

PRACTISING LAW INSTITUTE
TAX PLANNING FOR DOMESTIC AND FOREIGN PARTNERSHIPS, LLCs, JOINT
VENTURES AND OTHER STRATEGIC ALLIANCES 2008

APPENDIX TO OUTLINE ON

THE S CORPORATION RULES AND THE USE OF S
CORPORATIONS AS ACQUISITION VEHICLES

December 20, 2007

Mark J. Silverman
Steptoe & Johnson LLP
Washington, D.C.

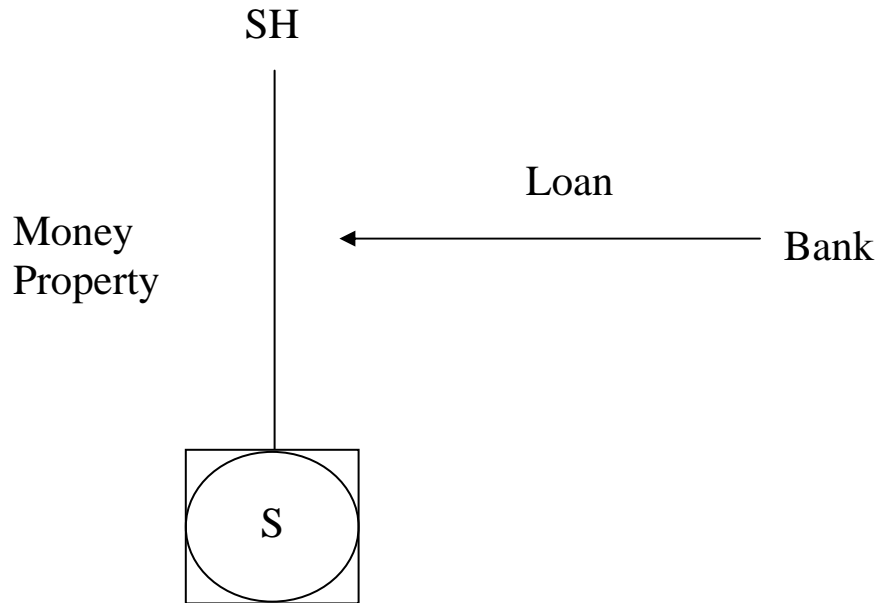
Steven B. Teplinsky
Steptoe & Johnson LLP
Washington, D.C.

Aaron P. Nocjar
Steptoe & Johnson LLP
Washington, D.C.

Internal Revenue Service Circular 230 Disclosure: As provided for in Treasury regulations, advice (if any) relating to federal taxes that is contained in this communication (including attachments) is not intended or written to be used, and cannot be used, for the purpose of (1) avoiding penalties under the Internal Revenue Code or (2) promoting, marketing or recommending to another party any plan or arrangement addressed herein.

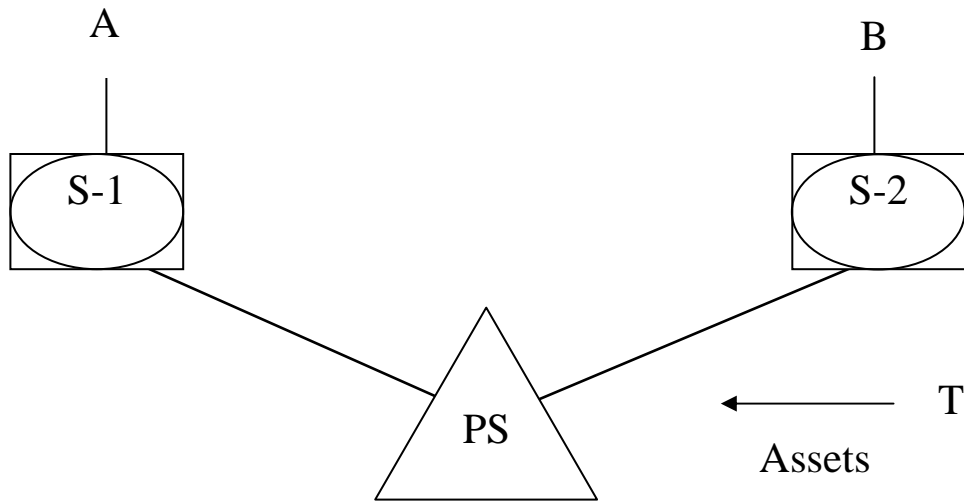
Copyright © 2007 Mark J. Silverman, Steven B. Teplinsky and Aaron P. Nocjar, All Rights Reserved.

Structuring Financing – Impact on Basis (Section III.D.1.)



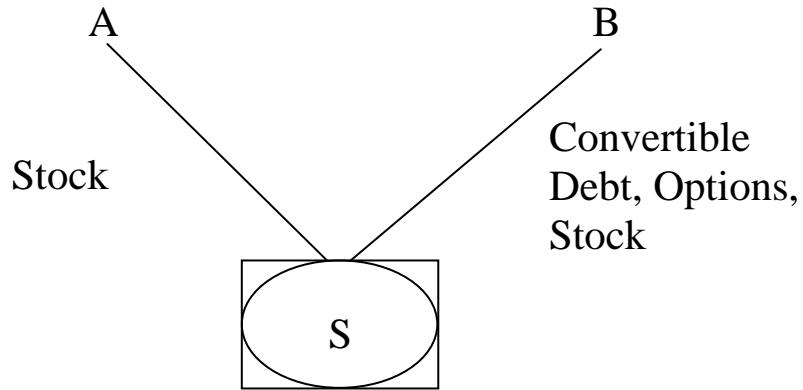
1. Planning to provide shareholders with the maximum basis in both debt and stock should begin at the same time that financing is being arranged.
2. Stock basis may be obtained through cash or property contributions by the shareholder to the S corporation or by purchase of stock.
3. Shareholders may also loan money to the S corporation. Loans from third party financiers should be made to the S corporation shareholders, not to the S corporation. The shareholder can then reloan the proceeds to the S corporation.
4. Shareholder guarantees of corporate debt generally will generate basis only when the shareholder is required to satisfy the corporate obligation.
5. Seller financing should be treated the same as third party debt to the corporation – no basis to the shareholder. The shareholder should consider purchasing the assets directly from the seller and contributing the property to the S corporation.

Priority Concerns of Investors (Section III.D.2.)



