if the sum of the Y liabilities treated as assumed by X exceeds the total of the adjusted basis of Y's property, Section 357(c) will apply to the transaction and the excess will be gain from the sale of the contributed assets as allocated under relative FMVs.[526]

*QSUB Election Involving Insolvent Subsidiary*. Despite receiving comments that insolvent subsidiaries should qualify for a deemed 332 liquidation, the final regulations treat insolvent subsidiary liquidations, even as part of a QSUB election, as outside of Section 332. In general, Section 332 does not apply to the liquidation of an insolvent corporation, because the parent corporation does not receive at least partial payment for the stock of its subsidiary. An example is provided in the final regulations.[527] In such instance the tax attributes and adjusted basis of the assets of the subsidiary will not carry over to the parent. As far as transitional relief is concerned, the final regulations provide that for related party acquisitions followed by a QSUB election, the step transaction will not apply provided the QSUB election is made prior to January 1, 2001.[528] Examples are provided in the regulations as to the application of transitional relief.

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

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525 71 FR 4259-01, 2006-7 I.R.B. 422, 2006 WL 173491 (F.R.).

526 This example has not been updated to reflect the 2004 amendment to Section 357(c).

527 Reg. §1.332-4(d), Ex. 5.

528 Reg. §1.1361-4(a)(5)(i).

use of the step transaction doctrine to an acquisition of stock followed by a QSUB election, employ the tax treatment applicable to a Type F reorganization.

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

Citing Rev. Rul. 64-250,[529] the IRS concluded that pursuant to the F reorganization, the S corporation election would continue in effect with respect to the surviving QSUB following the merger. Additionally, citing Rev. Rul. 2004-85,[530] the IRS found that the status of the S corporation's other QSUB would not terminate as a result of the F reorganization.

Interestingly, the ruling does not address whether the surviving entity should continue to use the federal identification number previously used by the S corporation or the federal identification number of the QSUB into which it was merged. In Rev. Rul. 73-526,[531] the IRS ruled that where an S corporation merges into another corporation in a transaction qualifying as an F reorganization, the acquiring (surviving) corporation should use the employer identification number of the transferor corporation. However, in Rev. Rul. 2008-18,[532] the IRS ruled that in the two situations presented in the ruling, which both qualified as F reorganizations within the meaning of Section 368(a)(1)(F), the newly formed corporations would be required to obtain new employer identification numbers and that the existing corporation which became a QSUB would retain its same employer identification number.

8.02. *Like-Kind Exchanges Using Disregarded Entities*

Section 1031(a) provides that no gain or loss is recognized on the disposition of property ("relinquished property") which was held for productive use in a trade or business or for investment if the relinquished property is exchanged solely for like kind property ("replacement property") which is to be held either for productive use in a trade or business or for investment. Section 1031(a)(2) provides that stocks and partnership interests do not qualify for like kind exchange treatment.

With the availability of disregarded entities, taxpayers can structure like kind exchanges with disregarded entities as special purpose holding companies.

Example: Taxpayer A has transferred some real estate and wishes to structure a like-kind exchange. B would like to acquire all of the interests in Swap LLC, an entity that owns like-kind property. Swap LLC is wholly-owned by B. The acquisition of all of the interests in Swap LLC by A would be treated as an acquisition of the like-kind property owned by Swap LLC. From B's perspective, the transaction would be treated as a sale of the Swap LLC assets.

529 1964-2 CB 333.
530 2004-2 CB 189.
531 1973-2 CB 404.
532 2008-1 CB 674.

Example: Assume the same facts as in the previous Example, except that Swap LLC is owned by B, C and D. The moment before A acquires all of the LLC interests, Swap LLC was an entity treated as a partnership for tax purposes. Immediately after the transaction, Swap LLC is a disregarded entity. Partnership interests are not good like-kind exchange property.[533] However, the transaction is treated as a sale of partnership interests by B, C and D, but it is treated as a purchase of assets by A.[534] Consequently, the transaction is a good like-kind exchange for A. Of course, if A only acquired the interests owned by B and C. but not D, A would not have a good like-kind exchange because Swap LLC would not be a disregarded entity immediately after the purchase.

Example: Assume that A held his relinquished real estate in a single member LLC. A transferred all of the interests in LLC to B, C and D. The transaction is treated as a transfer of assets by A to B, C and D.[535] B, C and D are treated as contributing their fictional undivided interests in the assets to the LLC immediately thereafter. Thus, A would be entitled to structure a like-kind exchange. Note that if B, C or D were attempting to use the purchase as replacement property in their exchanges, they would have to contend with the "holding" requirement of Section 1031.[536]

Suppose that A transferred only a portion of his interest in his single member LLC. Rev. Rul. 99-5[537] would still treat A as having transferred an undivided interest in the real estate owned by the single member LLC. Thus, A would still be entitled to 1031 treatment (assuming all requirements of Section 1031 are otherwise satisfied) because he did not sell a partnership interest.

Example: S Corp's only asset is 100% of the stock of QSUB, a qualified S subsidiary. QSUB owns investment real estate. Stock is not good like-kind exchange property.[538] The sale of all of the QSUB stock will be treated as if S Corp sold, and as if the purchaser bought all of the assets of QSUB.[539] The purchaser is then deemed to have contributed the assets to QSUB in exchange for QSUB stock. S Corp may close the like-kind exchange by buying all of the stock of an unrelated QSUB that owns investment real estate if the QSUB remains a QSUB in the hands of S Corp. However, a transfer of less than all of the stock would not qualify for like kind treatment.[540]

Alternatively, S Corp can form Newco LLC as a wholly-owned subsidiary of S Corp. QSUB merges into Newco LLC with Newco LLC surviving. Because the merger is between two disregarded entities, this transaction will be disregarded for federal income tax purposes. S Corp can then sell the interests in Newco LLC and qualify for like-kind exchange treatment.[541]

Example: Assume that A has transferred some investment real estate and wishes to do a like-kind exchange. A is a 10% member in Real Estate LLC and B is the unrelated 90% member. Real Estate LLC owns real estate that would qualify as good replacement property for A if A acquired the real estate from Real Estate LLC. What if A instead acquires B's 90% membership interest? Generally, an LLC membership

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533 Section 1031(a)(2)(D).

534 Rev. Rul. 99-6, 1999-1 C.B. 432.

535 Rev. Rul. 99-5, 1999-1 C.B. 434.

536 *See e.g.*, Magneson v. Commissioner, 81 TC 767 (1983), *aff'd*, 753 F.2d 1490 (9th Cir. 1985); Bolker v. Commissioner, 81 TC 782 (1983), *aff'd*, 760 F.2d 1039 (9th Cir. 1985).

537 1999-1 C.B. 434.

538 Section 1031(a)(2)(B).

539 Reg. §1.1361-5(b)(3), Ex. 9.

540 *But see* Section 503 of the Subchapter S Modernization Act of 2003 (H.R. 2576 and S. 1201).

541 *See* Reg. §1.1361-5(b)(3), Ex. 2.

interest is not good exchange property under Section 1031. However, under Rev. Rul. 99-6[542] B is treated as having sold an interest in an LLC. However, because A will own 100% of the membership interests in Real Estate LLC after the purchase, Rev. Rul. 99-6 treats A as having acquired the underlying assets of the LLC.

Example: Assume that each of A and B owns a 50% membership interest in LLCI. LLCI owns real property held for investment. A and B would like to convey their membership interests in LLCI (to avoid state transfer taxes) and treat this as the disposition of relinquished property under Section 1031. However, the sale of membership interests in an LLC treated as a partnership for tax purposes will not qualify under Section 1031.[543] A and B contribute their membership interests in LLCI to a newly formed entity, LLCII, in exchange for membership interests in LLCII. LLCI becomes a wholly owned subsidiary of LLCII and a disregarded entity. LLCII then conveys 100% of the membership interests in LLCI.

This structure achieves the objectives of avoiding state transfer taxes and qualifying the disposition for Section 1031 treatment. Under the Section 708 partnership merger rules, LLCII is deemed to be a continuation of LLCI.[544] Thus, LLCII is treated as "holding" the LLCI real property for investment to the same extent as LLCI, qualifying for like-kind exchange treatment.[545]

## IX. STRUCTURING PRIVATE EQUITY INVESTMENT TRANSACTIONS

### 9.01. *In General*

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

Private equity investors and private equity funds actively acquire portfolio investments through the buyout of operating companies from the founder shareholders, as well as from purchases of businesses from diversified companies operating many businesses and subsidiaries and divisions, wishing to divest a non-core business or a business that it is unable to make profitable. These middle market businesses may have been historically operated as C corporations, S corporations, or limited liability companies.

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

Private equity investors are generally willing to expose capital to risk in order to achieve higher rates of return. There are cheaper sources of capital than private equity capital, such as traditional bank loans and private placements of senior debt securities. However, such sources may not be available to an early stage entrepreneur with no proven business plan or collateral or an operating company producing

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542 1999-1 C.B. 432.

543 *See* Section 1031(a)(2)(D).

544 Reg. §1.708-1(c).

545 *See* Rev. Rul. 75-292, 1975-2 C.B. 333; Rev. Rul. 77-337, 1977-2 C.B. 305. *See also* Magneson & Bolker, supra.

cash flow deficits. Even if traditional financing is available for a portion of the capital required, private equity financing may be necessary to provide the equity base for a business plan to succeed.

Federal law has encouraged private equity investments through various tax and other incentives for over 50 years. The Small Business Investment Act of 1958 permitted banks and bank holding companies to invest in Small Business Investment Corporations (SBICs) subject to certain restrictions.[546] The involvement of banks in private equity investments through the 1960s and 1970s provided the basis for the development of a professional private equity industry in the United States.

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

An operating company may be reasonably successful, but it may require equity capital from nontraditional private equity sources if traditional financing is not available from bank lenders, or the bank lenders condition credit on the infusion of additional equity capital. The founders may not be ready to sell out to a third party, as they may still have confidence in the original business plan and their ability to execute it. However, without additional private equity, the company may not realize its true potential.

### 9.02. *Structuring Private Equity Investments in an Operating Company*

Private equity investors often find profit opportunities in "growth-equity" investments in existing operating companies. The investment capital may be used to fuel expansion, to provide an equity base to support cost effective borrowing from traditional bank lenders, to purchase the stock formerly held by senior founders or their estates, or to recapitalize the current equity and debt structure of the company to provide the foundation for future growth and expansion. The best use of the capital raised from mezzanine and private equity investors is the direct funding of growth and expansion initiatives or strategic acquisitions. In the alternative, mezzanine debt and equity and private equity capital may be raised to buyout original shareholders who no longer contribute to the business plan, or in the case of deceased shareholder, where money is needed to pay estate taxes.

#### [1] Capital Structure of Operating Company.

If a cheaper source of capital were available to the operating company, such as bank financing, asset based lending, or equipment leasing, the founders would take advantage of such sources. However, such sources may have "maxed out" and the founders may be required to seek either (a)

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

subordinated debt, in the form of debt mezzanine capital, or (b) equity, in the form of equity mezzanine capital or pure private equity, from private equity investors.

Debt mezzanine capital may be structured to provide the mezzanine lender with a preferred position through the issuance of subordinated debt, behind senior lenders but ahead of the founders' equity. In addition, equity may be provided through the issuance of preferred stock by a C corporation (multiple classes of stock are not permitted for an S corporation), preferred LLC or partnership interests, or through the issuance of warrants and convertible debt, discussed further below.

A concern of the mezzanine or private equity investor that must be addressed in the capital structure is maintaining a position that is senior to the equity holders, although junior to the senior lenders, putting them "second in line" to realize any value left in the event of the liquidation of the business. Generally, the private equity investment may be structured through a tax free recapitalization of the operating company. Since the private equity investor does not have control of the company, as in the case of a buy-out, the potential for a successful investment will continue to depend on the business acumen and ability of the existing founders or management group to execute the business plan. The private equity investors will seek to ensure that the management group IS properly incentivized to ensure the success of the portfolio company.

There are several ways to recapitalize an existing company to accommodate private equity investments, usually ensuring that the private equity investor has some liquidation preference over the founders. A recapitalization may be accomplished by the transfer of shares in the operating company to a holding company, qualifying as a tax free Section 351 transaction, or the tax free recapitalization of the operating company under Section 368(a)(1)(E) (an "E recap").

In either a Section 351 transaction or a type E recapitalization, there is risk that preferred stock, issued on a non pro rata basis to the passive shareholders in exchange for a substantial block of common stock, will subject the preferred stock to Section "306 stock" treatment. Since the proceeds of the disposition of Section 306 stock is subject to the tax rate of 20% applicable to "qualified dividends," without reduction for basis, or subject to the dividends received exclusion for a corporate taxpayer, the consequences of the Section 306 taint may not be particularly objectionable.

A private equity fund (PEF) is also frequently organized for US federal income tax purposes as a pass-thru entity such as a limited partnership or a limited liability company instead of a C corporation. The general partner in a flow through PEF may be a corporation. In the partnership PEF, investors make required capital contributions and "as needed" additional capital calls at designated times. Generally a "waterfall" distribution provision will set forth the various tiers or priorities established for making cash distributions and with further allocation of tax items from the private equity fund partnership to the investors. The manager or general partner of the fund will receive value for the project in two forms: (i) a management fee of 1% to 2% of net capital contributed perhaps with a mark-to-market or "book-up" feature after certain thresholds of cash and yield have been met; and (ii) a carried interest (profits interest) in the fund providing the manager or management partner the right to receive a percentage of profits and appreciation which is generally pegged at 20%. The manager with a carried interest may also be required to make capital contributions or be subject to the capital call provisions.

[2] Avoiding Nonqualified Preferred Stock Treatment for Portfolio Companies Operated as C Corporations.

The 1997 Tax Act imposed additional barriers to achieving favorable tax consequences through the use of preferred stock in the capital structure of a C corporation, by defining a new category of preferred stock called "nonqualified preferred stock." Nonqualified preferred stock is preferred stock that meets any one of four tests:

(a) The holder has the right to require the issuer (or a related person) to redeem or purchase the stock within 20 years after the issuance date.

(b) The issuer (or a related person) is required to redeem or purchase the stock within 20 years after the issuance date.

(c) The issuer (or a related person) has the right to redeem or purchase the stock, and as of the issuance date, it is more likely than not that the right will be exercised within 20 years after the issuance date.

(d) The dividend rate on the stock varies in whole or in part with reference to an indexed interest rate, commodity price, or other similar indices, regardless of whether varying the rate is an express term of the stock, or results from other aspects of the stock.

Even if stock qualifies under one of the foregoing tests, it is treated as nonqualified preferred stock only if it is "limited and preferred as to dividends and does not participate in corporate growth to any significant extent." A shareholder who receives nonqualified preferred stock in an otherwise tax free recapitalization is required to recognize gain (generally long-term capital gain) even where the redemption would have been "essentially equivalent to a dividend" under Section 302 or otherwise subject to treatment as a dividend under Section 301 and eligible for the 20% tax rate for qualified dividends, or the dividend received exclusion in the case of a corporate recipient.

Nonqualified preferred stock is, by definition, not tainted by Section 306 since nonqualified preferred stock is not received by the passive shareholder tax free. A subsequent sale or redemption of the nonqualified preferred stock would not produce Section 306 dividend income to the passive shareholders, although a redemption of nonqualified preferred stock might result in dividend income under Section 302.

[3] Preferred Interest in Portfolio Company Operated as Partnership or LLC.

While a preferred interest in an S corporation cannot be obtained by a private equity investor as a result of a single class of stock rules, the investment may be structured to avoid the double tax by issuing the private equity investor a preferred interest in a limited liability company, which may be the historic operating company, or a newly formed LLC or partnership with an S corporation as a member or partner.

While a preferred membership interest in an LLC is not secured and would be lower on the pecking order than subordinated debt, a preferred interest may be one component of the capitalization structure to ensure the private equity investor that it will "get its money back" with some level of return commensurate with its minimum expectations, while at the same time being ahead of the founder equity investors. Preferred returns and special allocation provisions, common to private equity

and venture capital investment transactions, may be drafted into the partnership agreement or the LLC operating agreement.[547]

[4] Unrelated Business Taxable Income for Tax-Exempt Entities.

If a portfolio company is organized as a pass-through entity, income tax is avoided at the entity level and passed-through to the private equity investors. Taxable investors pay federal income taxes at the marginal rate applicable after considering all other items of income, loss, deduction, and credit.

Tax-exempt entities, including employee pension plans, are exempt from federal income tax on many items of income. Section 511 imposes tax on the "unrelated business taxable income" or "UBTI" of a tax-exempt entity at regular graduated rates, computed under the same rules applied to domestic corporations.[548] This would include the tax-exempt partner's share of the UBTI of a partnership or limited liability company.

In addition, Section 514 may cause otherwise exempt interest, dividends or capital gains to be taxed as UBTI if the underlying investment is "debt financed" either as a result of borrowing by the tax-exempt entity, or borrowing by a partnership of which the tax-exempt entity is a partner.[549] While private equity funds seldom borrow or incur acquisition debt, as in the case of a hedge fund, acquisition debt commonly is incurred by a portfolio company. If the portfolio company is a pass-through entity, the debt may "taint" all or portion of any gain on the sale allocable to the tax-exempt investors.

[5] Effectively Connected Income for Foreign Investors.

"[I]ncome from sources within the United States" ("U.S. source income") earned by a foreign person including partners owning interests in a foreign based private equity partnership, is subject to varying tax rates based on the species of income, i.e., passive or business income, and whether regular, substantial and continuous activities are conducted directly by the foreign corporation or an agent or employee present in the United States. As to non-US investors realizing sourced fixed or determinable, annual, or periodic income ("FDAP"), such income, unless otherwise determined to be effectively connected with the conduct of a U.S. trade or business under Section 864(c) or other rule, is taxed at a flat rate of 30% on the gross amount of its FDAP unless reduced by applicable treaty. For a foreign corporation or foreign person, including a foreign partnership having non-resident owners, portfolio interest and capital gains are generally not subject to income tax in the U.S.[550] Where a foreign corporation has a controlled U.S. subsidiary,

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[547] Section 704(a) provides that a partnership's share of income, gain, loss, deduction or credit shall, unless otherwise provided, be determined by the partnership agreement. Under Section 704(b), the Service will respect allocations of partnership income or loss provided (i) the allocations have "substantial economic effect," as further defined in the Regulations, or (ii) taking into account all facts and circumstances, the allocations are in accordance with the "partner's interest in the partnership."

[548] Section 511(a)(i).

[549] Reg. §1.514(c-1)(a), example 4.

[550] See ACM Partnership, TC Memo 1997-115, aff'd in part, rev'd in part, 157 F3d 231 (3d Cir. 1988), cert. den. 526 US 1017 (1999). See Lipton, "Whither Corporate Tax Shelters?" 51 Tax Exec. 132 (1999); Lipton, "Partnership Interest Found to Be Debt—What Next for Corporate Tax Shelters?" 90 J. Tax'n 12 (Jan. 1999) ; Rosenberg, "ACM Partnership v. Comm'r—Its Implications for Corporate Tax Shelters and Beyond," 25 J. Corp. Tax'n 3 (1998).

dividends paid from the subsidiary, in general, will be treated as FDAP and taxed at 30% (and withholding), and subject to treaty reduction.[551]

The U.S. tax treatment of a foreign person, including a foreign corporation, dramatically changes when it is engaged in a U.S. trade or business. In such instance the foreign corporation is taxed on its ECI with respect to such U.S. trade or business but on a "net income" basis instead of the 30% flat rate of tax on its FDAP. The net-basis income tax regime imposed on a foreign corporation (or other foreign person) requires satisfying a two-part test: (1) is the foreign corporation (person) engaged in a trade or business? and (2) is the conduct of the trade or business in the U.S.? Where the government takes a position opposite the outcome intended by a foreign corporation (or foreign person), the taxpayer has the burden of proof to establish whether its reporting position with respect to a U.S. trade or business presence is correct. In some cases being taxed on a net basis will yield a reduced U.S. income tax burden than a flat 30% rate on FDAP. A foreign corporation is deemed to be engaged in a trade or business within the United States where it is a partner in a partnership engaged in a trade or business within the United States. Under Section 875(l) a foreign partner is deemed to be engaged in a US trade or business of a partnership so engaged. For example, in the case of a foreign corporation which is a passive investor-partner in a hedge fund that is actively engaged in a U.S. trade or business, then its share of its effectively connected income with that trade or business is taxed under Section 882 at graduated rates on a net basis. Section 875(2) treats a nonresident alien individual or a foreign corporation that is a beneficiary of an estate or trust engaged in a U.S. trade or business as being engaged in a U.S. trade or business. This would also apply to the estate's or trust's ownership of a limited partnership interest in a U.S. partnership engaged in a U.S. trade or business.[552]

A foreign partnership or foreign corporation serving as a foreign feeder to a private equity partnership, will frequently employ a wholly owned subsidiary to conduct business in the United States.[553] In general, the subsidiary will be organized as a domestic corporation and have an office in the U.S. The level and degree of the U.S. subsidiary's activities will generally determine whether it is engaged in a U.S. trade or business or, alternatively, under tax treaty analysis, whether it has a fixed base or permanent establishment in the U.S.

A foreign corporation may also engage in business in the U.S. through one or more branches, a common practice in the banking and financial services industry, which may be attributable to many industrialized countries' treatment of branches as separate

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[551] Most tax treaty agreements in which the United States is a party have reduced rates on tax and withholding on dividends from 30% to 5% or 15%. Note that the present corporation income tax rate in the U.S. is 21%. The U.S. source dividends treated as FDAP are, in general, not ECI with a U.S. trade or business. If the dividend is ECI, however, it is taxed at regular rates under Section 882 (or Section 871(b) ). See Sections 881(d), 861(a)(2)(A), 861(a)(2)(B), 871(a)(2)(B)(i).

[552] Unger, 936 F.2d 1320 (CA Dist Col (1991); Rev. Rul. 85-60, 1985-1 CB 187.

[553] The ECI rules generally do not reach up through a wholly owned or controlled subsidiary that carries on U.S. business operations in the U.S. to its foreign parent corporation. For tax and nontax reasons, foreign companies in most industries prefer domestic subsidiaries over U.S. branches. Largely for regulatory reasons, however, many foreign banks operate in the United States through branches. See, e.g., National Westminster Bank, 58 Fed. Cl. 491 (2003). See also Section 894(c) (denial of treat benefits for certain payments through hybrid entities).

taxpayers. For U.S. income tax purposes, a "branch" of a foreign corporation (a/k/a a "reverse hybrid" under the check-the-box regulations) is generally treated as a division (transparent entity) of the foreign corporation. It is required, however, to maintain separate books and records and an office or principal place of business address. While the idea of a U.S. branch of a foreign corporation sounds attractive in comparison to the "two taxpayer" U.S. corporate subsidiary alternative, the real risk of a branch profits tax under Section 884 on the deemed equivalent income of the foreign corporation through its U.S. branch needs to be given full consideration. Note further, the wide reach of the banking and financial services or similar business separate ECI regime contained in Section 864(c)(4)(B).[554]

Foreign persons are subject to federal income tax on income effectively connected with the conduct of a U.S. trade or business ("ECI"). If a treaty applies[555] the IRS must establish that the income in question is "attributable to" a U.S. permanent establishment of the foreign corporation, in which event the income is subject to tax at the maximum rate of 35% (21% after the TCJA of 2017 effective for taxable years commencing after 2017). For a non-resident person, the maximum federal income tax rate is 39.6% (reduced to 37% under the TCJA 2017 effective for taxable years commencing after 2017). Absent treaty protection,[556] foreign corporations are subject to the "branch profits tax" on the repatriation of ECI (the "dividend equivalent amount") from the United States to the foreign jurisdiction, at a rate of 30%. In effect, foreign corporations are subject to federal tax on ECI at a rate of 54.5%, without regard to state and local taxes.[557]

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[554] See August, "The Inbound Foreign Corporation: Knowing When Its Income Is US Effectively Connected Income (Part Two), Corporate Taxation (July/August 2023).

[555] U.S. Model Income Tax Convention of September 20, 1996, Article 5.

[556] See, e.g., US-Australia Income Tax Treaty, Article 10(8) as amended by Protocol; US Germany Income Tax Treaty, Article 10(10) as amended by Protocol, June 1, 2006. Tax treaties impact the branch profits tax rate as well where an exemption is not relevant and further the branch profits tax base to branch profits attributable to a permanent establishment. Reg. s1.884-1(g)(4)(ii)(B).

[557] Section 11 and Section 884 (35% plus (1 - 35%) x 30% = 54.5%). Treaties may affect the branch profits tax rate as well as the tax base for §884 as only repatriations of earnings from a permanent establishment are included for this purpose. Reg.§ 1.884-1(g)(4)(iii). Section 884(e) requires a foreign corporation be a "qualified resident" to a foreign country unless either of two ant-treaty shopping provisions contained in §884(e)(4) apply. See also InverWorld, Inc. v. Comm'r TC Memo. 1996-301; Medieval Attractions N.V. v. Comm'r, TC Memo. 1996-455; North West Life Assurance Co. of Canada v. Comm'r, 107 TC 363 (1996). But see Sun Capital Partners III, LP et al v. New England Teamsters & Trucking Industry Pension Fund, 943 F.3d 49 (2019) private equity funds, which acquired, and managed portfolio companies through limited liability companies (LLCs), did not form a partnership-in-fact, and thus were not jointly and severally liable for partnership debts, including Multiemployer Pension Plan Amendments Act (MPPAA) withdrawal liability, even though funds exercised mutual control, assumed mutual responsibilities, and pooled resources and expertise, and two men had sole management authority; funds expressly disclaimed any sort of partnership, filed separate tax returns, kept separate books, maintained separate bank accounts, and did not invest in the same companies at a fixed or even variable ratio, and formation of LLCs prevented funds from conducting business in joint names and limited manner of exercising mutual control. 26 U.S.C.A. § 7701(a)(2); Employee Retirement Income Security Act of 1974 § 4203, 29 U.S.C.A. § 1383(a); 29 C.F.R. §§ 4001.2, 4001.3. The First Circuit therefore reversed the holding of the District Court. The courts analyzed Supreme Court decisions under the Internal Revenue Code as guideposts for whether Sun Capital was engaged in trade or business for ERISA purposes. The potential income tax impacts were also quite concerning. The recent decision of the Tax Court in YA Global Investments, LP et al v. Comm'r, 161 TC 11 (2023) endorses and perhaps expands the reach of the Inverworld, supra, decision, by holding that the activities of an agent can be attributed to the agent's principal for the purpose

Like tax-exempt organizations, which are subject to UBTI on business activities of a partnership, foreign persons are subject to tax on ECI attributable to a partnership engaged in U.S. trade or business and allocable to the foreign person. A foreign person or a partnership in which the foreign person is a partner is subject to tax on ECI upon the sale of an interest in a partnership engaged in a U.S. trade or business.[558] The ECI tax regime is backstopped by the requirement that a partnership that generates ECI must withhold the foreign partner's "applicable percentage" determined under Section 704.[559]

[6] Use of "Blocker" Entities to Avoid UBTI/ECI.

Tax-exempt and foreign investors, and funds in which tax-exempt and foreign investors invest, often interpose a corporate "blocker" entity between the investors and the portfolio investment to "trap" the operating profits of the portfolio company within a separate taxable entity. The blocker structure prevents the trade or business activities of the entity from passing through the tiers to the tax-exempt or foreign shareholders.[560] While not resulting in any significant tax savings, the use of a blocker entity avoids the need to report the UBTI, including investments that are debt-financed, and ECI at the investor level of the foreign parent corporation or company.[561] The tax-exempt or foreign investor may avoid the need to file a U.S. tax return otherwise triggered by the EBTI or ECI from a portfolio company investment shielded by the blocker.

Unlike hedge funds, which often structure investments made by tax-exempt and foreign investors through offshore entities, private equity funds must deal with the fact that income generated by U.S. based portfolio companies is subject to tax as U.S. source income.

Blocker entities may reside in parallel fund structures, in which the fund invests all capital earmarked for pass-through entities and invested by foreign and tax-exempt investors through a blocker entity, and all other funds directly in the portfolio company. This prevents the other investors (not tax-exempt and foreign investors) from being subject to an additional level of tax at the blocker level. If the fund (or a direct investment in a portfolio company by a foreign or tax-exempt investor) does not involve a blocker in its structure, the tax-exempt or foreign investor may choose to interpose a blocker between the investor and the fund or portfolio investment as a "feeder" organization. If the tax-exempt or foreign investor forms its own blocker, it may domicile the entity in a tax haven jurisdiction to avoid U.S. taxes on income that is not ECI and to avoid U.S. withholding taxes from distributions to the investor by the blocker. The use of a blocker domiciled in a tax haven jurisdiction will permit a tax-exempt investor from being subject to tax on UBTI sourced in a foreign jurisdiction.

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of determining whether the principal is engaged in the conduct of a U.S. trade or business. This result would subject foreign feeders to US taxation on its share of ECI.

[558] See Rev. Rul. 91-32, 1991-1 C.B.107.

[559] Section 1446(a).

[560] Prior to the TCJA of 2017, tax-exempt entities were allowed to reduce or net UBTI and net operating losses. The new law precludes "netting" and UBTI must be computed separated for each unrelated business activity. Reg. §1.512(a)-6. This change in the law has caused tax-exempt entities that previously benefitted from "netting" with respect to multiple investments in business operations in different industry sectors, to re-examine their ownership position in determining UBTI flowing from multiple partnerships. See Regs. §§ 1.612(a)-6(a)(1), 1.512(a)-6(c).

[561] The indirect tax burden incurred by the investors at the blocker level will roughly approximate the tax that the tax-exempt or foreign investor would have paid on the UBTI or ECI. See Gilbertson, Dougherty and Patton, "The Impact of Blockers on Tax-Exempt Organizations and Investments", J. Int'l Tax'n (WG&L) May, 2022.

The transfer of investments or the structuring of investments to utilize blocker entities by tax-exempt and foreign investors should be respected for federal tax purposes.[562] A corporation should be recognized as a corporation for tax purposes if it is either formed for a substantial business purpose or engaged in substantial business activity.[563] Even if an explicit shareholder purpose is to avoid taxes by the use of the blocker, the blocker corporation should be perceived as carrying out substantive business functions and therefore the corporation should not be ignored as a viable business entity. Similarly, where the blocker corporation is actively managed and has separate organizational integrity, i.e., employees, books and records, agreements, business purpose, etc., the IRS should not be able to assert that the shareholders formed or acquired control of the blocker for "tax avoidance" purposes under Section 269 of the Code. In a parallel fund structure, shareholder use of the blocker may be sufficiently dispersed to avoid the "control" test of Section 269. In addition, in some instances, however, the blocker structure may achieve only marginal tax savings for the shareholders, serving primarily to downstream the tax return filing requirements to the US subsidiary or blocker and/or to facilitate the later sale of stock in the blocker entity. As a separate corporation, the blocker will always bear full corporate tax on its ECI, and in the case of a domestically formed blocker, on its worldwide income.[564]

[7] Limitations on the Use of Debt to Minimize Corporate Tax ("Earnings Stripping").

The use of senior and subordinated acquisition debt on favorable terms may provide the private equity investor with the opportunity to generate tax deductions at the entity level and increase the overall return on capital deployed in a portfolio company acquisition. The senior financing may be provided by a traditional lender. Subordinated debt financing may be used by the private equity investor to create interest deductions and "strip" (perhaps that is too negative a word to use based on sensitivity to "base erosion" issues) corporate earnings from a C corporation. Earnings stripping, at least payments that tax administrators may regard as "earnings stripping", is subject to numerous limitations, including: (i) the proposed debt/equity regulations under Section 385 (discussed further below), (ii) the original interest discount ("OID") rules requiring the amortization of the debt holder's interest income over the life of a debt obligation on a constant yield to maturity basis,[565] (iii) the Section 279 limitations on interest on convertible and nonconvertible debentures accompanied by warrants to acquire equity, (iv) the Section 163(e)(5) limitations applicable high yield discount obligations ("AHYDO") involving debt instruments issued by C corporations with a maturity of more than 5 years after issuance and OID and payment in kind ("PIK") features with a yield equal or in excess of 5 percentage points over the applicable federal rate ("AFR"), (v) the Section 163(j) limitations on interest payable to or guaranteed by a related lender, and (vi) the Section 163(l) limitation on equity linked debt where there is a substantial certainty that an option to convert the debt into equity will be exercised.

Each of these limitations and the Section 385 Regulations must be carefully navigated where debt is used in the capital structure of a private equity investment through a C corporation, regardless of whether the use of debt is tax motivated. Whether an instrument is classified as debt or equity of the issuing corporation has important tax consequences other than with respect to the characterization of the payments that the holder of the instrument receives and whether the payment

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562 But see YA Global Investments, LP, supra, 161 TC No. 11 (2023).