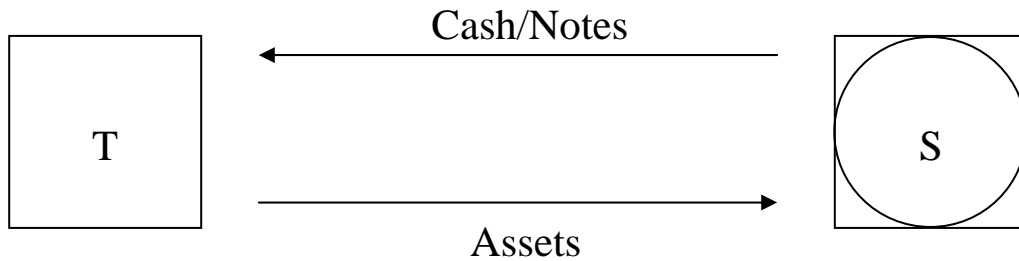
1. A forms S-1. B forms S-2. Both S-1 and S-2 elect S status.
2. S-1 and S-2 form partnership PS. PS acquires the T assets.
3. The partnership agreement grants S-1 a preference as to distributions. A has obtained the equivalent of a preferred stock interest in the acquired business.
4. The formation of PS should be respected. With the issuance of Rev. Rul. 94-43, 1994-2 C.B. 198, there is significantly less risk that the Service will treat the two corporations as one for purposes of determining eligibility for an S election.

Special Allocations (Section III.A.4.d.)



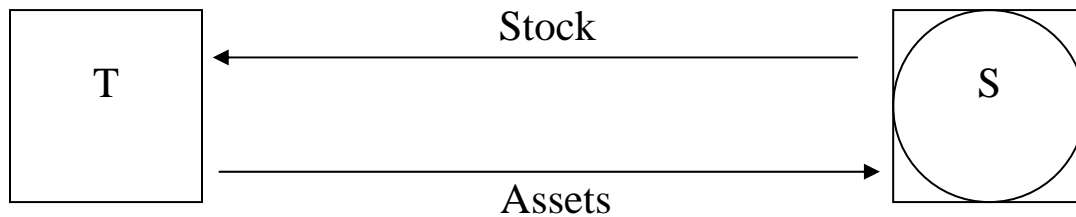
1. A contributes \$100 of cash to S in exchange for stock of S.
2. B contributes \$100 of cash to S in exchange for convertible debt, options, and some stock.
3. The terms of the convertible debt and the options must be structured so that they will not be considered a second class of stock under Section 1361 or the regulations thereunder.

Taxable Asset Acquisitions by S Corporations (Section IX.B.1.a.)



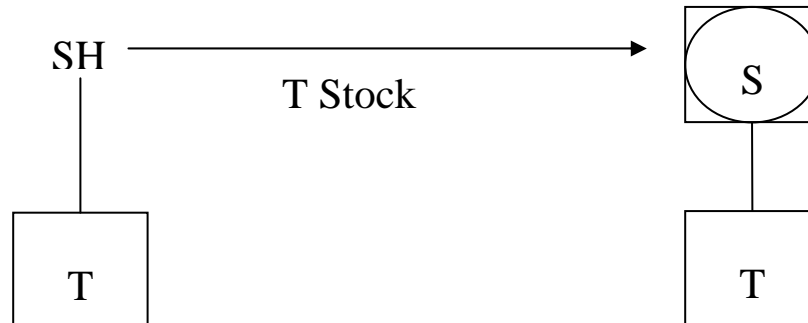
1. An S corporation may acquire target assets directly for cash or notes. Alternatively, T may merge into S in a cash merger.
2. The transaction should not, in general, affect the S election.
3. Income (loss) generated by the acquired assets will be blended in with other S corporation income (loss) and allocated according to the usual per-day per-share rule.
4. Section 1374 should not apply because the assets will have a cost basis.

Tax-Free Asset Acquisitions by S Corporations (Section IX.B.1.b.)



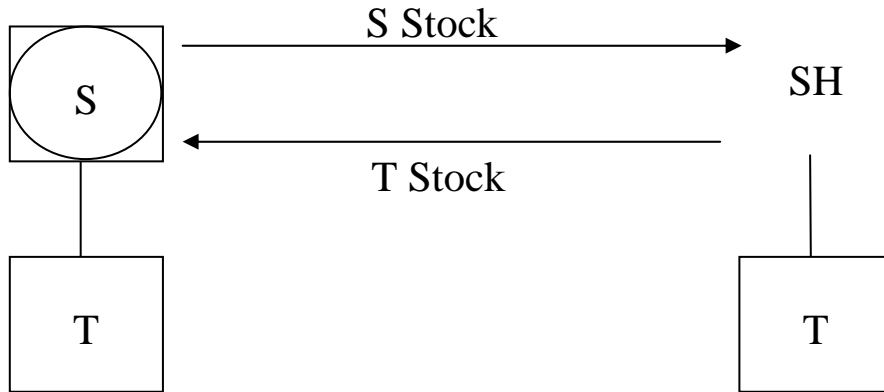
1. An S corporation may make a tax-free asset acquisition using several formats – A, C, or acquisitive D reorganizations, for example.
2. The tax-free asset acquisition should not alone terminate the S election.
 - a. This is true with a merger and consolidation, and certain acquisitive D reorganizations.
 - b. There was concern that a C reorganization would terminate the S election because a corporate shareholder would be present. However, G.C.M. 39768 allays that concern.
3. Income (loss) items generated during the acquisition year by T assets may be shifted among the shareholders: pre-acquisition income (loss) to former T shareholders and post-acquisition income (loss) to S shareholders (new and historic).
4. S will succeed to T's historic asset bases, earnings and profits, and other tax attributes. Thus, Section 1374 may apply.
5. Pre- and post-reorganization distributions by S should be governed by Section 1368. It is unclear whether distributions pursuant to the plan of reorganization are taxed under Sections 356 or 1368.

Taxable Stock Acquisitions by S Corporations (Section IX.B.2.a.)