563 Moline Properties v Commissioner, 319 U.S. 436 (1943).

564 See, AM 2022-004, "Exceptional Situations Backstop Active Trade or Business Requirement" Tax Notes Oct. 24, 2022 (Type B reorganization effectuated by foreign corporation in acquiring domestic corporation and avoiding gain recognition under §367. See Reg. §1.367(s)-3(c).

565 Sections 1272 and 1273.

made can be deducted or is otherwise charged to capital or a reduction in retained earnings. The host of additional issues extends not only to whether the "interest" paid or accrued is deductible to the "borrower" corporation or partnership, but potential withholding tax and foreign currency gain or loss, and overall impact on management of cash flows. Note further that Section 385(c)(1), in general, binds a corporate issuer to its chosen characterization of the instrument as of the instrument's issue date. Note further that Section 385(c)(2) provides that subject to the regulations, the issuer's classification of an instrument is not binding on the holder provided the holder discloses inconsistent treatment on its tax return.[566]

On April 4, 2016, Treasury and the Service released proposed regulations under Section 385.[567] If finalized in their current form, the Proposed Regulations would make sweeping changes to the characterization of instruments issued by a corporation to a related party that were previously treated as indebtedness under current law.

The Proposed Regulations consist of three sets of rules. First, the Bifurcation Rule provides that the Service may treat certain instruments that are in the form of debt as in part indebtedness and in part stock to the extent they are properly treated as such under general debt/equity testing principles.[568] In particular, the Bifurcation Rule can potentially apply to any expanded group instrument ("EGI"), as modified by Proposed Regulation Section 1.385-1(d)(1). The term "expanded group" generally refers to an affiliated group as defined in Section 1504(a), with certain modifications to expand its scope, including by counting indirect stock ownership under the rules of Section 304(c)(3). The term "modified expanded group" is defined in the same manner as the expanded group, but adopting a 50% ownership threshold, and adding further potential noncorporate members. An EGI is an instrument that is in form a debt instrument issued by a member of an expanded group and held by a member of the same expanded group.[569] Proposed Regulation Section 1.385-1(d)(2) modifies the definition of EGI to apply to instruments issued and held by members of a modified expanded group.[570]

Second, the Documentation Rule provides that an EGI is treated as stock for U.S. federal income tax purposes if certain documentation and information requirements are not satisfied.[571]

Third, the Proposed Regulations provide a regime whereby certain instruments that would otherwise be treated as indebtedness for U.S. federal income tax purposes are instead treated as stock of the issuer to the extent such instruments are issued in certain specified transactions or issued with a principal purpose of funding, or are treated by the Proposed Regulations as being issued with a principal purpose of funding, such specified transactions.[572]

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566 See Holt and Leonard, "Section 385(c): Don't You Forget About Me", Tax Notes Today (11/20/2022).

567 *See* Notice of Proposed Rulemaking, 81 Fed. Reg. 20,914.

568 *See generally* Prop. Reg. §1.385-1(d), 81 Fed. Reg. 20,912, 20,931 (2016).

569 Prop. Reg. §§1.385-1(d)(2), 1.385-2(a)(4), 81 Fed. Reg. at 20,931.

570 Prop. Reg. §§1.385-1(d)(2), 1.385-2(a)(4), 81 Fed. Reg. at 20,931.

571 *See generally* Prop. Reg. §1.385-2, 81 Fed. Reg. at 20,931.

572 *See generally* Prop. Reg. §1.385-3, 81 Fed. Reg. at 20,934.

Final (and Temporary Regulations under Section 385 were issued by the Service in October, 2016.[573] The Final Regulations under Section 385 focused on the treatment of certain interests in corporations as stock or indebtedness, as well as temporary regulations providing exceptions for qualified short-term debt and provided additional rules regarding partnerships and consolidated groups (the Temporary Regulations). On the same date, Treasury and the IRS also published a notice of proposed rulemaking (2016 Proposed Regulations) by cross-reference to Temporary Regulations. The text of the 2016 Proposed Regulations is the same as the text of the Temporary Regulations. The Temporary Regulations expired on October 13, 2019; however, Notice 2019-58 and ANPR published on November 4, 2019, provided that a taxpayer may rely on the 2016 Proposed Regulations for periods following the expiration date of the Temporary Regulations, provided that the taxpayer consistently applies the rules in the Proposed Regulations in their entirety.

Final Regulations, i.e., the 2020 Final Regulations, to Section 385 were issued in May 2020. The 2020 Final Regulations are somewhat comprehensive set out in a dozen pages of preamble, over 50 pages of regulation text and multiple examples. The 2020 Final Regulations finalize the 2016 Proposed Regulations without making substantive changes.

## X. NEGOTIATION AND DOCUMENTING THE ACQUISITION TRANSACTION

Corporate acquisitions of any size, even straightforward ones, involve considerable legal documentation and negotiation. The purchase of a lower or middle market business operated by an S corporation target may require the same degree of legal and tax analysis and negotiation, as ultimately reflective in the set of purchase agreement and acquisition documents as a $500 million or more upper middle market business. With growth companies and healthy multipliers on EBITDA formula purchase prices, the math can quickly climb to high levels. Add to that deemed debt assumed or taken subject to in a Section 338(h)(10) or similar taxable acquisition, and the consideration amount received by the seller target corporation quickly escalates. In many instances, however, the owners of target have been focused throughout on “net cash after tax” or “equity after taxes”. The idea of adjusted gross up purchase price is not always recognized at the time the “term sheet” or “letter of intent” is set out on one or two pages perhaps without the aid of sophisticated tax counsel or tax advisor.

The major tasks for the seller, its lawyers and its accountants are: (i) reaching agreement with a financial adviser, if one is to be used; (ii) negotiating the basic terms of the acquisition and formalizing them in a letter of intent; (iii) responding to the due diligence investigation by the purchaser; (iv) negotiating and drafting the definitive purchase agreement; and (v) negotiating and drafting supporting documents.

### 10.01. *Agreement with Financial Adviser*

In reaching agreement with a financial advisor, the issues most commonly subject to negotiation are compensation and indemnification. Typically, the investment banker receives an initial and/or periodic financial advisory fee as well as a more significant success fee if the transaction is completed. The

[573] TD 9790 (10/21/2016). 81 Fed. Reg. 72858. Final regulations under §385 had been issued in December, 1980 in TD 7747, 45 Fed. Reg. 86438. Subsequent revisions were made three times with each set being more complicated they were ultimately withdrawn in November, 1983. TD 7920. 48 Fed. Reg. 50711.

investment banker also typically receives "all events" indemnification, except for liabilities caused by the investment banker's bad faith or negligence.

The engagement of an investment bank is a particularly good idea if the acquirer is pursuing an acquisition for the first time, the available targets are not known, the acquirer needs advice on price, or the target itself is represented by an investment bank. In a competitive situation, the acquirer should be careful not to side-step the target's investment bank. This will only encourage the target's bank to find other acquirers or exact a higher price.

10.02. *Letter of Intent*

Once a target company has been identified and approached and the parties have agreed in principle to the essential terms of the transaction, they typically execute a letter of intent. The letter of intent is usually not binding as to the ultimate consummation of the acquisition, but customarily sets forth the parties' binding agreement to negotiate in good faith and to maintain confidentiality. The letter can contain a binding exclusivity provision restricting the seller from soliciting or negotiating a similar deal with another acquirer for an agreed period of time. A letter of intent will typically set out the parties' agreement with respect to cooperation and the ability of acquirer to perform its purchase investigation and the seller's agreement to assist the acquirer with such investigation.

A letter of intent is not an essential step in a business acquisition, and, unless exclusivity is important to the acquirer, letters of intent are often skipped in favor of moving directly to the definitive documentation. In such a case, the parties typically sign a separate confidentiality agreement at this stage to allow the acquirer's purchase investigation to begin. While nonbinding, the letter of intent gives both parties the comfort of knowing that the time and expense of the due diligence process will not be incurred unless the essential terms of the transaction (primarily the price) have been agreed upon.

10.03. *Due Diligence Investigation*[574]

Once a letter of intent or confidentiality agreement is signed, the acquirer often conducts a legal and financial investigation (a so-called "due-diligence" investigation) of the target's business. A purchase investigation is less important if the target is an audited company with recent financial statements certified by reputable accountants, and the purchase investigation, may be accelerated.

In connection with such an investigation, the acquirer asks the seller to provide it with information about the target's business (including detailed information about its operations, real property, personal property (including patents, trademarks and other intellectual property), environmental matters, employee benefit plans, financial condition, litigation, and tax filings) and to provide it with copies of the relevant material documents (including corporate and organizational records, insurance policies, supply contracts, employment and labor contracts, employee benefit plans, leases, debt agreements, licenses, tax returns and informational filings and, if applicable, SEC filings). The acquirer, its lawyers and its accountants review these documents and information, as well as any other information they can obtain about the company or business, to determine if there are any legal, financial or other problems with the

[574] See August and Looney, "Electing Subchapter S: Benefits and Perils For The Unwary---Asset Sales, Stock Sales And Mergers", ALI-CLE (12/8/2015) VCXG1208 WESTLAW. The Appendix to this article provides: (i) sample representations and warranties, indemnification provisions and right of offset suggested provisions; and (ii) items to be included in the due diligence checklist associated with acquiring an S corporation target.

company or business and to learn as much about the target company as possible. In certain environmentally sensitive industries, specialist environmental consultants may be retained to conduct at least a Phase I audit (review of environmental records) and, in certain situations, a Phase II audit (soil and ground water testing).

The purchase investigation may, but need not, precede the execution of a definitive purchase agreement. Rather, the satisfactory completion of the purchase investigation could be a condition to the acquirer's obligations under the purchase agreement. The seller often resists such a condition since it provides the acquirer with a one-sided and somewhat subjective option to terminate the deal or renegotiate the price. The seller might instead offer the acquirer an opportunity to conduct its investigation before the agreement is signed or within a specified period of time thereafter.

If the seller offers neither a due diligence condition nor an opportunity for a meaningful purchase investigation before the agreement is signed, the acquirer should insist on comprehensive warranties.

The buyer's ability to conduct a purchase investigation and/or to obtain detailed warranties will depend, at least in part, on whether there is competition for the target. If the seller or its investment bankers are auctioning the business, a "document room" is typically set up by the seller and a buyer's opportunity to conduct its investigation of the target may be limited in practice.

For an S corporation target, certain information will be requested with respect to the S corporation history and various tax matters.

10.04. *Purchase Agreement*

The purchase agreement sets forth the basic terms of the transaction (i.e., what is to be sold and the price to be paid). Particularly in an asset sale, it should specifically and carefully describe the assets to be transferred and the liabilities to be assumed and should also set forth how the purchase price will be allocated among the assets. This allocation will determine, in part, both the taxation of the seller in the transaction and the taxation of the buyer after the transaction.

The following discussion is a general overview of the standard terms and provisions included in a purchase agreement for the acquisition of all of the stock of the target company or the acquisition of substantially all of the assets of the target business. In drafting such agreements or reviewing drafts of such agreements prepared by counsel for the other party, the practitioner may refer to provisions designed as "neutral," "pro-seller," and "pro-buyer," in the monographs entitled "*Model Asset Purchase Agreement with Commentary*" and "Model *Stock Purchase Agreement with Commentary*," published by the Committee on Negotiated Transactions of the Section of Business Law of the American Bar Association. Similar standard form provisions and sophisticated variations thereof are set forth in Volume 4 of Ginsburg and Levine, *Mergers, Acquisitions and Buyouts – Sample Acquisition Agreements with Tax and Legal Analysis.*[575]

[1] Representations and Warranties.

[575] See August and Looney, "Electing Subchapter S: Benefits and Perils for The Unwary-Asset Sales, Stock Sales and Mergers", ALI-CLE (2015)WESTLAW VCXG1208 ALI-CLE 113. Wolters Kluwer Law & Business, February, 2014.

Typically, the seller makes extensive representations and warranties to the acquirer, including with respect to (i) the due incorporation and valid existence of the target company, (ii) the seller's authority to enter into the transaction, (iii) the capitalization of the target company, (iv) the accuracy and completeness of the financial statements and other documents given to the acquirer by the seller, (v) contingent and other liabilities, (vi) the target company's title to its assets, (vii) tax matters, (viii) absence of litigation and governmental investigations, (ix) environmental matters, (x) compliance with ERISA and related employee benefit matters, (xi) necessity for consents to the transaction, (xii) absence of defaults under existing agreements, (xiii) intellectual property matters, and (xiv) absence of burdensome provisions in existing agreements. Other warranties may be required, depending on the nature of the target's business and other facts unique to the transaction. The parent company or principal shareholders of the target company also may be asked to make or stand behind at least some of these representations and warranties.

The tax matters representations are important for any transaction, but special considerations arise when the target is an S corporation. On the one hand, the fact that the target is a pass through entity leaves the selling shareholders with the tax liabilities resulting from the audit of periods prior to the closing. On the other hand, the validity of the S election and the qualification of the target for S status at all times prior the closing is critical to the eligibility of the target for the Section 338(h)(10) election and deemed asset sale treatment with a full basis step up for the assets. Therefore, the selling shareholders will be expected to make significant representations with respect to the S election and the qualification of the target for the S election, including satisfaction of all the requirements of S status for periods prior to the closing.

If the buyer is paying for the acquired business with its own shares, it may make representations and warranties as to its financial condition comparable to those of the seller; otherwise, its representations and warranties are minimal.

[a] *Covenants*.

The purchase agreement sets forth various covenants of the seller and the buyer. One of the most important covenants made by the seller concerns the operation of the acquired business during the period between the signing of the purchase agreement and the closing. The seller generally agrees to conduct the target company's operations in the usual course and to maintain the assets of the company. It also typically agrees not to take any action that would have a material adverse effect on the business or engage in any other material transaction without the buyer's approval. For an S corporation target, the sellers would be expected to maintain the S election through the closing.

[b] *Conditions*.

The purchase agreement sets forth conditions to the obligations of the parties to complete the transaction. Buyers customarily make their obligation to proceed with the acquisition contingent on the truth and accuracy of the seller's representations and warranties, the performance of the seller's covenants, the absence of litigation and other material proceedings, and the absence of material adverse changes in the seller's financial condition.

The acquirer often seeks to make its obligation contingent upon satisfactory completion of its purchase investigation, but, as noted above, this condition is often resisted. While retaining flexibility for itself, the acquirer seeks to commit the seller to the transaction as firmly as possible. Because the parties' obligations to complete the transaction are contingent on obtaining

necessary approvals and consents, it may be difficult or impossible to commit the seller completely. For example, if the transaction requires the approval of the seller's shareholders, as will be the case in acquisitions of public companies, an intervening, better offer can thwart the acquirer's offer regardless of whether the board of directors of the target had previously approved the acquirer's deal. In such a circumstance, a buyer must decide whether to revise its offer or drop out of the bidding. A buyer may be able to recover some of its losses if it is forced to drop out by obtaining lock-ups or break-up or topping fees.

Significant transactions involving public companies are often completed with great speed to minimize the risk of competing offers. In the case of acquisitions of private companies, haste makes waste, especially if confidentiality and exclusivity provisions are in place.

[c] *Purchase Price Adjustments for Tax Costs of Section 338 Election.*

In some cases, the value of a Section 338(h)(10) election to the buyer may require a sharing of the cost of the election to the selling shareholders as an adjustment to the purchase price. This is especially true in the case of unsophisticated sellers who may be overwhelmed by the complexities of the transaction and the tax costs of a deemed asset sale as opposed to a straight stock sale. The more sophisticated sellers appreciate that the goal is to get the best price for the business, period.

In these cases, consideration may be given to language to the effect sellers will be "made whole" (including a tax gross up) to the extent the tax cost of the asset sale or deemed asset sale (under a Section 338(h)(10) election) to the sellers would exceed the tax cost of a stock sale (without a Section 338(h)(10) election) to the sellers. The sources of differences in the after-tax effects of the Section 338(h)(10) election on the sellers, as opposed to a straight stock sale, include the (a) character of gain as ordinary income, long term capital gain or Section 1250 gain, as compared with all capital gain on a straight stock sale, (b) additional inside gain attributable to corporate level liabilities included in the calculation of the Aggregate Deemed Selling Price ("ADSP") under Section 338,[576] (c) for a shareholder with a high tax basis in the stock as a result of a step up basis for the stock of a deceased shareholder or the purchase of the stock at a higher price, the shareholder may recognize ordinary income and capital loss without any current tax benefit for the latter, (d) where the target is doing business in states where income is apportioned subject to higher tax rates than the states of the shareholders' residences, additional state tax will be payable by the selling shareholders, (e) exposure for entity level taxes under Section 1374 or entity level state taxes, and (f) the potential for the reallocation of purchase price by the Service, and (g) the timing of gain recognition (i.e. consequences of an installment sale).

A Section 338(h)(10) tax gross up provision may be useful when the parties have not already negotiated and priced the transaction with full knowledge of the tax consequences. For example, when a stock sale is agreed upon between the parties, with the assumption that there will be no step-up in the basis of the underlying assets, the buyer may be willing to agree to gross up the purchase price to reimburse the seller for the additional taxes due as a result of a deemed asset sale should it be determined, after the closing, that a Section 338(h)(10 election is more advantageous to the buyer than the straight stock sale. Such provisions would not be appropriate, for example, where the transaction is

[576] The gain on the deemed asset sale is based on the difference between the Aggregate Deemed Selling Price ("ADSP") and Adjusted Grossed-Up Basis ("AGUB") of the assets determined under Reg. §1.338-4, et seq. The ADSP includes any liabilities taken or assumed as a part of the transaction.

priced as an asset purchase, and the buyer has already agreed to pay for the business with the expectation of a basis step up and the opportunity to amortize the goodwill component.

[d] *Remedies for Breach of Agreement; Indemnification.*

A purchase agreement will generally include provisions providing the buyer with some form of security to ensure that the seller's pre-closing representations and warranties are correct. The purchase agreement will generally provide that all of the representations and warranties of both parties contained in the agreement shall survive the closing and continue in full force and effect subject to any applicable statute of limitations and subject to any other periods specified in the agreement.

The purchase agreement may also contain alternative provisions for (a) full indemnification, where there is no deductible, threshold or ceiling on indemnifications against breaches, and (b) limited indemnification, where the representations and warranties for the transaction itself and tax, environmental, and capitalization matters and certain other fundamental representations and warranties survive indefinitely, but the other representations and warranties survive only for a specified period, and there is a threshold, or a deductible, or a ceiling, on the indemnification obligation. A pro-seller approach to the purchase agreement may involve only minimal indemnification, where only the representations and warranties concerning the transaction itself survive the closing. Provisions may also specify that if the damaged party knew or had reason to know of the misrepresentation or breach of warranty at the time of closing, then a claim of breach would not survive the closing.

The buyer may also seek some form of additional security to ensure that the seller's obligation to indemnify the buyer may be satisfied after the closing, including (a) an escrow deposit of a portion of the purchase price with a third party escrow agent, (b) a "hold back" by the buyer of a portion of the purchase price, to be paid later with interest, or (c) the buyer retaining a lien on certain assets of the sellers. Finally, where there are multiple sellers, including shareholders, the agreement may provide for severable liability, where each seller is responsible for a proportionate share of a claim for a breach of representations and warranties, or joint and severable liability, where all of the sellers are responsible for the full amount of the claim for indemnification, subject to a right of contribution against each other.

The assistance of the practitioner with experience in drafting indemnification provisions and a library of alternative indemnification provisions is invaluable to both the buyer and seller's efforts to negotiate reasonable and fair indemnification provisions.

The experienced tax counselor can be especially useful in drafting and negotiating tax indemnification provisions, provisions allocating responsibilities for pre-closing and post-closing tax liabilities, and tax sharing agreements.

10.05. *Sandbagging and Anti-Sandbagging Provisions*

A "sandbagger" is a golfer who pretends to have a higher handicap and play a worse game of golf than his or her true playing skills deserve. By gaining additional strokes over opponents, the chances of winning a match are improved.

In connection with an asset purchase agreement, stock purchase agreement, or merger agreement, a "pro-sandbagging" provision states that a buyer's remedies against the seller for indemnification based on representations, warranties, and covenants in the agreement will not be

impacted by whether or not the buyer has knowledge, prior to the closing, of facts or circumstances giving rise to the indemnification claim, and closes anyway.[577] An "anti-sandbagging" provision prohibits the buyer from "sandbagging" the seller by limiting the buyer's ability to seek recourse against the seller if the buyer has knowledge of the facts prior to closing and closes with such knowledge.[578]

Counsel for sellers will seek to include "anti-sandbagging" language and resist "pro-sandbagging" language. Counsel for buyers will seek to include "pro-sandbagging" language and resist "anti-sandbagging" language. Where the agreement is silent, state law will control whether or not the buyer believed it was "purchasing the promise as the truth of the relevant warranties," as in *CBS, Inc. v. Ziff-Davis Publishing Co., et. al.*[579]

10.06. *Additional Documentation*

Other documents required to complete an acquisition can be extensive, and may include employment agreements with key employees; non-competition agreements with principals leaving the business; a merger agreement if the purchase of shares will be followed by a merger of the acquired corporation with the acquirer or a subsidiary of the acquirer; deeds, assignments and other transfer documents in the case of an asset sale; certificates of the seller regarding important representations and warranties; consents of major suppliers, governmental agencies, major creditors, landlords and others; resolutions of the boards of directors of the corporations and their shareholders; a "cold comfort" letter from the accountants of the seller regarding their investigation of the target business; an escrow agreement if any of the purchase price is placed in escrow; an opinion of counsel to the seller concerning certain representations and warranties made by the seller in the purchase agreement; receipts for money paid at the closing; and promissory notes representing a portion of the purchase price.

10.07. *Holdbacks, Escrows and Contingent Purchase Price Consideration*

As discussed above, in a typical purchase and sale agreement (whether an asset purchase agreement or a stock purchase agreement), the seller will:

- Make certain representations and warranties regarding the business being sold;

- Make covenants, including those regarding operation of the business between signing the agreement and closing the transaction;

- Indemnify the buyer for losses caused by any breaches of the representations, warranties or covenants; and

- May agree for the buyer to hold back a portion of the purchase price or to place a portion of the purchase price in an escrow account for a period of time to secure the payment on

[577] An example of pro-sandbagging language: "The rights of the Purchaser under this Agreement for indemnification or any other remedy under this Agreement shall not be impacted or limited by any knowledge that the Purchaser may have acquired, or could have acquired, on or before the Closing Date, nor by any investigation or diligence by the Purchaser."

[578] An example of anti-sandbagging language: "In no event shall the Seller have any liability to the Purchaser with respect to a breach of representation, warranty, or covenant under this Agreement to the extent that the Purchaser knew of such breach as of the Closing Date."

[579] 75 N.Y.2d 496 (1990).

the indemnification. If there are no claims against the holdback or the escrow during the term of the holdback or escrow, the full amount is ultimately paid to the seller. However, if claims are made by the buyer, all or a portion of the holdback or escrow will be paid to the buyer and any balance paid to the seller.

[1] Earn-Outs.

Additionally, in many transactions, contingent purchase price, or an "earn-out" is an increasingly popular technique. Typically, a portion of the purchase price is contingent on the future financial performance of the target business so that the buyer pays the agreed earn-out amount, if at all, in years subsequent to the sale upon satisfaction of the specified contingencies. Options for measuring the earn-out include, among others, EBITDA (earnings before interest, taxes, depreciation and amortization), income or revenue growth, gross profit or some other specific event. In addition to the business issues relating to holdbacks, escrows and contingent purchase price provisions, tax practitioners should be familiar with the tax treatment related to such provisions.

[2] Holdbacks and Escrow Accounts.

Frequently, the asset purchase and stock purchase agreements attendant to the acquisition of a corporation, including an S corporation, will provide for some portion of the sales proceeds to be placed in escrow, or otherwise held back from the sales proceeds due to the seller at closing. Some or all of these proceeds will normally be released to the seller in a future tax year after satisfaction of certain conditions, or when the buyer is assured that it has received the benefit of the bargain.

[a] *Intersection with Section 453 and the Installment Sales Rules.*

While holdback and escrow arrangements often qualify for use of the installment sales method under Section 453 discussed above, under certain circumstances, the installment sales method may not be available. Transactions involving escrow arrangements or holdback agreements will require the tax practitioner to consider Treas. Reg. Section 15A.453-1(b)(3)(i), which states that payments include amounts actually or constructively received by the taxpayer.

[b] *Constructive Receipt Issues with Escrows or Hold-Backs.*

Reg.§1.451-2(a) provides that income is constructively received by a taxpayer when, without substantial limits or restrictions on his control of the receipt, the income is either (a) credited to his account, (b) set apart for him, or (c) made available so he may draw on it at any time. Conversely, there will not be constructive receipt when: (i) the taxpayer enters into an agreement to defer income before it is earned, (ii) the taxpayer's right to the income has not yet matured or vested, and (iii) the taxpayer's right to the income is contingent on the occurrence (or nonoccurrence) of an event or condition (and is therefore subject to a restriction).

[c] *Substantial Restriction on Right to Funds in Escrow.*

Where an escrow arrangement or holdback imposes a substantial restriction on the seller's right to receive the sales proceeds, such amount can be reported on the installment sales method, provided the transaction otherwise qualifies. For an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of a buyer, which is a real and definite restriction placed on the seller, or a specific economic benefit conferred on the buyer. Escrows that secure a seller's representations and warranties have been held to be a substantial restriction.[580] It is worth noting that both in Stiles and in Murray v Commissioner,[581] 75% of the sales proceeds were held in escrow and in both cases installment accounting was available. In Stiles, the restriction was that the funds could be used to satisfy breaches of representations and warranties. In Murray, the restriction was that the funds were held in escrow as security for the taxpayer to honor their covenant not to compete. It is equally clear that a seller's restriction on escrowed funds based solely on the passage of time is not a substantial restriction.[582]

[d] *Cash Equivalents.*

Reg. §15A.453-1(b)(3)(i) states that receipt of an installment obligation secured "directly or indirectly by cash or cash equivalent" will be treated as a "payment" in the year of sale. The regulations define "cash" and "cash equivalents" as bank certificates of deposit and treasury notes.

[e] *Constructive Receipt Equals Inclusion in Amount Realized.*

Finally, where an escrow arrangement is established by a seller after a buyer has made available the funds to the seller directly or to the seller's agent, without substantial restriction, the full amount of the purchase price, regardless of the terms of the escrow, the constructive receipt doctrine would apply so that the entire amount would be taxable currently and not eligible for the installment sales method.

10.08. *Contingent Purchase Price*[583]

Where the buyer successfully negotiates with the seller or shareholders of the seller that part of the consideration will be contingent on the post-acquisition success of the target, the contingent purchase price amount or "earn-out" portion of the amount realized will be set forth in detail in the stock purchase agreement in a Section 338(h)(10) or Section 336(e) type transaction or in a direct asset purchase agreement. It is obvious that the shareholders of the target corporation will want to receive more cash up front and less with respect to an earn-out, and conversely the private equity purchaser or buyer will want to pay less up front and more on the earn-out. The practical implementation of earn-outs can be quite difficult.

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[580] See Stiles v Commissioner, 69 T.C. 558 (1978); Ltr. Rul. 8629038 and Ltr. Rul. 8645029. The IRS has maintained this position as recently as 2005 in Ltr. Rul. 200521007, and in 2007 in Ltr. Rul. 200746004.

[581] 28 B.T.A. 624 (1933).

[582] See Rev. Rul. 79-91, 1979-1 C.B. 179.

[583] See Wellen, "Contingent Consideration And Contingent Liabilities In Acquisitions", ALI-CLE (March/April 2011) SS034 ALI-ABA 113 WESTLAW; 10th Annual Institute on Tax Aspects of Mergers & Acquisitions, NY City Bar CLE (2013 WL 2297415); Kwall, "Out With The Open-Transaction Doctrine: A New Theory For Taxing Contingent Payment Sales", 81 N.C.L.Rev. 977 (March, 2003) WESTLAW.

1. Any earn-out provision should be specific and address:

(a) Control of the entity post-closing;

(b) Method of operation of the business post-closing; and

(c) Method of accounting for profits, losses and expenses.

2. Earn-out provisions should include the following:

(a) The performance metric or milestone;

(b) The timeframe or achievement of the earn-out metrics and milestones;

(c) Methods to be used to determine whether the performance metrics have been attained; and

(d) Control issues relating to the earn-out business against which the performance is being measured.

The parties should expressly agree in the asset purchase agreement or stock purchase agreement on the calculation methodology, involve the accountants in such calculation and attach a schedule and sample calculation. It is also important that a dispute resolution mechanism be included in the stock purchase agreement or asset purchase agreement to minimize disputes, cost and time, which will usually involve the appointment of an independent accounting firm.

[1] Taxation of Contingent Purchase Price to the Seller.

As discussed previously, any disposition of property in which at least one payment is to be received after the close of the taxable year in which the disposition occurs qualifies for installment sales treatment and the statute does not distinguish between a payment whose amount is fixed and a payment whose amount is contingent on future events. It is fair to say that the contingent payment provisions contained in the installment sales regulations make some very unfriendly assumptions on the behalf of sellers. The installment sales regulations basically set forth three categories into which contingent payment sales may fall.

[a] *Sales with a Stated Maximum Selling Price.*

If there is a stated maximum price, the gross profit ratio will be computed on the assumption that the maximum amount will be paid. If less than the maximum price is ultimately paid, the seller is allowed a loss (undoubtedly a capital loss) in the final year equal to the excess gain previously included in income, unless one of the specific rules permitting the seller to re-compute the maximum selling price applies.

[b] *Sales with a Fixed Period.*

If the price is open-ended, but payments are due only for a specified period, basis is generally recovered ratably over the period for which payments are received. If in any particular year, the payment received is less than the basis allocated to that year, no loss is allowed; the unrecovered

basis allocated to that year is carried forwarded to the next succeeding year, and if it is not recovered in that year likewise to the subsequent succeeding years until it has been recovered or until the obligation becomes worthless and a bad debt or loss deduction is allowable.

[c] *Sales with Neither a Stated Maximum Selling Price nor a Fixed Period.*

If both the purchase price and payment periods are indefinite, basis is recovered ratably over 15 years, unless the seller can demonstrate that recovery over 15 years would substantially and inappropriately defer the recovery of basis. In this case, if payments received in a particular year are less than the ratable share of basis allocated to the year, no loss is allowed. Rather, the unrecovered basis originally allocated to that year is reallocated over the remaining years of the original 15-year period. If any basis remains unrecovered at the end of the 15 years, it is carried forward until it is recovered (on a dollar-for-dollar basis) or until the obligation becomes worthless and a bad-debt or loss deduction is allowable.

[d] *Electing Out of Installment Sales Method.*

As an alternative, the seller could decide to elect out of the installment method. If the seller elects out of the installment method, the seller will need to demonstrate that it has used a reasonable method for determining the fair market value of the contingent purchase price, and will be subject to immediate taxation on that amount at the time of closing.

[e] *Open Transaction Doctrine.*

Additionally, the taxpayer could argue that the "open transaction" doctrine should be applied to contingent purchase price. Under the open transaction doctrine, the seller is permitted to recover his or her basis in the asset being sold before reporting any gain. The open transaction doctrine can be traced to the seminal case of Burnett v Logan.[584] Although the regulations do not completely rule out the possibility that the "open transaction" method may be available to report the sales gain attributable to a contingent payment obligation, the temporary regulations provide that "only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value ... cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is 'open'. Any such transaction will be carefully scrutinized to determine whether a sale has taken place." Reg. §15A.453-1(d)(2)(iii).

[f] *Buyer's Tax Consequences.*

The treatment of contingent purchase price or earn-out to the buyer is such that the buyer cannot generate depreciable basis until the earn-out has been earned and paid to the seller. Frequently, any contingent purchase price will be allocated to goodwill and amortized over the allowable 15-year period.

[g] *Examples of Installment Method and Contingent Payment Sale.*

Example (1). A owns all of the stock of X corporation with a basis to A of $20 million. On July 1, 1981, A sells the stock of X to B under an agreement calling for fifteen annual payments

[584] 283 U.S. 404 (1931).

respectively equal to 5% of the net profits of X earned in the immediately preceding fiscal year beginning with the fiscal year ending March 31, 1982. Each payment is to be made on the following June 15th, commencing June 15, 1982, together with adequate stated interest. The agreement specifies that the maximum amount (exclusive of interest) payable to A shall not exceed $60 million. Since stated interest is payable as an addition to the selling price and the specified rate is not below the section 483 test rate, there is no internal interest under the agreement. The stated maximum selling price is $60 million. The gross profit ratio is 2/3 (gross profit of $40 million divided by $60 million contract price). Thus, if on June 15, 1982, A receives a payment of $3 million (exclusive of interest) under the agreement, in that year A will report $2 million ($3 million x 2/3) as gain attributable to the sale, and $1 million as recovery of basis.