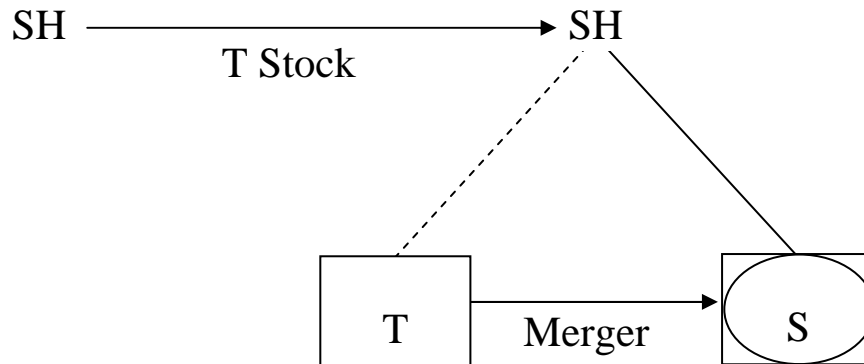
1. Prior to the Small Business Act of 1996, an acquisition of T stock could terminate S's S election. However, if T were immediately liquidated or spun-off, S status could be preserved.
2. A stock purchase followed by a liquidation of T could be treated as an asset acquisition. Alternatively, the transaction could be treated as a qualified stock purchase followed by a liquidation under Section 332. Compare PLR 8818049 with PLR 9323024 (revoking PLR 8818049).
 - a. However, in Rev. Rul. 90-95, the Service held that an acquiring corporation that makes a qualified stock purchase of stock of a target corporation and immediately liquidates the target as part of a plan to acquire the assets of the target is treated as having made a qualified stock purchase followed by a liquidation, rather than having made an asset acquisition. In TAM 9245004, the Service concluded that the purchase of target corporation stock by an S corporation, followed immediately by the liquidation of the target into the S corporation, is treated as a qualified stock purchase of the target stock followed by a liquidation under Section 332. See also PLR 9323024.
3. Structurally, S also could merge downstream into T immediately after the acquisition of T stock. T should be able to elect S corporation status.
4. The Small Business Act of 1996 repealed the affiliation limitation for S corporations. Thus, S would be allowed to own up to 100 percent of T, though S could not be included in a group filing a consolidated return.
5. Furthermore, the Small Business Act of 1996 permitted S to treat T as a disregarded entity if (i) S owned 100 percent of the T stock and (ii) S elected to treat T as a QSub. The QSub election transaction generally should be treated as a complete liquidation of T into S to which Sections 332 and 337 would apply. However, step transaction principles could recharacterize the transaction. See Treas. Reg. § 1.1361-4(a)(2).

Tax-Free Stock Acquisitions by S Corporations (Section IX.B.2.b.)



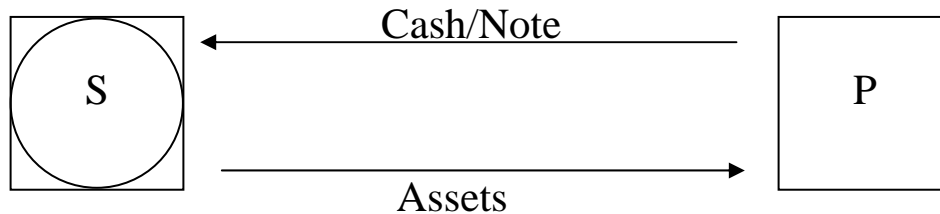
1. A tax free stock acquisition may be accomplished as a B reorganization or under Section 368(a)(2)(E).
2. Prior to the Small Business Act of 1996, a tax-free stock acquisition was likely to terminate the S election. Was it possible that S corporation status could be preserved if the target was liquidated immediately? This should cause the transaction to be viewed as a C reorganization.
3. Because the Small Business Act of 1996 repealed the affiliation limitation for S corporations, it is less likely that a tax-free stock acquisition will terminate the acquiring corporation's S election. However, the S election may still be terminated due to the number or status of shareholders that receive stock of the acquiring S corporation in the transaction.
4. Pre-reorganization distributions by S should be governed by Section 1368.
5. Post-reorganization cash distributions may be tax-free under Section 1371(e) (assuming S corporation status is terminated).
6. Distributions made contemporaneously with the reorganization should emanate from T – neither Section 1368 nor 356 should apply.

Stock Acquisition Alternative (Section IX.B.2.c.(i))



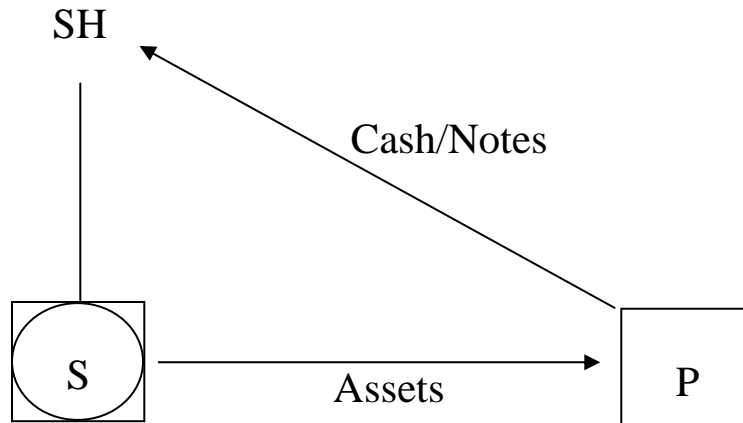
1. Shareholders of S may acquire T stock directly from T's shareholders. T would then merge into S.
2. The merger of T into S may not qualify as a reorganization since historic shareholder continuity of interest is lacking. But see Treas. Reg. § 1.368-1(e).
3. If the merger is taxable, T would be deemed first to sell its assets in a taxable transaction and then to liquidate.
 - a. According to the Service, the gain (loss) would be reportable on the buyer's side. Sections 267 and 1239 may apply.
 - b. The deemed liquidation would also be a taxable event. Since the shareholders have a cost basis in the T stock, the liquidation transaction should produce minimal gain.
4. The merger of T into S should not affect the S election. Income (loss) items for the entire year would be allocated under Section 1377(a). If the merger is tax-free, Section 1374 may apply.

Taxable Asset Dispositions by S Corporations -- Direct Sale of Assets (Section X.A.1.)



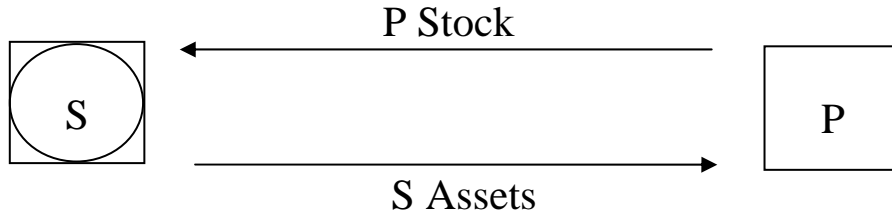
1. An S corporation sells assets to a purchaser in exchange for cash or notes.
2. The asset sale should not affect the S election. However, if notes are received or the proceeds invested, Section 1375 may apply and, in addition, the S election may be terminated under Section 1362(d) (excess passive investment income).
3. A taxable asset sale may produce immediate gain if installment notes are received – Sections 453(b)(2), 453(i), and 453A.
4. Section 1374 may apply to the asset sale.
5. Also, Sections 1239 and 267 may apply if the purchaser is related to the S corporation.
6. The usual allocation rules should apply. Gain (loss) from the asset sale will flow through to the S corporation shareholders.

Taxable Asset Dispositions by S Corporations -- Taxable Merger (Section X.A.2.)



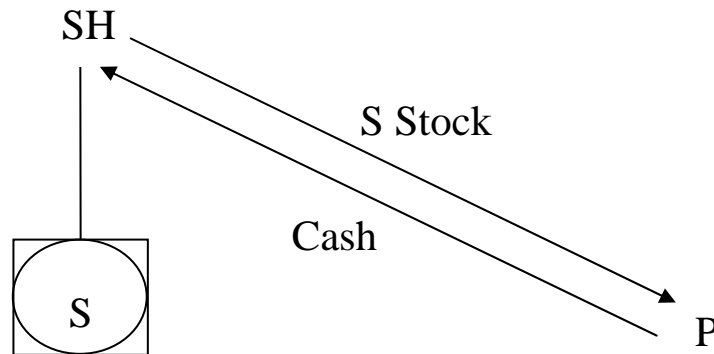
1. An S corporation may effect an asset sale to a purchaser in a taxable merger. For example, S merges into P, with P surviving. S's shareholders receive cash or P notes.
2. The transaction should be viewed as an asset sale by S followed by a complete liquidation of S.
3. As to the asset sale, gain or loss will flow through to the shareholders. The usual allocation rules will apply.
4. The deemed liquidation may cause all gain inherent in the P notes to be accelerated under Section 453B. However, Section 453B(h) would allow gain deferral to continue (subject to Section 1374).
5. Section 1374 may apply to the asset sale.

Tax-Free Asset Dispositions by S Corporations (Section X.A.4.)



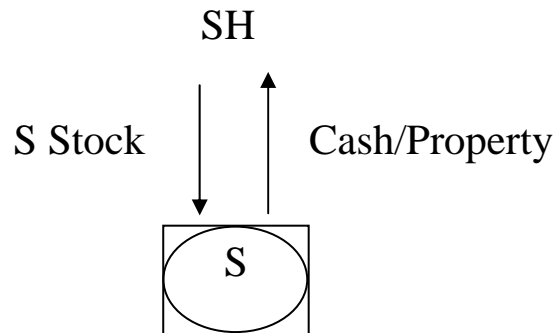
1. An S corporation may also dispose of its assets in a tax-free transaction. This may occur in an A, C, or D reorganization. See GCM 39768; see also section 1310 of the Small Business Act of 1996 (repealing Former Section 1371(a)(2) of the Code).
2. Effect on election
 - a. A merger or consolidation will terminate the S corporation's existence. However, the S corporation's election does not terminate with respect to the final taxable year. See Rev. Rul. 70-232; Rev. Rul. 64-94. Section 1362(g) should not apply to P as a result of the merger.
 - b. A C reorganization should not terminate the S election. G.C.M. 39768. However, the corporate existence of the S corporation will terminate upon the liquidation.
3. The allocation of income (loss) items should not be affected by the asset disposition. However, if the reorganization terminates the corporate existence in mid-year, an acceleration of the pass-through of income (loss) items will occur.
4. P should inherit the Section 381(c) attributes, if any, possessed by S. It is unclear whether the AAA carries over to P if P is a C corporation.
5. If the shareholders of the S corporation have losses suspended under Section 1366(d)(2), the rules in Treas. Reg. § 1.1366-2(b) and (c) apply.
6. Distributions
 - a. Pre-reorganization distributions by S should be governed by Section 1368.
 - b. It is unclear whether distributions pursuant to the plan of reorganization are covered by Section 1368 or Section 356.
 - c. The treatment of post-reorganization distributions by P is uncertain because it is unclear whether the AAA carries over from S to P. But see Treas. Reg. § 1.1368-2(d)(2) (AAA carries over to P if P is also an S corporation).

Taxable Stock Dispositions (Section X.B.1.)



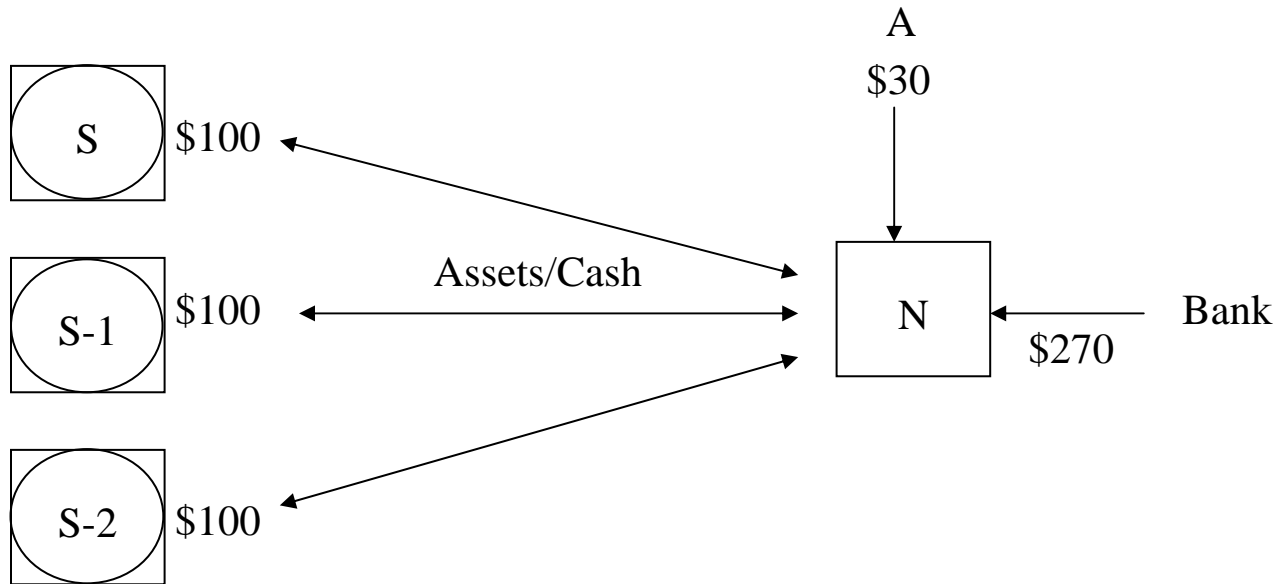
1. The shareholders of an S corporation may sell their stock to a purchaser.
2. Such a sale will affect the S election only if the stock is sold to an ineligible shareholder or too many shareholders.
3. If S corporation status continues, income (loss) items are allocated under the usual per-day per-share rule, unless a Section 1377(a)(2) election is made. If the S election is terminated, income (loss) items will be allocated between the resulting S short year and C short year under Section 1362(e).
4. The allocation of income (loss) items in the year of sale will increase (decrease) the basis of the S stock sold, thus affecting the amount of gain on the sale of the stock. The gain on the sale of stock generally should be capital gain.
5. If the election is not terminated, post-sale distributions should be governed by Section 1368 – tax-free to the extent of basis or AAA, whichever is less. If the election is terminated, Section 1371(e) may apply to cash distributions.
6. Pre-sale distributions by the S corporation should be governed by Section 1368.
7. A Section 338(g) election by P will produce a double-tax, even though the S corporation is a pass-through entity.