Example (2). (i) The facts are the same as in example (1) except that the agreement does not call for the payment of any stated interest but does provide for an initial cash payment of $3 million on July 1, 1981. The maximum amount payable, including the $3 million initial payment, remains $60 million. Since section 483 will apply to each payment received by A more than one year following the date of sale (section 483 is inapplicable to the contingent payment that will be received on June 15, 1982 since that date is within one year following the July 1, 1981 sale date), the agreement contemplates internal interest and the price-interest recomputation rule is applicable. Under the rule, an initial determination must be made for A's taxable year 1981. On December 31, 1981, the last day of the taxable year, no events with regard to the first fiscal year have occurred which are subject to prompt subsequent calculation and verification because that fiscal year will end March 31, 1982. Under the price-interest recomputation rule, on December 31, 1981 A is required to assume that the maximum amount subsequently payable under the agreement ($57 million, equal to $60 million less the $3 million initial cash payment received by A in 1981) will be paid on the earliest date permissible under the agreement, i.e., on June 15, 1982. Since no part of a payment received on that date would be treated as interest under section 483, the initial stated maximum selling price, applicable to A's 1981 tax calculations, is deemed to be $60 million. Thus, the 1981 gross profit ratio is 2/3 and for the taxable year 1981 A will report $2 million as gain attributable to the sale.

(ii) The net profits of X for its fiscal year ending March 31, 1982 are $120 million. On June 15, 1982 A receives a payment from B equal to 5% of that amount, or $6 million. On December 31, 1982, A knows that the maximum amount he may subsequently receive under the agreement is $51 million, and A is required to assume that this amount will be paid to him on the earliest permissible date, June 15, 1983. Section 483 does not treat as interest any part of the $6 million received by A on June 15, 1982, but section 483 will treat as unstated interest a computed part of the $51 million it is assumed A will receive on June 15, 1983. Assuming that under the tables in the regulations under section 483, it is determined that the principal component of a payment received more than 21 months but less than 27 months after the date of sale is considered to be .82270, $41,957,700 of the presumed $51 million payment will be treated as principal. The balance of $9,042,300 is interest. Accordingly, in A's 1982 tax calculations stated maximum selling price will be $50,957,700, which amount is equal to the stated maximum selling price that was determined in the 1981 tax calculations ($60 million) reduced by the section 483 interest component of the $6 million payment received by A in 1982 ($0) and further reduced by the section 483 interest component of the $51 million presumed payment to be received by A on June 15, 1983 ($9,042,300). Similarly, in determining gross profit for 1982 tax calculations, the gross profit of $40 million determined in the 1981 tax calculations must be reduced by the same section 483 interest amounts, yielding a recomputed gross profit of $30,957,700 ($40,000,000–$9,042,300). Further, since prior to 1982 A received payment under the agreement (1981 payment of $3 million of which $2 million was profit), the appropriate amounts must be subtracted in the 1982 tax calculation. The total previously received selling price payment of $3 million is subtracted from the recomputed maximum selling price of

$50,957,700, yielding an adjusted selling price of $47,957,700. The total previously recognized gain of $2 million is subtracted from the recomputed maximum gross profit of $30,957,700, yielding an adjusted gross profit of $28,957,700. The gross profit percentage applicable to 1982 tax calculations thus is determined to be 60.38175%, equal to the quotient of dividing the adjusted gross profit of $28,957,700 by the adjusted selling price of $47,957,700. Accordingly, of the $6 million received by A in 1982, no part of which is unstated interest under section 483, A will report $3,622,905 (60.38175% of $6 million) as gain attributable to the sale and $2,377,095 ($6,000,000–$3,622,905) as recovery of basis.

The net profits of X for its fiscal year ending March 31, 1983 are $200 million. On June 15, 1983 A receives a payment from B equal to $10 million. On December 31, 1983, A knows that the maximum amount he may subsequently receive under the agreement is $41 million, and A is required to assume that this amount will be paid to him on the earliest permissible date, June 15, 1984. Assuming that under the tables in the regulations under section 483 it is determined that the principal component of a payment received more than 33 months but less than 39 months after the date of sale is .74622, $30,595,020 of the presumed $41 million ($51 million–$10 million) payment will be treated as principal and $10,404,980 is interest. Based upon the assumed factor for 21 months but less than 27 months (.82270) $8,227,000 of the $10 million payment is principal and $1,773,000 is interest. Accordingly, in A's 1983 tax calculations stated maximum selling price will be $47,822,020, which amount is equal to the stated maximum selling price determined in the 1981 calculation ($60 million) reduced by the section 483 interest component of the $6 million 1982 payment ($0), the section 483 interest component of the 1983 payment ($1,773,000) and by the section 483 interest component of the presumed $41 million payment to be received in 1984 ($10,404,980). The recomputed gross profit is $27,822,020 ($40 million–$10,404,980–$1,773,000). The previously reported payments must be deducted for the 1983 calculation. Selling price is reduced to $38,822,020 by subtracting the $3 million 1981 payment and the $6 million 1982 payment ($47,822,020–$9 million) and gross profit is reduced to $22,199,115 by subtracting the 1981 profit of $2 million and the 1982 profit of $3,622,905 ($27,822,020–$5,622,905), yielding a gross profit percentage of 57.18176% ($22,199,115/$38,822,020). Accordingly, of the $10 million received in 1983, A will report $1,773,000 as interest under section 483, and of the remaining principal component of $8,227,000, $4,704,343 as gain attributable to the sale ($8,227,000 x57.18176%) and $3,522,657 ($8,227,000–$4,704,343) as recovery of basis.[585]

## XI. SPECIAL PURPOSE ACQUISITION COMPANIES (SPACS)

### 11.01. *Introduction to the "Blank Check" Company: "Only A Look Down from 1000 Feet"*

A growing trend in the capital markets has been the use of special purpose company (SPAC) transactions. While the SPAC is essentially a "back door" method of taking a private company public, the idea is not new.[586] Many private equity firms are reported as sponsors of SPACs. In fact, there may be cost savings and avoidance of regulatory approvals that are avoided by the SPAC. However, their popularity increased to a high water mark level in 2007 where it was reported that there were 47 SPAC IPOs which accounted for 34% of all IPOs in that year.[587] The needle has moved upward and in 2020, SPACs enjoyed

[585] See Reg. §15a.453-1(c)(2)(ii) Examples (1) and (2).

[586] The SPAC was introduced in the 1990s perhaps as an acquisition structure of the last resort for a company desire of moving forward with an IPO but unable to assemble the necessary underwriting backing to make the public offering a reality.

[587] See SEC Rule that applies to "blank-check companies". A "blank-check" company is formed to raise capital as an alternative to private equity funds (but not always) and an easier method than the traditional IPO process. On

a record raise of funds of $78 billion through more than 230 IPS which was a multiple of the funds raised and IPOs formed by SPACs in 2018. During 2020 SPACs continued to flourish and during that year it was reported that SPAC initial offerings climbed to more than $83 billion or more. But, that upward trend has waned in 2022 as The Wall Street Journal recently reported that creators of SPACS are valuing companies they seek to take public at the lowest levels in three years and has fallen to about $200 million in January 2023 down from more than $2 billion for much of 2021 at the peak. Since SPACS in certain market sectors, such as clean-energy, have loss much their value, and may have cash management problems, they may be targets for acquisitions by other energy companies such as Shell (in acquiring Volta) or newly organized SPACS.[588]

As noted in note 566, supra, the SEC opened an inquiry into the "blank check" SPAC phenomenon. The Enforcement Division of the SEC to issue letters to the investment banking industry on their SPAC transactions and risk management criteria.[589]

Notwithstanding the present lull in SPAC activity, the increasing use of SPACs over the past few years during the pandemic which is perhaps attributable to the observation that IPOs are risker and more difficult to market with social distancing. In a period of lower interest rates on debt, which has changed

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December 22, 2020, the SEC's Division of Corporation Finance issued new disclosure guidance concerning SPACs. See "Special Purpose Acquisition Companies," SEC CF Disclosure Guidance: Topic No. 11, December 22, 2020; https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies. This guidance focused on the potential conflict of interest between a SPAC's public shareholders and a SPAC's sponsor, directors, officers, and their affiliates (collectively, the insiders). The insiders' economic interests may differ from the economic interests of public shareholders in a number of important ways. Unlike the traditional IPO process where a private operating company's securities are valued through market-based price discovery, the SPAC insiders are solely responsible for deciding how to value potential targets. While this is often cited as a reason why SPACs provide greater certainty for private companies considering a traditional IPO, the SEC points out that this can lead to potential conflicts of interest and risks for the public shareholders of the SPAC.

As explained in footnote 56 of the Morrissey Arkansas Law Review article, infra, note 547, "The SEC has issued safe-harbor regulations delineating the scope of these exemptions and continually expanded them over the years. Regulation D is the safe harbor for small, limited offerings and for non-public offerings. 17 C.F.R. §§ 230.504, .506 (2021). Today, its Rule 504 exempts offerings up to $10 million under Section 3(b). 17 C.F.R. § 230.504. Its Rule 506 exempts 4(a)(2) offerings, the so-called private placements. 17 C.F.R. § 230.506. And the Commission's Rules 147 and 147A exempt the so-called intrastate offerings. 17 C.F.R. §§ 230.147, 147A (2021). See Private Placements--Rule 506(b), SEC (Apr. 28, 2022), [https://perma.cc/7Q6E-7NTX], for the latest version of the SEC regulations for the private placement exemption, Exemption for Limited Offerings Not Exceeding $10 million--Rule 504 of Regulation D, SEC (Apr. 28, 2022), [https://perma.cc/YXQ4-3C9T], for the latest version of the SEC regulations governing the exemption for small or limited offerings, and Intrastate Offerings, SEC (Sept. 6, 2022), [https://perma.cc/GTN3-24H6], for the current SEC safe-harbor regulations governing the intrastate exemptions. See Press Release, SEC, SEC Harmonizes and Improves "Patchwork" Exempt Offering Framework (Nov. 2, 2020) [hereinafter Press Release], [https://perma.cc/788B-SV6L], for the SEC's general discussion about how it has recently harmonized these exemptions. A modified form of registration exists under the SEC's Regulation A, which is, strictly speaking, an exempt offering. 17 C.F.R. § 230.251 (2021). It can now be used by companies under certain conditions to raise up to $75 million. 17 C.F.R. § 230.251(a)(2)."

[588] See Morrissey, "Special Purpose Acquisition Companies: Wall Street's Latest Shell Game", 74 Ark. L. Rev. 465 (2022) Castelli, "Not Guilty By Association: Why The Taint Of Their "Blank Check" Predecessors Should Not Stunt The Growth Of Modern Special Purpose Acquisition Companies", 50 B.C.L. Rev. 237 (Jan. 2009);

[589] Special Purpose Acquisition Companies, Shell Companies, and Projections, Securities Act Release No. 11048, Exchange Act Release No. 94546, Investment Company Release No. 34594, 87 Fed. Reg. 29,458 (proposed Mar. 30, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 230, 232, 239, 240, 249, 270).

dramatically during the past several years, SPACs could profile and project much greater rates of return to the investors, provide some degree of downside protection, i.e., pre-acquisition closing redemption rights. Since costs of financing have increased dramatically, so has the market for debt-financed acquisitions of target companies at least where projected profitability margins are low or because of tax law changes such as Section 163(j) or perhaps the anti-hybrid rules in Section 267A.

The SPAC's business plan is to acquire one or more privately owned companies by offering a mix of consideration, including shares of the publicly-traded company funded with the capital raised through the SPAC investors. The idea is to bring a private equity type operational structure to the public markets so that private equity can tap into the public markets participating in a manner similar receiving a profits interest. There are many complex tax questions associated with the use of a SPAC to acquire US companies, and for purposes of this paper, closely-held domestic corporations.

All is not good for SPACS however at this time. The recent inflation rate upward spiral tends to flatten or reduce price points for acquisitions, drives up the cost of high redemption rate "money back guarantees" and the market has been reportedly shifting towards growth stocks. Last week on January 23, 2023, the Wall Street Journal reported that a SPAC formed by PEF L. Catterton agreed to combined with the elective-vehicle maker Lotus Technology to value out the combined entity at $5.4 billion. Three days later WSJ reported that the shipping platform company Freightos went public in a SPC deal. In the news story WSJ noted that "SPAC mergers have dwindled in number over the past few years …[through] a reverse merger …[as] a favored way of going public…particularly for startups looking to skip the rigors and scrutiny of the conventional initial public offering process". In a December 25, 2022 news story from the WSJ it was announced that approximately 70 SPACs during December 2022 liquidated and returned money to investors to the tune of $600 million and more than $1.1 billion in 2022. The 1% federal excise tax on share repurchases has accelerated investors. There is further recent talk of increasing the excise tax on share repurchases to as high as 4%. A big tax on enterprise value no doubt is what some in Congress want to do.

Presumably SPACs may be experience a "bust" more than the "boom" that it generated in alternatives to capital markets through IPOs but the attractiveness that the SPAC can offer when there is perceived valuable target companies, including startups and small to medium size companies, as well as lower interest rates, the marketplace may "re-adjust" to again look to the SPAC for investor capital.

11.02. *Definition of a SPAC*

A SPAC is a company with no operations that offers securities for cash and places substantially all the offering proceeds into a trust or escrow account for future use in the acquisition of one or more private operating companies. Following its initial public offering, or IPO, the SPAC will identify acquisition candidates and attempt to complete one or more business combination transactions after which the company will continue the operations of the acquired company or companies ("combined company") as a public company.[590]

11.03. *Structure and Operation of SPACs*

The basic structure of a SPAC, in general, is complex. Overall, a SPAC is a shell company with no operations. It proceeds in two stages. In the first stage, it registers the offer and sale of redeemable

[590] SEC Division of Corporation Finance Disclosure Guidance Topic No. 11. Dec. 22, 2020;

securities for cash through a conventional underwriting, sells them primarily to hedge funds and other institutions, and places the proceeds in a trust for a future acquisition of a private operating company. Initial investors also commonly obtain warrants to buy additional stock as at a fixed price, and sponsors of the SPAC obtain a "promote" - greater equity than their cash contribution or commitment would otherwise imply - and their promote is at risk. If the SPAC fails to find and acquire a target within a period of two years, the promote is forfeited and the SPAC liquidates.[591] Since a SPAC is not a permanent capital generating or investment entity and merges into the public company in an IPO or existing public company, in many transactions the target company is treated as the acquisition entity from an accounting and, to a certain extent, from a tax law standpoint as a reverse recapitalization/acquisition.[592]

SEC Monitoring of SPACs: An Overview. Disclosure Guidance Topic No. 11 (Dec. 22, 2021). Taken from Wolff, "43 No. 4 Securities and Federal Corporate Law Report, April 2021":

> As the SPAC market continued to heat up (there were 47 SPAC IPOs in December 2020 compared to 27 non-SPAC IPOs),48 the SEC's Division of Corporation Finance published CF Disclosure Guidance: Topic No. 11. This is required reading for securities counsel involved in the drafting of SPAC prospectuses and other disclosure documents. In Topic No. 11 the SEC states that the sponsors and management of the SPAC have interests which may differ from the public shareholders, and clear disclosure of these differing interests and conflicts of interest is necessary. For example, SPAC sponsors and affiliates may have obligations to other entities which could create conflicts of interest with respect to the SPAC. SPAC sponsors and affiliates may be under pressure to complete a business combination as the window for the acquisition begins to close. This could create or exacerbate conflicts of interest. The SPAC should disclose securities ownership in the SPAC by sponsors and affiliates including the price paid for such securities and how the terms of such securities differ from those offered to public IPO investors. Topic No. 11 also addresses disclosure considerations applicable to the business combination. Many of these considerations relate to potential conflicts of interest.
>
> Select Issues Pertaining to SPACs (March 31, 2021). This Statement prepared by the Division of Corporation Finance addresses several accounting, reporting and governance issues that must be considered prior to the business combination. The first grouping discussed in the Statement relates to the fact that the SPAC is considered a shell company. Among the points made in the Statement relating to shell company status are the following: (i) Target financials must be filed within four business days of completion of the business combination under Item 9.01(c) of Form 8-K; (ii) The registrant may not incorporate by reference on Form S-1 for 3 years after the combination (see General Instruction VII.D.1(b) to Form S-1); (iii) The registrant may not use Form S-8 for 60 days after filing Form 10 information (General Instruction A.1 to Form S-8); (iv) The registrant will be an "ineligible issuer" under Rule 405 for 3 years; this relates to WKSI status, use of free writing prospectuses and use of the Rule 163A safe harbor for pre-filing communications. (footnote omitted); (iv) The Staff Statement on Select Issues also points out that the books and records and internal controls provisions of the Exchange Act apply to SPACs before and generally after the business combination.(footnote omitted) The combined company must be ready to fulfill its obligations under these and other provisions of the federal securities laws; and (vi) the staff

[591] Coates, "SPACs, IPOs and Liability Risk Under the Securities Laws, April 8, 2021 https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.

[592] See generally Deloitte, Accounting and SEC Reporting Considerations for SPAC Transactions, Financial Reporting Alert 20-6, Oct. 2, 2020, updated April 30, 2021.

advises companies of their continuing obligations under stock exchange rules, including the corporate governance provisions thereof. There are associated disclosure issues as well, such as under Item 3.01 of Form 8-K to report a notice of non-compliance from a stock exchange.

[In] Public Statement and Financial Reporting and Auditing by Acting Chief Accountant (March 31, 2021). Acting Chief Accountant Munter noted that a SPAC may bring a private company to the public markets earlier in the private company's life cycle than would be the case in a typical IPO. Munter stresses that companies brought to the public market in this manner must be ready to assume their financial reporting and other obligations under the federal securities laws. There are numerous accounting issues that arise in the de-SPAC transaction; for example, issues relating to the identification of the predecessor entity, identification of the entity that should be treated as the acquirer, and whether the de-SPAC transaction is a business combination or a reverse recapitalization. (footnote omitted).

In general, management must annually evaluate internal control over financial reporting. In certain situations, where a registrant consummates a material business combination during the fiscal year, the staff does not object if management excludes the acquired business from its Section 404 report. (footnote omitted) While this guidance does not necessarily apply to reverse acquisitions between an issuer and a private operating company and the surviving issuer is not a "newly public company" as used in further guidance,(footnote omitted) the staff has provided further guidance that applies to reverse acquisitions that in certain cases and subject to certain conditions allows the surviving issuer to exclude management's report on ICFR in the 10-K for the fiscal year in which the transaction is consummated. This may include cases where the legal acquirer is a non-operating company public shell. (footnote omitted)..."

In Spring, 2021, John Coates, Acting Director, Division of Corporation Finance, issued Public Statement on Accounting and Reporting Considerations for Warrants Issued by SPACs concern focused on provisions in warrants issued by the SPAC that provided for potential changes to the settlement amounts dependent upon the characteristics of the holder of the warrant. The warrants should be classified as a liability measured at fair value that could change with each reporting period. https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs.

On March 30, 2022, Chair Gary Gensler of the US Securities and Exchange Commission, issued his "Statement on Proposal on Special Purpose Acquisition Companies (SPACs), Shell Companies and Projections". https://www.sec.gov/news/statement/gensler-spac-20220330. Among the proposals were additional disclosure, both financial and conflict of interests issues, additional standards on marketing practices to avoid overly optimistic promises on future performance that would be misleading to investors and provide gatekeeper and issuer obligations. Chair Gensler also concluded his Statement by providing comment on when SPACs become subject to the Investment Company Act in providing important investor protection.

Securities laws issues and regulation is beyond the scope of this article and its inclusion on basic issues and concerns with SPACs with the SEC are set forth solely for informational purposes. The reader is directed to independently determine the nature, scope and compliance issues related to the securities

regulations by the Federal, state and other applicable jurisdictions pertaining to "blank check" SPACs and second-stage roll outs into IPOs or public companies.[593]

11.04. *SPAC Founders*

[1] Contribution of Funds to SPAC Followed by or with IPO.

The SPAC founders forms or "sponsors" a SPAC to engage in a capital raise of some magnitude, i.e., several hundred million dollars, or through an initial public offering (IPO) with the intent of buying another operating company, a target corporation, such as, for example, an S corporation, with the funds raised through the investment pool. A SPAC may have separate pools for different investors and in acquiring companies in different industry sectors. As a "blank check" company, a SPAC will, in general, start off with tons of cash and no operating business. This does not necessarily have to be the case, but frequently is. The SPAC may also offer investors different equity positions to purchase depending on the rate of return and degree of economic risk the specific investor wishes to subscribe. Warrants are commonly offered to the investors as well to attract additional capital and/or add value to the investors' rate of return. In contrast to a profits interest type position, the founder shares effectively dilute the public shareholders' ownership interest at inception. Therefore, to attract the capital raise, the sponsors or founders will often provide that the public investors can put their shares back to the SPAC for cash within a certain period of time. There may also be provision for closing down the SPAC if the capital raise is not invested in accordance with the business plan and legal documentation. Additional private funding may be required or contributed which may provide sponsors or founders with a greater percentage of ownership prior to effectuating one or more acquisitions. SPACs establish a definite term, such as two years, to identify and complete an acquisition(s). Until an acquisition is completed, almost all the cash raised by the SPAC must be held in a trust account to be used for the future acquisition and to facilitate any required redemptions.

The Inflation Reduction Act, P.L. 117-169, enacted a non-deductible 1% excise tax on certain stock redemptions and buybacks made by publicly traded corporations beginning in 2023 applicable over the difference of the fair market value of any stock repurchased by the "covered corporation" or by its "specified affiliates" during the taxable year less the FMV of any stock issued by the "covered corporation or any stock provided to the employees of the covered corporation or special affiliate" in the same taxable year, i.e., the so-called netting rule. A covered corporation is any U.S. corporation whose stock is traded on an established securities market (e.g. NYSE, Nasdaq, Mexico, London or Tokyo Stock Exchange). A specified affiliate in general is any corporation in which a covered corporation, directly or indirectly, owns more than 50% of the stock by vote or value. A "repurchase" includes (i) any stock acquisition by a covered corporation from a shareholder in exchange for cash or property,(ii) an acquisition of the stock of a covered corporation by a Specified Affiliate from a person who is not the covered corporation, in which case it will be treated as a repurchase of the stock of the covered corporation by such covered corporation, and (iii) any transaction considered by the Treasury to be economically similar, which are currently described in section 3.04(4)(a) of Notice 2023-2 IRB 1. Certain transactions are exempt from the buy-back excise tax, including: (i) repurchases from shareholders part

[593] Additional proposals were made with respect to de-SPAC transactions based on the conclusion that the SPAC target IPO is an alternative means to conduct an IPO. Mr. Gensler, as to this issued, wrote "Thus, investors deserve the protections they receive from traditional IPOs, with respect to information asymmetries, fraud, and conflicts, and when it comes to disclosure, marketing practices, gatekeepers, and issuers" https://www.sec.gov/news/statement/gensler-spac-20220330.

of a reorganization under the Code, provided no gain or loss is recognized by the shareholder; (ii) repurchases of stocks (or an equivalent value of the stock repurchased) that are contributed to certain employee pension, stock-option or similar employee plans; (iii) repurchases whose aggregate fair market value do not exceed $1 million annually (before applying any statutory exception and the netting rule); (iv) certain repurchases by dealers in securities in the ordinary course of business; (v) repurchases by regulated investment companies (e.g., mutual funds) or real estate investment trusts; and (vi) repurchases characterized as a dividend for income tax purposes. Other transactions that according to the Notice will not be subject to the buy-back excise tax are: divisive Section 355 transactions that are not split-offs, complete liquidations of a covered corporation under Sections 331 or 332, cash payments in lieu of a fractional share, in certain circumstances, and deemed distributions under Section 304(a)(1).

The SPAC Association has been recently reported as seeking an exemption from the excise tax provision contending that it was not intended to apply to stock redemptions in return of funds situations involving a failed SPAC or where an investor pulls out before closing. The argument is that those redemptions are built-in the SPAC formation documents and are not akin to a voluntary corporate decision to repurchase shares' in order to increase the price per share of the remaining outstanding stock. [594]

[2] Residence of the SPAC.

SPACs are incorporated off-shore, such as the Cayman Islands exempted companies, for regulatory, corporate law, tax and other reasons. In many instances one or more US subsidiaries, branches or hybrid entities will become part of the organizational chart in acquiring companies in different industry, sector, or geographical location. Where the target is based in a foreign country the organizational structure may vary then when the target or target companies are situated in the US. In general, the most important tax factor in forming the SPAC and selecting a foreign versus domestic residence is whether the SPAC plans on acquiring a domestic or foreign target. There are dividend and tax compliance issues to sort out, including the ability to file a US consolidated income tax return, in planning out the acquisition schedule of the SPAC. Another factor is the inversion rules under Section 7874 (26 USC).

[3] Domestic SPAC Acquiring Foreign Target Corporation.

Where a domestic SPAC seeks to acquire a foreign target corporation, it may set up a foreign acquisition subsidiary to acquire the target stock. This would allow the domestic SPAC to avoid or "block" the flow through of foreign source income of the target foreign corporation under Subpart F or under the global intangible low-tax rules in addition to taxes imposed by country or countries in which the foreign corporation target is operating. [595] Dividends then traveling to the parent corporation may qualify for the exclusion provided under Section 245A.[596] Where there is some uncertainty as to whether

[594] Wallace, "SPACs Need Urgent Relief From Buyback Tax, Industry Says", Tax Notes (12/19/2022). The Wallace article notes that liquidations of failed SPACs are occurring at an accelerate rates with 79 occurring in December 2022.

[595] See August, "The Maze of Tunnels and Bridges Pass-Through Entities Must Traverse In Reporting Subpart F And GILTI Income Inclusions And Previously Taxed Income Recoveries", 48 Corp. Tax'n 35 (Jul/Aug 2021); "President Biden's "Made in America" Tax Plan: Reversing the International Tax Benefits Extended to US Corporations Under the TCJA", 48 Corp. Tax'n 4 (May/June 2021); "US Taxation May Drive More Citizens and Long-Term Residents to Become Tax Refugees" 34 No. 1 Prac. Tax Law. 21 (Nov. 2019).

[596] As part of the TCJA 2017, §245A (a) provides, in general, that dividends received from a "specified 10-percent owned foreign corporation" by a domestic corporation which is a US shareholder, i.e., 10% or more in voting or value

the target corporation will be a US or foreign corporation, the formation of a SPAC in the Cayman Islands or similar tax-haven jurisdiction may provide more flexibility by later having the SPAC merge with the US target corporation or acquisition holding company or domesticate.

[4] Inversion Factor.

Where a SPAC is formed and organized in a foreign jurisdiction, such as a tax-haven jurisdiction, and the target is a domestic US business, perhaps operated for years under Subchapter S, inversion issues may surface. In particular, if a foreign SPAC acquires a domestic S or C corporation, the foreign SPAC is potentially subject to Section 7874 which in turn may make it more difficult for the shareholders of the target to exchange their shares of stock, including S stock, for SPAC shares on a non-taxable basis because of Section 367(a) and supporting regulations.[597]

[a] *Inversion Overlap.*

An inversion is a transaction where a U.S. parented company and a non-U.S. or foreign company combine and locate the tax residence of the merged company in a foreign jurisdiction. Section 7874 is designed to deter inversion transactions from resulting in a corporate (or partnership) expatriation in order to avoid US income tax on foreign source income and foreign based operations of a multinational enterprise (MNE) provided three requirements are satisfied. First, a foreign acquiring (or "surrogate foreign corporation")[598] corporation completes the direct or indirect acquisition of substantially all the assets held directly or indirectly by a U.S. corporation or, in certain instances, a U.S. partnership. Second, after the acquisition, the former shareholders or partners of the expatriated U.S. corporation or partnership hold a specified percentage of the stock (by vote or value) of the foreign acquiring corporation or partnership by reason of their interest in the expatriated U.S. corporation or partnership. Third, after the acquisition, the expanded affiliated group (EAG) (as defined per Section 7874(c)(1)) that includes the foreign acquiring corporation does not, prior to the merger or transfers of assets, have substantial business activities in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized when compared to the total business activities of the EAG. Under Reg.§1.7874-3 the "substantial business activities" test may only be met if at least 25% of the group's employees, employee compensation, assets, and income are derived from or located in the

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of the foreign corporation's stock (unless the foreign corporation is a PFIC), is allowed as a deduction an amount equal to the foreign-source portion of such dividend.

[597] See Cummings, Jasper L., Jr., "Are Inversions So Bad?" Tax Notes Federal, Vol. 178, January 2, 2023.

[598] A "surrogate foreign corporation" is a corporation that satisfies the following requirements: (i) the corporation is organized as a foreign corporation; (ii) the foreign corporation (or partnership) has directly or indirectly acquired "substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership; (iii) the acquisition consists of more than one transaction, the transactions are "pursuant to a plan" or are "a series of related transactions."; (iv) after March 4, 2003 (closing of the acquisition); (v) after the acquisition, at least 60% of the foreign corporation's stock, by vote or by value, is owned by former shareholders or partners of the domestic corporation or partnership "by reason of holding" stock of the domestic corporation or capital or profits interests in the domestic partnership; and (vi) after the acquisition, the "expanded affiliated group" of which the foreign corporation is part does not have "business activities" in the foreign country under the laws of which the corporation is created or organized that are "substantial" in relation to "the total business activities of" the expanded affiliated group.
The term "expanded affiliated group" (EAG) is an affiliated group, as per the consolidated return regulations, except (i) foreign corporations are included for this purpose; and (ii) the ownership threshold of at least 80% under the consolidated return rules is relaxed to "more than 50%".

applicable foreign country. This may pose a difficult hurdle for a large foreign multinational EAG. The start-up exception may be a far easier exception to qualify under.[599]

Where the "outbound" transaction constitutes an inversion under Section 7874, then, where the ownership interest by the former shareholders or partners of the U.S. corporation or partnership in the foreign acquiring corporation is at least 80%, then the foreign acquiring corporation is deemed to retain its character as a U.S. corporation for U.S. tax purposes pursuant to Section 7874(b). If the retained ownership interest is at least 60%, but less than 80%, then the foreign acquiring corporation is respected as a foreign corporation but the U.S. transferor entity and certain other related persons are denied the use of certain tax attributes to reduce the U.S. federal income tax owed on income or gain from certain related-party transactions. Under the 60% or more but less than 80% scenario gain recognized by a US corporation and certain related parties from the transfer of stock or other property is fully taxable at the maximum corporate tax rate without offset for losses, credits or other tax attributes.[600] A 60% inversion results in application of Section 367(a), which after the TCJA 2017 has extended its reach somewhat significantly, but the expatriated entity is subject to a minimum tax for 10 years thereafter.[601] Under Section 367 former shareholders of the domestic SPAC cannot own more than 50% of the acquiring foreign company in order to avoid a taxable event.[602]

The inversion rules can pose obstacles to the non-taxable exchange of SPAC founder and investors shares of a domestic SPAC in merging into a foreign corporation or partnership that is described in Section 7874, and in particular the 60% inversion provision. While a detailed look at the inversion rules is beyond the scope of this article, in general, the preferred course of acquisition in this particular context may be a National Starch type (double-dummy) structure where the SPAC shares and the target's shares are contributed to new holding company in a contribution controlled by Section 351. While a Section 351 acquisition template may leave warrant holders "out in the cold" and result in a taxable exchange, the tax consequences to the warrant holders may not be significant depending on the value of the warrants on the date of the transaction.

[b] *Target's Evolving from Being a Private Company into the Orbit of a Public Company.*

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[599] See Reg. §1.7874-9 which imposes a penalty where: (i) the foreign acquiring corporation acquires a foreign target corporation; (ii) 60% or more of the foreign acquirer's stock (excluding shares held by the former shareholders of the domestic target) is held by former shareholders of the foreign target; and (iii) after the acquisition, the foreign acquirer is not resident of the foreign country where the foreign target was a tax resident before the acquisition. If the test is met, the stock of the foreign acquiring corporation held by former shareholders of the foreign target is excluded in determining the relevant ownership percentages which will make it more likely the outbound restructuring will be treated as an inversion for §7874.

[600] See §7874(a)(2).

[601] §7874(a)(60% inversion); §7874(b)(80% inversion).

[602] See Reg. §1.367-3(a). There is also a 15% excise tax imposed under §4985 on the value of options and other species of stock-based compensation where a US domestic corporation (or partnership) inverts. The expatriated corporation's payment of a tax imposed on the inversion is also treated as "specified stock compensation". Where the corporation pays ore reimburses an officer, director or shareholder for the additional excise tax on the deemed reimbursement an "tax-on-tax" pyramiding effect occurs.