Redemptions of S Corporation Stock (Section X.B.2.)



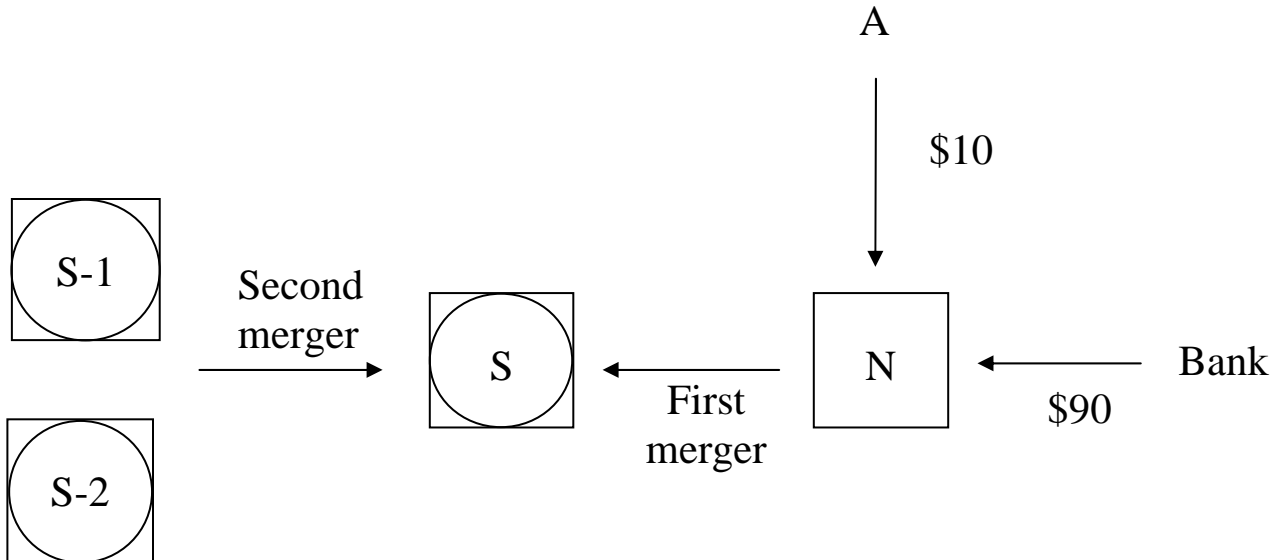
1. A redemption often occurs in connection with an S shareholder's disposition of the S corporation stock (e.g., a bootstrap sale). A purchase of S corporation stock may also be treated as a redemption to the extent that debt is secured by S corporation assets or the S corporation assumes the debt.
2. A redemption alone should not affect the S election.
3. Distributions of appreciated property will trigger gain at the S corporation level which will be allocated to all of the S shareholders.
4. The usual per-day per-share allocation rule will apply; unless an election under Section 1377(a)(2) is made.
5. If Section 302(b) is met, the transaction will be treated as a sale or exchange under Section 302(a). Gain is recognized under the usual Section 302 rules (amount realized less basis of surrendered shares). Both AAA and E&P, if present, would be adjusted.
6. If the redemption is covered by Section 302(d), the redemption will be governed by Section 1368. Section 1368 treatment may produce favorable results where the shareholder's holdings are only partially redeemed. Section 1368 treatment also may produce favorable results where a part of the distribution is taxed as a dividend under Section 1368(c)(2). Treas. Reg. § 1.302-2(c); see also Prop. Treas. Reg. §1.302-5 (removed on April 19, 2006, by Announcement 2006-30, 2006-19 I.R.B. 879).

Multiple S Corporation Targets



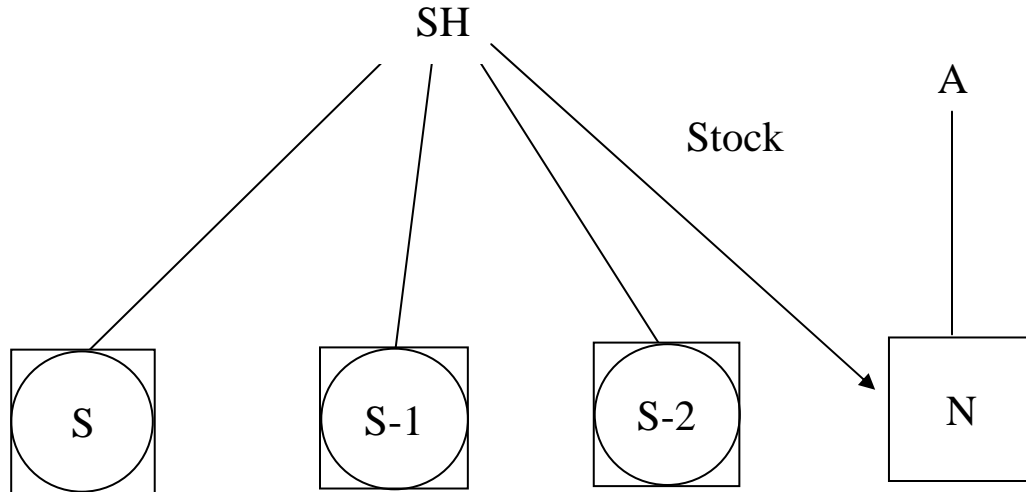
1. S, S-1, and S-2 are each S corporations having a value of \$100.
2. A would like to acquire all three S corporations and combine them into one S corporation.
3. Accordingly, A forms N with \$30. N makes an S election.
4. N borrows \$270 from Bank.
5. N then buys the assets of the S corporations for \$300.
6. N has a cost basis in the assets acquired.
7. Section 1374 does not apply to N.
8. Only a single level of tax to the shareholders of S, S-1, and S-2 applies – unless Section 1374 applies.