In 2017, Congress imposed another sanction on corporate migrations off-shore by denying "qualified dividend income" status to block preferential rates from dividends from a corporation that becomes a surrogate foreign corporation after 2017. §1(h)(11)(C)(iii); P.L. No. 115-97, §14223, 131 Stat. 2196 (2017).

Once the target corporation is acquired and brought into the public company sphere, the target shareholders will receive cash and/or shares of stock of the SPAC. In this regard, most SPAC transactions can be affected through a tax-free rollover for the target shareholders via a double-dummy or National Starch type transaction. The continuity of business enterprise requirements, however, may present a problem with a Section 368 type reorganization when a "shell" or newly formed entity holding only cash is involved. Does the SPAC have a "historic business" that can be continued by the acquisition company, or can the SPACs assets constitute historic business assets that may be used by the acquiring company after the de-SPAC transaction? Reg. §1.368-2(j)(3) (iii) provides that property provided "in the transaction" by the surviving target in exchange for its stock generally may not be used to meet the "substantially all" requirement under a reverse triangular merger in Section 368(a)(2)(E).[603] The "substantially all" statutory requirement is not present in a Section 351 exchange or in a Type B reorganization under Section 368(a)(1)(B).[604] The continuity of business enterprise rule in the regulations to Section 368 distinguishes between transactions that are sales from those in which the target's historic business or assets are retained under modified corporate form. [605]

Enacted in 2004, Section 7874 reduces the incentives for engaging in corporate (or partnership) inversions moving companies off-shore to avoid US income tax. Section 7874 applies to certain inversions of a domestic corporation for example into a new foreign parent corporation of the domestic target which is referred to as the "surrogate foreign corporation" provided all of the following three tests are satisfied: (i) the acquisition test; (ii) the ownership test; and (iii) the substantial business activities test. The tax consequences to the inversion transaction depend in large part to the ownership test which is the required percentage of stock ownership of the foreign corporation held by the former target (domestic) corporation shareholders.

- Under an 80% stock ownership inversion, the new foreign corporation parent is treated as a domestic corporation for all purposes, including for purposes of Section 367(a). There is no "toll charge" to the exit and the surrogate foreign (parent) corporation is viewed as a domestic corporation.

- Under a 60% stock ownership inversion the new foreign parent corporation keeps its foreign corporation status for US income tax purposes. However, the taxable income of the expatriated domestic corporation will be no less than the "inversion gain" recognized during a 10 year applicable period without use of net operating losses or other tax attributes to reduce US tax on the inversion gain. This would apply to taxable transfers of assets to the new entity falling within the grasp of Section 367(a). An exception from the adverse impact of a 60% inversion is where

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[603] Note that the COBE regulations in Reg. §1.369-1(b) exempt recapitalizations under §368(a)(1)(E) and type F reorganizations. The preamble to the proposed version of those regulations explains that the continuity of interest and COBE requirements are necessary in an acquisitive reorganization to ensure that the transaction does not resemble a sale but that such concern is not present in single-entity reorganizations under section 368(a)(1)(E) and (F). See REG-106889-04.

[604] See Kliegman, "Continuity of Business Enterprise in SPAC Transactions," 62 Tax Mgmt. Memo. 10 (5/10/2021).

[605] See Regs. §§1.368-1(d)(2)(ii), 1.368-1(d)(5) Examples (1) and (2). See also Abegg v. Comm'r, 429 F.2d 1209 (2d Cir. 1970), aff'g 50 TC 145 (1969)(target sells patent and equipment leasing business two years before reorganization for cash, marketable securities and receivables; target then transferred proceeds to a new holdco; IRS treated the transaction as a Type D reorganization but taxpayer, a Swiss citizen, liquidated holdco claiming non-recognition of gain treatment under §337; Tax Court held, as was affirmed by the Second Circuit, that the liquidation amounted to a Type D reorganization and further than since no ruling under §367 was sought, gains realized by holdco on liquidation are required to be recognized).

the foreign corporation and its expanded affiliated group have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of the expanded affiliated group.

The foregoing summary merely describes the "surface" of Section 7874. The provision is complex as a statutory matter and the regulations and Service pronouncements add layers of complexity. The practitioner working on a transaction involving a proposed or already effectuated "inversion" type SPAC or non-SPAC transaction involving the acquisition of a domestic corporation or simply a roll-out into a foreign jurisdiction of a MNE previously situsued in the US, must grapple with the complexity.[606]

Acquisitions of unincorporated companies can also be made such as through an "umbrella partnership" UP-C corporation structure. In this instance a tax receivable agreement between the SPAC and partners of the target partnership may be entered with respect to the step-up resulting under Section 754.

[c] *Foreign SPAC Acquisition of US Target Company.*

The acquisition transaction, obviously, must identify whether the foreign SPAC is or is not a "domestic corporation" for purposes of applying the acquisition rules. There are also anti-stuffing rules and various testing rules in determining the extent to which Section 7874 applies.[607] The bottom line type thought here is that it may be difficult for a foreign SPAC to acquire a domestic US target company without generating an anti-inversion rule issue or problem. In general, the foreign SPAC will want to domesticate, such as engaging in a Type F reorganization, with the SPAC shareholders receiving domestic corporation shares for their foreign corporate shares. Section 367(b) will apply.[608] This results in US shareholders becoming subject to tax on the "all earnings and profits amount" but this should not prove to be problematic to the "blank check" SPAC which is generating only interest income on funds contributed.

[d] *Foreign SPAC Acquisition of Foreign Target Company.*

Where the SPAC and target corporations are foreign companies, a first step may be for the SPAC, formed in the Cayman Islands or other tax-haven jurisdiction, will reorganize in a more desired jurisdiction so as to qualify, for example, for a participation exemption in the country in which the operating target corporation is resident. This reorganized SPAC will be treated as a F reorganization (foreign-to-foreign) under Section 367(a)(1) in which case the US shareholders of the foreign SPAC may not be viewed as having transferred property to a foreign corporation turning off Section 367(a). Alternatively, Section 367(a)(2), were it to be the controlling provision, turns-off a taxable event with respect to the transfer of stock or securities of a foreign corporation that is a party to a reorganization unless otherwise provided in the regulations. Presumably, the exchange of foreign shares in the SPAC for

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606 See Tootle, "The Regulation of Corporate Inversions And Substantial Business Activities", 33 Va. Tax Rev. 353 (Fall 2013); Salaimi, "Corporate Inversions: Evolutionary Process And Key Policy Considerations" 41 Va. Tax Rev. 203 (Winter, 2022); August, "Corporate Expatriation Transactions And The Anti-Inversion Rules", 16 No 5 Bus. Ent. 16 (Sept/Oct 2014).

607 See, e.g., §7874(a)(2)(B) (surrogate foreign corporation rule). See also TD 9834, 83 FR 32524-01, 2018 WL 3377356 (F.R.) (7/12/2018) (final regulations under Section 7874).

608 Treas. Reg. §1.367(b)-3.

foreign shares in the de-SPAC foreign entity, is not regarded as a transfer of an intangible under Section 367(d).[609]

For the entities engaged in the transaction, Reg. §1.367(b)-4 applies. Reg. §367(b)-4T(b) requires that a US shareholder include in income as a deemed dividend under Section 1248 in the event that: (i) a Section 1248 shareholder ceases to be a Section 1248 shareholder as a result of the exchange; (ii) where the shareholder receives certain preferred stock and does not exchange similar preferred stock per Reg. §1.367(b)-4(b)(2)(i); or (iii) in the event of Type E reorganization is also present per Reg. §1.367(b)-4(b)(3). Consideration must also be given to whether the exchange results in gain unless US shareholders enter into a five-year gain recognition agreement. Consideration must be given to the PFIC rules as discussed, see, e.g., Section 1291(f).[610]

The TJCA 2017 also made certain anti-abuse additions to Section 7874.

(1) First, Section 965(l) provides that a company that becomes a surrogate foreign corporation during the 10 years beginning on December 22, 2017, the date of its enactment, computes its repatriation of accumulated foreign earnings and profits at 35% rather than at the reduced rate of 15.5% for cash and 8% as to noncash assets.

(2) Second, Section 59A(d)(4) provides that for the base erosion alternative tax (BEAT), a base erosion payment which gets added to the base amount, includes payments for costs of goods sold to a related party that first becomes a surrogate foreign corporation after November 9, 2017. Now that the BEAT tax has been repealed as part of the Inflation Reduction, the new corporate alternative minimum on book income may have to be taken into account for certain publicly traded companies.

(3) Third, Section 1(h)(11)(C)(iii), as amended by the TCJA 2017, provides that dividends paid by a company that first becomes a surrogate foreign corporation after the date of its enactment are taxed at ordinary rates rather than at the lower rate applicable to qualified dividends.

(4) Fourth, Section 4985(a)(1), TCJA 2017 provides that some stock compensation of a director, officer, or more-than-10% owner of an entity first expatriating after the date of enactment is subject to a 20% excise tax on that compensation (increased from 15% pre-TCJA 2017).

(5) Finally, a new income inclusion provision was added to Subpart F income inclusions under Section 951A with respect to global-intangible low taxed income or GILTI. This resulted in revisions to Section 1249 and further required revisions to the Section 367(b) regulations.

11.05. *Founder Shares*

Founder shares are issued after a SPAC is formed (or in connection with the formation of the SPAC) but prior to the registration statement is filed with the SEC. The sponsor subscribes for a class of

[609] But see §367(d)(4)(G) introduced into law by TCJA 2017.

[610] See in general, Kuntz, Peroni & Bogdanski, "US International Taxation", ¶B5.07 (WG&L).

common for a relatively small amount. However, when the deal is fully funded, and the founders acquire a fixed percentage of the capital raise, there is an immediate valuation increase of substantial magnitude. Founder shares automatically convert into public shares at an agreed conversion ratio. The "cheap stock" issue presents itself with respect to the founder's successful registration of the SPAC.[611] Shareholders of a SPAC often acquire warrants or form of participation enhancement for organizing the deal and bringing it to market. See the preceding discussion of the use of "warrants" and treatment for financial and SEC accounting and regulatory purposes.

11.06. *Passive Foreign Investment Company (PFIC) Implications*

[1] PFIC Rules.

A SPAC will be considered a PFIC for a given tax year if at least 75% of its gross income in a tax year is passive income (the "income test") or if at least 50% of its assets for such tax year, determined based on the FMV of the PFIC's assets averaged quarterly over the year, are held for the production of passive income (the "asset test"). Passive income generally includes cash, dividends, interest, some rents and royalties, and gains from the disposition of passive assets. Where a SPAC is a blank check foreign corporation with no operations or assets other than cash proceeds raised in the IPO (passive asset), and no income other than possibly interest earned in the trust account (passive income), it runs the risk of meeting the asset test or the income test and will likely treated as a PFIC at the outset unless it can satisfy the start-up exception. This is because in a typical (foreign) SPAC, the initial year and possibly for next 12-to-24-month period its assets will be cash or cash equivalent and its income will be interest income. That's a PFIC subject to the "start-up" exception described below which exception is not easy to satisfy.

[2] Impact of PFIC Rules on US Shareholders.

In general, Section 1291 and Sections 1293 through 1297 set forth special rules for US investors in passive foreign investment companies. There are essentially two sets of rules for the income taxation of such US investors in a PFIC. The first set of rules applies to a PFIC that is not a "qualified electing fund" (QEF). US shareholders of a non-QEF are required to pay tax on gain realized from disposition of stock in the passive foreign investment company or upon receipt of an "excess distribution" and to pay an interest charge which is attributable to the value of deferral. Such gain is taxed as ordinary income at the maximum rate and in interest charge is imposed on the tax liability for each specified year.

[3] Application to Warrants/Options.

Section 1298(a)(4) provides that to the extent provided in Treasury regulations, the holder of an option to acquire stock of a PFIC is treated as owning that stock. Prop. Reg. §1.1291-3. A QEF election is not available for warrants which could therefore be taxed as ordinary income and subject to an interest charge.

[4] QEF Election.

Where the QEF election is made, the US shareholder is required to include in gross income its allocable pro rata share of the SPAC's net capital gains and other earnings and profits each taxable year

[611] Compare Berckmans v. Comm'r, TC Memo 1961-100 with Husted v. Comm'r, 47 TC 664 (1967); Trust Company of Georgia v. Rose 25 F2d 997, aff'd 28 F.2d 767 (5th Cir. 1928).

regardless of whether distributions are made. Once the target corporations or companies are acquired, the SPAC presumably will no longer be a PFIC. Presumably, the PFIC that is a SPAC should make the QEF election given the time delay in testing for whether the SPAC will meet the "start-up" exception rule.[612] Note also under Section 1291(f), to the extent provided in the regulations, gain is recognized on a transfer by a US person of PFIC stock in override of any other non-recognition provision. This rule also applies for options and most likely warrants.[613] Under final regulations, no QEF election may be made for warrants even though they may otherwise be treated as PFIC shares.[614]

[5] Start-up Exception.

Under Section 1298(b)(2), a foreign corporation will not be characterized as a PFIC for the first tax year it has gross income (its start-up year) if: (1) no predecessor corporation was a PFIC; (2) the corporation establishes with the IRS that it will not be a PFIC for either of the first two tax years following its start-up year; and (3) the corporation is not in fact a PFIC for either of the first two tax years following its start-up year. It is not entirely clear if the SPAC will fall within the start-up exception. Arguably it should since its purpose is to acquire an active business within a short period of time.

[6] "Always a PFIC" Issue.

A significant consequence of being treated as a Section 1291 fund is that the foreign corporation will continue to be treated as a passive foreign investment company, and thus the shareholder will continue to be subject to Section 1291, even after the corporation ceases to satisfy either the income or asset test for passive foreign investment company status under Section 1296.

[7] Qualified Electing Fund.

Under the PFIC rules, a qualified electing fund is a foreign corporation which meets the definition of a passive foreign investment company and a shareholder of which elects to be taxed under Section 1293 rather than Section 1291. US shareholders of qualified electing funds are required to include currently in gross income their share of a passive foreign investment company's ordinary earnings and net capital gain; however, an election is provided to defer payment of the tax, subject to an interest charge, on income not currently received. The QEF election may be desirable for the first tax year in which the SPAC is a PFC. If the election is not made for the first tax year, the shareholders could make a "purging election" (deemed sale or deemed dividend) as well as a QEF election or mark-to-market election in a subsequent year. The Section 1295 regulations provide that a QEF election cannot be extended to options to purchase PFIC shares.

[8] SPAC Moves "On-shore" or Perhaps Moves "Off-shore".

Where a foreign SPAC acquires a US company the domestication by the SPAC "on-shore" into the US could be a taxable event under the PFIC provisions. On the other hand, where a US SPAC, i.e., domestic C corporation, wants to acquire a foreign corporation it may seek to "invert" in connection with

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612 An excellent treatment of this area is set forth in Hochberg and Motten, "Are Foreign SPACs PFICs, And Should Investors or the IRS Care", Tax Notes 1/22/2023.

613 See §1298(a)(4). Under proposed regulations the deemed exchange of SPAC warrants in an outbound de-SPAC transaction may trigger a taxable event.

614 See §1298(a)(4); Reg. §1.1295-1(b)(2)(iii).

the acquisition of the foreign target in side-stepping Section 367(a) and Section 367(d), for example, as well as Sections 7874(a) or Section 7874(b).

[9] Target Corporation's Tax History and Tax Attributes.

Target corporation represents and warrants that its books and records, including financial accounting records, i.e., audited GAAP (or IFRS) financial statements are acceptable to regulators as part of SEC review including SEC Form S-4, SEC proxy statements, SEC Form 8K, SEC Form 10K, etc. This will include current and deferred income tax payables, deferred tax assets and liabilities, reserves for taxes, valuation allowances on tax assets such as net operating losses and tax credits, footnote disclosures including tax receivable termination payouts, if part of the deal such as in a SPAC UP-C transaction.

Where the target corporation is a partnership, additional due diligence must be performed with respect to each target partner's share of tax basis and partnership liabilities. There also is the issue of proper capital account balances and items of potential gain or loss under Sections 704(b), 704(c) and 743, etc.

[10] Tax Receivables Agreement (TRA).