Multiple S Corporation Targets (cont'd)



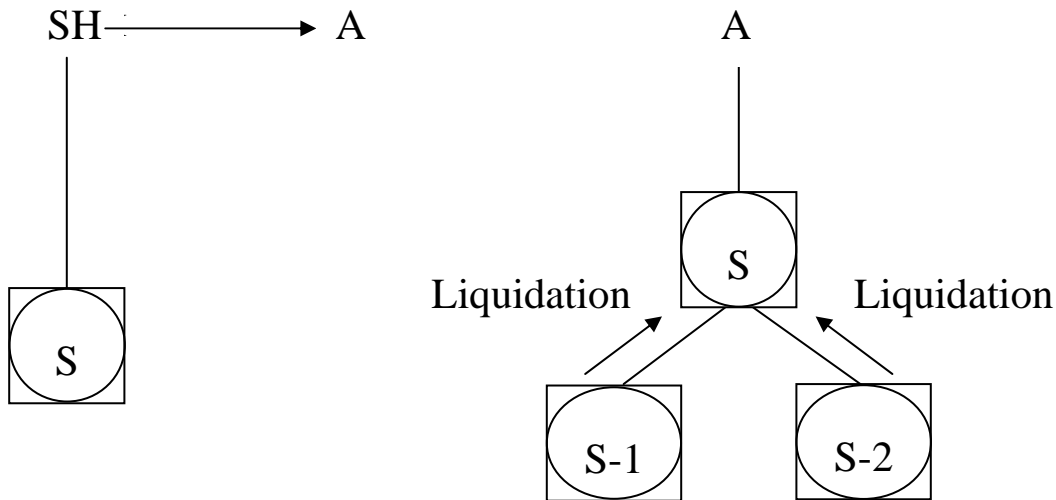
1. Same as the previous diagram, except the form of the acquisition will be as follows.
2. A forms N with \$10. N borrows \$90 from Bank.
3. N merges into S, with S surviving. The S shareholders receive cash for their S stock. This transaction should be treated as a purchase of S stock to the extent of \$10, and a redemption by S to the extent of \$90. See Rev. Rul. 78-250; Rev. Rul. 73-472.
4. S-1 and S-2 are then merged into S, with S surviving. The shareholders of S-1 and S-2 receive cash for their stock. This transaction should be treated as an asset sale by S-1 and S-2 followed by a liquidation of S-1 and S-2. See Rev. Rul. 69-6. S takes a cost basis in the acquired assets.
5. Only a single level of tax should apply to the shareholders of S-1 and S-2 – unless Section 1374 applies.
6. If S uses its own notes to acquire the assets of S-1 and S-2, the deemed liquidation of S-1 and S-2 will result in the acceleration of any Section 1374 tax. See Section 453B(h). As an alternative, S-1 and S-2 could sell their assets to S and remain in existence to collect on the notes.

Multiple S Corporation Targets (cont'd)



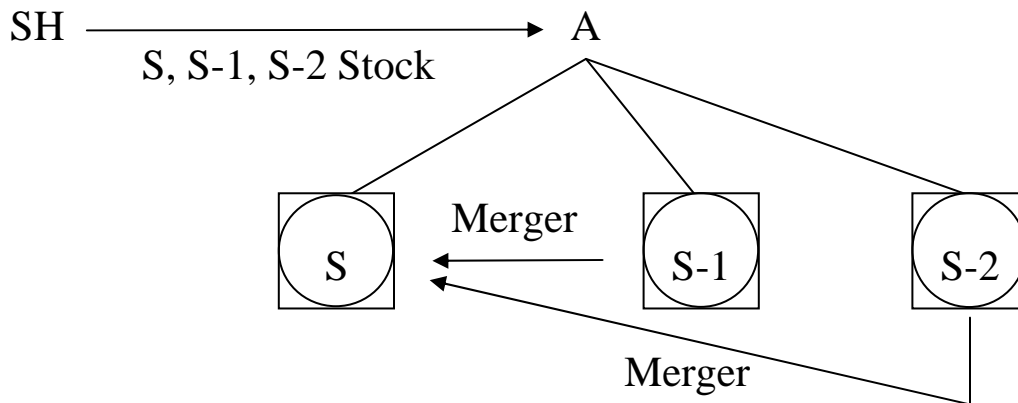
1. Same facts as the previous two diagrams, except A must purchase the stock of S, S-1, and S-2.
2. Accordingly, A forms N, a C corporation.
3. N buys the stock of S, S-1, and S-2.
4. N then liquidates S, S-1, and S-2.
5. N then elects S corporation status.
6. The S corporation status of S, S-1, and S-2 should terminate when N acquires the stock of such corporations.
7. The liquidation of S, S-1, and S-2 should be tax-free under Sections 332 and 337.
8. Section 1374 will apply to N.
9. What is the result under the Small Business Act of 1996 if N properly elects S corporation status before acquiring the stock of S, S-1, and S-2?
 - a. If N does not elect to treat S, S-1, and S-2 as QSubs?
 - b. If N does elect to treat S, S-1, and S-2 as QSubs?
 - c. When must N elect to treat S, S-1, and S-2 as QSubs?

Multiple S Corporation Targets (cont'd)