It is understood in the marketplace with UP-C acquisition structures that the tax receivables agreement (TRA) is a core component of the UP-C IPO structure. The target shareholders may wish to be compensated for part or perhaps more than part of the deferred tax asset it will be contributing in the transaction. A tax receivables agreement or TRA may therefore be put into place and require that the public company will pay a specific percentage of the tax savings generated by using the target corporation's tax attributes.[615] This contractual obligation, in turn, may generate financial accounting issues as to how to treat the potential payouts under the TRA on the public SPAC's books and records. When a taxpayer wants to dispose of a TRA, there are in general, two methods to consider: (i) total cash out which is treated as part of the original sale transaction including for installment sale purposes as a contingent purchase price amount or contingent boot under Section 351 under a corporate double-dummy transaction; or (ii) sell the TRA payment obligation to a third party for cash which should be treated for tax purposes as the sale generally two potential paths: (1) negotiate with the TRA counterparty to extinguish the agreement for an agreed sum, or (2) sell the TRA to a third party in which case the characterization of the gain, if any, from the sale would need to be evaluated, including consideration as to whether the sale of the contract claim represents the sale of a contingent debt instrument.

[615] See, e.g., Tax Receivable Agreement by Agiliti, Inc., Agiliti Holdco, Inc. and IPC/UHS L.P. 1/4/20119 https://www.sec.gov/Archives/edgar/data/1749704/000110465919001493/a19-2323_1ex10d4.htm;Brown, "The UP-C IPO and Tax Receivable Agreements: Legal Loophole?," 156 Tax Notes 859 (Aug. 14, 2017).

[11] Excise Tax on ex-SPAC Buybacks?

Under the Inflation Reduction Act of 2022, new Section 4501 imposes a non-deductible excise tax on buybacks of equity securities of entities, called "covered corporations". For this purpose, a "covered corporation" is any domestic corporation the stock is traded on an established market per Section 7704(b)(1). In general a "covered corporation" will be a publicly traded domestic corporation. However, the rules are potentially applicable to publicly trade "inverted" corporations under Section 7874 with respect to "covered surrogate foreign corporations." The rules include purchases by related party "specified affiliates" by a covered corporation.[616] Exception is provided for repurchases that are part of a reorganization under Section 368(a) provided no gain or loss is recognized by the shareholder whose shares are redeemed.[617]

With respect to redemptions of stock, to the extent consideration is received in "boot" even though part of a reorganization, it should be subject to Section 4501. Another important exception applies to redemptions of stock which are treated as a dividend under Section 301. Exception is provided with respect to contributions of stock and repurchases of stock from an ESOP. As pointed out by a recent commentary on this issue, a Section 4501 penalty could well be assessed against other quite common merger and acquisition transactions, including those involving "going private" acquisitions with third party financing as well as de-SPAC redemptions of stock once the second leg of the SPAC transaction has occurred.[618]

11.07. *Acquisition Patterns of Acquiring S or C Corporation Targets by SPACs.*

[1] Horizontal Double Dummy SPAC Merger.

Where the target is a C or an S corporation, perhaps with or without affiliates, including one or more QSUBs or single member LLCs, the horizontal double dummy involves the following sequence:

(a) SPAC forms a new parent corporation, NewCo which forms wholly owned subsidiaries S1 and S2 with S2 being the target C or S corporation, which actively operates one or more trades or businesses, again, directly or indirectly through a subsidiary or single member entity (division or branch) to be acquired.

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[616] §4501(c)(2). See also §4501(c)(1)(B). For an overview of this area in the context of Subchapter C, see Rizzi, "New Buyback Tax Raises Range of Issues for M&A Transactions", Corp. Tax'n (Jan/Feb. 2023). See also, Comments on Notice 2023-2 Regarding the Excise Tax Under Section 4501, ABA Section of Taxation, March 20, 2023. https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/2023/032023comments-3.pdf

[617] §4501(e)(1). The list of exceptions to the excise tax on stock buy-backs are set forth in this provision.

[618] Rizzi, note 556, supra. See, e.g., Rev. Rul. 78-250, 1978-1 CB 83 (plan to eliminate the minority stock interests, a new corporation, Y, was formed by A who received all of the Y stock in exchange for A's X stock on a share-for-share basis, Y was then merged with and into X under applicable state law. In the merger each share of A's Y stock was converted into a share of X stock and the minority shareholders of X received cash in exchange for their X stock, in an amount equal in value to the stock exchanged. * * * Such cash is treated as received by the minority shareholders as distributions in redemption of their X stock for purposes of §302,); Rev. Rul. 79-273, 1979-2 CB 125. See also Rev. Rul. 73-427, 1973-2 CB 301 (transaction treated as direct stock purchase where cash was supplied by acquiror). Of course, following the "going private" transaction, the target is no longer a "covered corporation." In certain instances, the transaction may also be characterized as a reverse acquisition where the target files a consolidated return. See Reg. §1.1502-75(d)(3)(i).

(b) After formation, S1 will be merged under a binding contract in place with the SPAC with the existing SPAC (founding shareholders and initial investor shareholders in the SPAC) as the surviving entity. Then, transitory acquisition subsidiary S2 will merge into the target corporation These transitory merger steps may be disregarded on the basis that in substance, the series of transactions involve the shareholders of target, the sponsor SPAC transferring their stock in the target and the SPAC to NewCo in exchange for NewCo stock. This transaction should, constitute a "good" Section 351 transaction.[619] Note further that the use of the Section 351 template may prove to be particularly important where, for example, a potential purchase by the public SPAC of selected assets of the target may not constitute "substantially all of the assets" of T thereby making a non-taxable reorganization under a Type C (including a forward or reverse tax-free reorganization) not possible.

(c) After steps [i] and [ii], NewCo owns 100% of target corporation now T2 (surviving merger with S2) and 100% of the SPAC (T1 surviving merger with S1). Assuming all are domestic corporations, they may elect and file as a consolidated group.

(d) Under Section 351 the target shareholders do not recognize taxable gain except to the extent of boot or other nonqualifying consideration received and the assets of the target corporation continue except of gain recognized at the shareholder level. However, most SPAC transactions will involve the "cashing out" of target shareholders perhaps with a few or more accepting rollover equity in NewCo. Perhaps certain target shareholders will not want to be cashed out or otherwise would accept a form of earn-out payment based on the post-acquisition value of the company based on a financial formula.

[2] Partnership Conversions of Target Company to Corporation.

When the target is organized as a partnership for federal income tax purposes, the parties may want to convert the target into a corporation.[620] Many target partnerships may already be owned by private equity funds that will have in place corporate blocker entities which own the target partnership. The corporate blockers may have corporate tax attributes that may be transported to the NewCo and its consolidated group.

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[619] For purposes of §351 the term "control" requires at least 80% of both voting and number of shares of each class of nonvoting stock in the corporation. Compare §368(c)(80% of voting and 80% of total number of shares of each class of non-voting stock). See Rev. Rul. 76-123, 1976-1 CB 94 (merger into target can be viewed as Type A reorganization per §368(a)(2)(E) or if no boot is received as a Type B organization). See, however, Rev. Rul. 68-349, 1968-2 CB 143. Non-qualified preferred stock received as part of a §351 transaction is treated as taxable "boot". §351(g). Section 351(g)(2)(A) defines nonqualified preferred stock as stock that has specific preferential redemption (or repurchase) rights or has a dividend rate that is set (directly or indirectly) with reference to "interest rates, commodity prices or other similar indices." Other exceptions to non-recognition treatment under §351 are sourced from Reg.§ 1.351-1(c)(1) which denies nonrecognition treatment when the purported §351 transfer results in diversification of the transferors' interests and the transferee is either (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation more than 80 percent of the value of which assets are held for investment and are readily marketable stock or securities, or interests in RICs or REITs.

[620] See Rev. Rul. 84-111, 1984-2 CB 88 revoking Rev. Rul. 70-239, 1970-1 CB 74. See §7704(f)(reclassification of a publicly traded partnership as a corporation, transaction is treated as a deemed § 351 transfer of assets, followed by a liquidation of the partnership and a distribution of stock to partners). The conversion will most likely be effectuated through and interests up method. See Rizzi, "Tax Planning for the Reincorporation of America," J. Corp. Tax'n (Mar./Apr. 2018).

If the parties prefer to convert the operations to a corporate entity, then the transaction structure should result in a double dummy merger, with the target company becoming a C corporation. This will require the target to reconcile its partnership tax history, capital accounts and attributes among its owners who will be exchanging their partnership interests for shares of stock in NewCo. There is the potential for gain recognition under Section 357(c) with respect to liabilities transferred or assumed in excess of outside basis of the transferred partnership interest.[621] Where there is gain recognition from the receipt of boot or liabilities transferred in excess of business, this gain will increase target's basis in its assets which in turn may generate a tax receivable item under a TRA agreement between the public company and the target's owners or "legacy" shareholders. The increase in tax basis resulting from a double dummy partnership conversion are often attributes that are subject to a TRA between the public company and the legacy owners. As previously discussed, this TRA liability may be a material item on the public company's financial statements and is likely a significant value driver for the target's historical owners. Accordingly, it will be important to all parties to arrive at an accurate estimated TRA liability in advance of the S-4 or proxy filing. Because these step-up calculations are determined based on each partner's tax profile in the target partnership, both the SPAC and the target have a vested interest in confirming the historical accuracy of partnership allocations and capital accounts before effectuating the business combination.[622]

[621] Rev. Rul.

[622] See ASC 740-10-45-19. Cf. ASC 740-20-45-11. See PWC Viewpoint, Chapter 8.5 "Conversion of a partnership to a corporation" December 31, 2022. (viewpoint.pwc.com).

[3] Up-C SPAC Structure.

[a] *Venture Capital, REIT and Private Equity Up C Structures.*

The Up-C structure involves the use of a C corporation which is owned, in part, by the C corporation and partially by an investor group, generally investors in partnership such as venture capital or private equity companies. The investors receive exchange rights that allow them to periodically tender their LLC interests for equivalent-value stock in the parent C corporation. When these exchanges occur, there are taxable exchanges to the investors and result in a stepped-up basis in a proportional part of the LLC's assets. This will result in gain to the LLC members receiving public corporation stock which will result in an increased or "stepped-up" basis in the proportional part of the LLC assets assuming, of course, that the LLC had made a Section 754 election.[623] This increase in basis will reduce the income tax obligations of the members or the LLC under Section 6225(a) should that provision be operative under the new BBA partnership audit rules.[624] Legacy owners need to be advised on the sharing TRA agreement idea and whether they should participate in the tax savings that the outside investors will be receiving as a result of the acquisition. The TRA agreement seems to be more of a product of the SPAC phenomenon than the typical private equity fund acquisition of operating corporations where the corporation is an S or C corporation. The UP-C SPAC acquisition documents may limit the amount and timing for the exchange of membership interests for de-SPAC (public) shares. Issues for planning transactions in this area depend on a set of tax and financial (and SEC) accounting matters which are only briefly alluded to herein.

The UP-C IPO structure was rolled out during the mid-2000s before the financial crisis of 2009 in the 2006 IP) of Evercore Partners (Barnes and Noble and Bertelsmann AG).[625] The Up-C IP structure may attribute its origin to the umbrella partnership real estate investment trust or UPREIT which use the same overall structure. This transaction is approved in Reg. §1.701-2(d) Ex. 4 of the partnership anti-abuse regulations.[626] The UPREIT permits a closely held historically operated business operated in a pass through form, even though a corporation can be acquired in the manner, to "go public" in a way that defers taxation on the unrealized appreciation in the company to the historic owners.[627] The trend line for

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[623] See Reg. §1.743-1.

[624] See August, "Assessments and Collection of Income Tax From Partnerships, Partners And Former Partners Under The BBA Partnership Audit Rules", Corp. Tax. 49 WGL-CTAX 03 (Jan/Feb 2022). "Tax Controversies and Litigation Under The New Centralized Partnership Audit Rules: Are You And Your Clients Ready? (Parts I and II)", Practical Tax Lawyer (March and May 2020).

[625] See Brown, "The UP-C IPO and Tax Receivable Agreements: Legal Loophole?" 156 Tax Notes 859 (Aug. 14, 2017). Fleischer & Staudt, "The Supercharged IPO," 67 Vand. L. Rev. 307 (2014); Edwards, Hutchens & Rego, The Pricing and Performance of Supercharged IPOs (Kelley Sch. of Bus. Research Paper No. 16-14, 2017), http://ssrn.com/abstract=2725531; Shobe, "Supercharged IPOs and the Up-C," 88 U. Colo. L. Rev. 913 (2017)

[626] The example in the anti-abuse regulation, Reg. §1.704-2(d), Ex. 4, with respect to an UP-C PTP requires that the partnership whose interests are trade on an established securities market or whose interests are "readily tradable on a secondary market (or the substantial equivalent thereof)". What does "readily tradeable" mean for this purpose. There is a "safe harbor" of sorts in Reg. §1.7701-4 which provides that a historic partner's exchange right (its redemption and repurchase agreement) will meet "readily tradable" standard as long as, the redemption or repurchase occurs at least 60 calendar days after the partner notifies the partnership in writing of the partner's intention to exercise the redemption or repurchase right. See Elliot, "IRS concerned by Aggressive Exchange Rights in Up-Cs, UP-REITs", Tax Notes (12/4/2015).

[627] It should also be mentioned that the UP-PTP (publicly traded partnership) also uses the same overall structure. Section 7704(b) defines a PTP as any partnership whose interests are traded on an established securities market or whose interests "are readily tradable on a secondary market (or the substantial equivalent thereof)."

UP-C IPOs grew little by little through 2012 and then it has been reported that the "UP-C Revolution" began in earnest in 2013 with twelve UP-C IPOs filed and then at least seventeen filed in 2014.[628]

[b] *UP-C SPAC Structure.*

In the SPAC UP-C structure, the public company acquires partnership units from the partnership entity formed by the SPAC founders and the owners of the target corporation (or partnership). The shareholders or owners of the target corporation recognize gain to the extent cash is at the time of the target-SPAC merger as well as prospectively when legacy owners exercise their exchange rights. The exchange rights are issued when the operating partnership recapitalizes prior to the SPAC (UP-C) transaction. Provided the operating partnership has a valid section 754 election in place, the taxable exchanges result in a tax basis adjustment for the benefit of the public company under Section 743(b). As the public company claims cost recovery and amortization deductions such as goodwill amortization under Section 197 sourced from the basis adjustment increase, the tax savings are the subject of negotiation between the parties. The legacy or historic owners of the target company will want to receive cash-payments or other form of consideration sourced from the tax savings as realized. Where the target company is already operating as a partnership, the UP-C SPAC transaction will generate additional complexities in allocating and tracking Section 704(c) layers, Section 743(b) adjustments, partnership capital accounts, income and distribution provisions, including "waterfall" provisions, the disguised sale and "mixing bowl" rules and then the tax procedure "nightmares" that await under application of the BBA centralized partnership audit regime.

[c] *Eventual Unwind Of Partnership.*

When the legacy or historic owners of the target partnership completely sell-out the public company will own the partnership interests which will terminate the partnership in accordance with Section 708.[629] This "going to one" partner transaction is treated as a distribution to each partner of its pro rata share of the assets of the partnership in complete liquidation of their interests followed by the public company's purchase of the assets held by the partners. The transaction may generate additional levels of gain to the historic owners and basis increase to the retained assets now receiving, in part, a cost basis by the public company. Is such gain part of the TRA agreement or result in additional cash payments as part of the final exit of the historic owners. The deemed tax fiction is that assets of the operating partnership are distributed to each partner in full liquidation of their interests in the partnership, followed by the SPAC acquiring the assets deemed held by the legacy owners. From a tax perspective, there are a few key tax calculations that will be required as a result of the transaction. This includes the calculation of the basis of distributed assets to the SPAC (that is, section 732), as well as determining the acquired tax basis and recovery of the assets acquired from the legacy owners. Depending on the profile of the assets held by the operating partnership, the direct acquisition of assets from legacy owners could result in bonus depreciation, which may increase the value of any TRA associated with the delivery of tax basis in the unwind transaction.

In addition to the general tax considerations, there are specific tax accounting nuances to address when the operating partnership becomes a disregarded entity in a SPAC UP-C unwind. For example, because of the different basis rules applied for tax versus financial accounting principles,

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[628] See Polsky and Rosenzweig, "The Up-C Revolution", 71 Tax L. Rev. 415 (2018).

[629] See also Rev. Rul. 99-6, 1991-1 CB 432.

there is usually a deferred tax asset or liability attached to the public company's interest in the operating partnership. This tax basis will be allocated to the underlying assets that are deemed distributed to the public company in the Rev. Rul. 99-6 transaction as described above. As a result, when a valuation allowance may have been recorded against the deferred tax asset associated with the SPAC's interest in the operating partnership, the Rev. Rul. 99-6 transaction may result in a removal or modification of the valuation allowance if the SPAC's excess tax basis is allocable to recoverable property (for example, ordinary income property, fixed and intangible assets) and the SPAC otherwise constitutes a deferred tax asset.