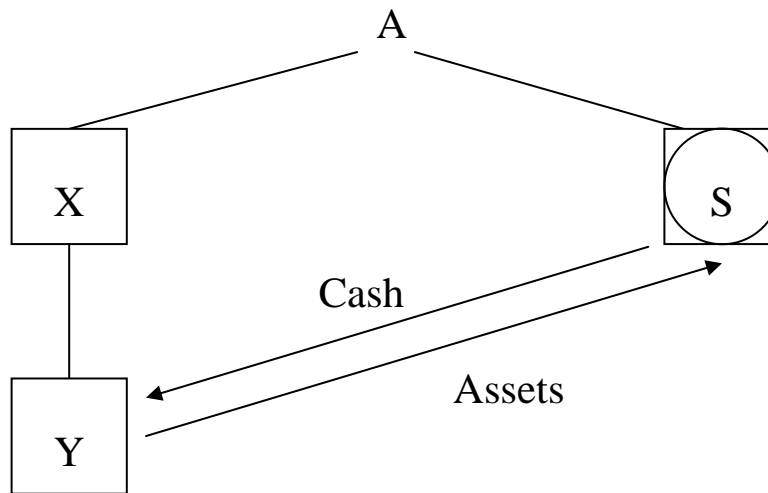
1. The facts are the same as the previous diagram, except that the acquisition and combination will be completed as follows:
 - a. A buys the S stock.
 - b. S buys the stock of S-1 and S-2. S-1 and S-2 are immediately liquidated.
2. Does the S corporation status of S continue if it buys the stock of S-1 and S-2 prior to the Small Business Act of 1996? Compare *Haley Bros. Construction Corp. v. Comm'r*, 87 T.C. 498 (1986), with TAM 9245004; Rev. Rul. 73-496; Rev. Rul. 72-320. Does the S corporation status of S continue if it buys the stock of S-1 and S-2 after the Small Business Act of 1996? See section 1308 of the Small Business Act of 1996.
3. Does the S corporation status of S-1 and S-2 end as a result of the purchase by S of their stock prior to the Small Business Act of 1996? See PLR 8818049 (Service refused to rule on the issue); compare Sections 1361(b)(1)(B), 1362(b)(2)(B)(i) with PLR 9108059; PLR 8810045; PLR 8736014. Does the S status of S-1 and S-2 end as a result of the purchase by S of their stock after the Small Business Act of 1996? See section 1308 of the Small Business Act of 1996.
4. Assuming S continues as an S corporation, the liquidation of S-1 and S-2 should be tax-free under Section 332. Alternatively, the transaction could be viewed as a purchase of assets. Compare PLR 8818049 with PLR 9323024 (revoking PLR 8818049).

Multiple S Corporation Targets (cont'd)



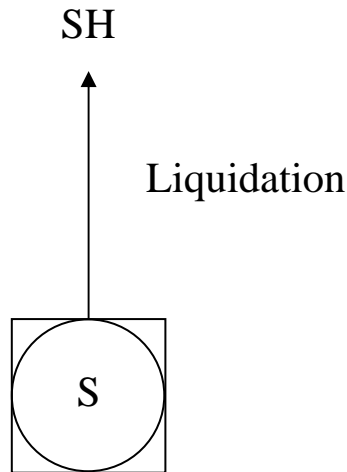
1. The facts are the same as the previous diagram, except that the stock acquisition and combination will be completed as follows:
 - a. A buys the stock of S, S-1, and S-2.
 - b. A merges S-1 and S-2 into S.
2. If the mergers are tax-free, the S corporation status of S continues; S-1 and S-2 asset bases carry over to S; Section 1374 does not apply.
3. However, the mergers may not qualify as tax-free since historic shareholder continuity is lacking. See Yoc Heating Corp. v. Comm'r, 61 T.C. 168 (1973). But see Treas. Reg. § 1.368-1(e).
 - a. If the mergers are not tax-free, each merger should be treated as a taxable sale of assets followed by a deemed liquidation.
 - b. According to the Service, the gain (loss) on each asset sale is taxable on the buyer's side. Nevertheless, the gain (loss) would pass through to A with respect to its stock in S-1 and S-2, respectively.
 - c. Recognition of gain (loss) by A would increase (decrease) A's basis in S-1 and S-2 stock.
 - d. Thus, A would recognize offsetting loss (gain) on the constructive liquidations. The character may be different however – ordinary income (loss) at the corporate level and capital loss (gain) at the shareholder level.
 - e. In addition, Sections 1239 and 267 could apply to the asset sales by S-1 and S-2.
4. Historic shareholder continuity should not be a problem if the reorganizations constitute F reorganizations (which is unlikely here).

Related Party Asset Acquisition



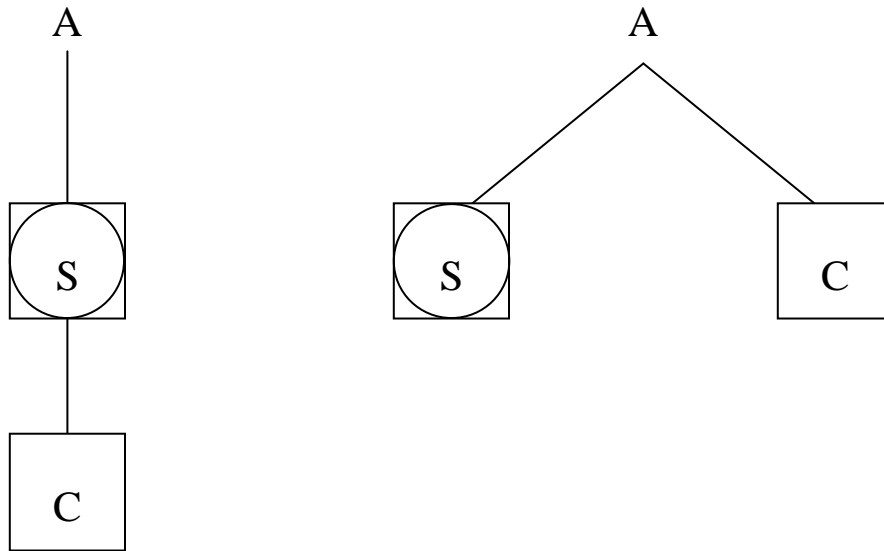
1. Individual A owns all of the stock of corporations S and X. X owns all of the stock of corporation Y. S is an S corporation; X and Y are C corporations.
2. Y transfers its assets to S in exchange for cash.
3. If all of the assets of Y are transferred, there may be a constructive liquidation of Y. Also, even though no stock of S was used, the issuance of stock may be viewed as a meaningful gesture. Thus, the transaction may be treated as a D reorganization.
4. Can S be deemed to have transferred stock to an ineligible shareholder (i.e., Y), followed by a constructive distribution of such stock to X and then A? If so, what affect is there on S's continuing status as an S corporation?
5. If the transaction is a D reorganization with boot, assuming S's status is not affected, Section 1374 will apply to Y's assets, and Y's earnings and profits will carry over to S. It is unclear whether the tax treatment of the boot is governed by Section 1368 or Section 356.
6. If the transaction is respected as a sale, S receives a cost basis in the assets. Sections 1239 and 267 may apply to Y. Any gain from the sale will increase Y's earnings and profits. In addition, if X and Y are members of a consolidated group, any gain from the sale will cause X's basis in Y stock to be adjusted under the consolidated return regulations. See Treas. Reg. § 1.1502-32.

Complete Liquidation of S Corporation (Section X.C.)



1. An S election ceases with the corporate existence of the S corporation, which should occur upon the final liquidating distribution; until then, the election should remain in effect.
2. Section 336 should apply to distributions of appreciated property in complete liquidation. The TAMRA of 1988 clarified Congress's intent to have Section 336 apply by repealing Former Section 1363(d).
3. The allocation of income (loss) items during the year should not be affected by the liquidation; however, the liquidation of a fiscal year S corporation may trigger a bunching of income.
4. The allocation of income (loss) items will affect the amount of gain to the shareholder on the liquidation. Gain or loss on the liquidation, however, is determined separately from income (loss) items that are passed through to the shareholders.
5. Query what the tax consequences may be if the "liquidating" S corporation is insolvent. Cf. Prop. Treas. Reg. § 1.332-2 (providing that Section 332 does not apply when a corporate shareholder fails to receive at least partial payment for the liquidating corporation's stock that the shareholder owns).

Spin-Offs & Converting C Corporations to S Status (Section VIII.A.3.)

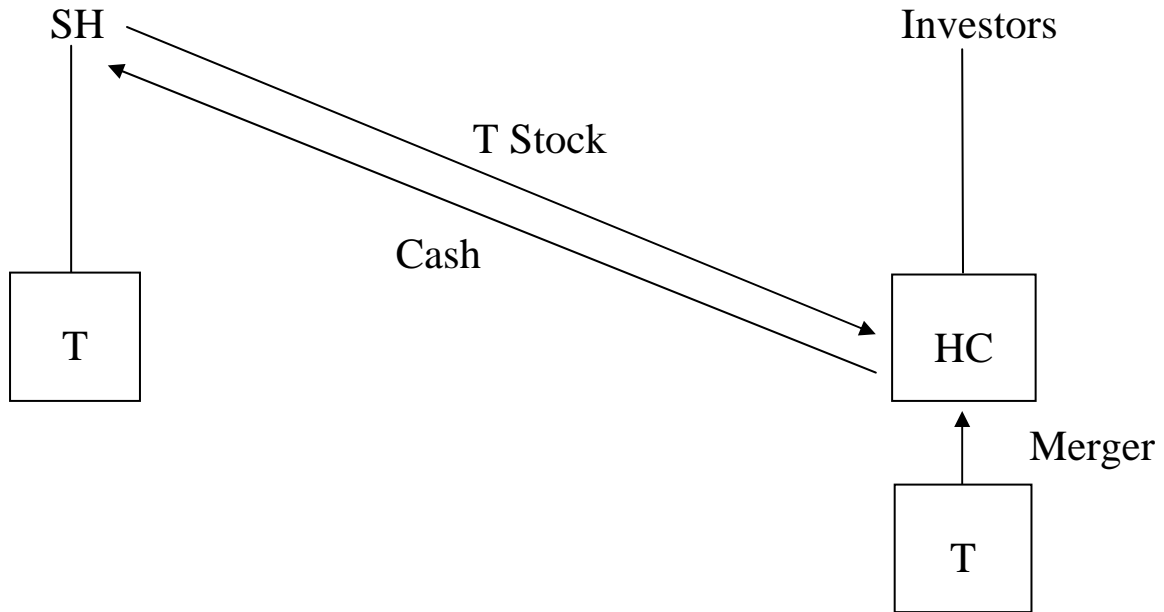


1. A divisive D reorganization may precede an S election of the newly formed spun-off corporation (unless Section 1362(g) applies to the transferor).
 - a. It is unclear whether the spun-off corporation must wait one year before any election will be effective. However, the Service has ruled privately that the spun-off corporation could make an immediate election. Compare Sections 1361(b)(1)(B), 1362(b)(2)(B)(i) with PLR 9414016; PLR 9405014; PLR 9404014; PLR 9402029 (same regarding a split-off).
 - b. Also, a business purpose other than making an S election at the federal level must support a divisive D reorganization.

See also Rev. Proc. 96-30, 1996-1 C.B. 696, 713 app. C at 713 (stating additional representations that may be required in such circumstances). But see Rev. Proc. 2003-48, 2003-2 C.B. 86 (removing appendix C of Rev. Proc. 96-30 in response to the Service's decision not to issue private letter rulings that determine whether a divisive D reorganization is being carried out for a corporate business purpose).

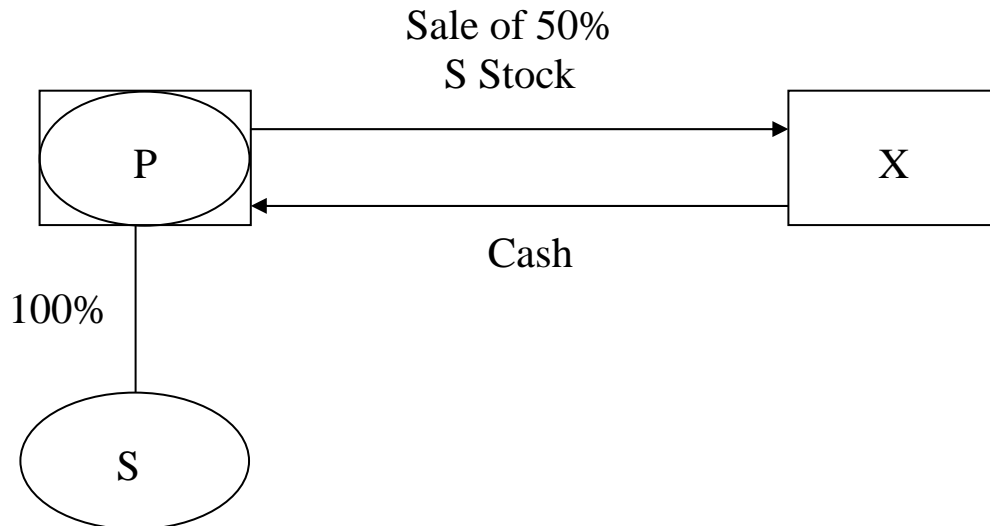
2. An election by C to be taxed as an S corporation will have several effects.
 - a. C generally will be required to adopt a calendar year.
 - b. C may be subject to Section 1374. C also may be subject to LIFO recapture under Section 1363(d).
 - c. The existence of C corporation E&P will cause the restrictions on passive investment income to apply. See Sections 1362(d)(3), 1375.

Acquisition of Existing C Corporation Accelerating the Benefits of an S Election (Section VIII.B.3.)



1. Investors form HC on April 1, 2001.
2. On April 15, 2001, HC purchases the stock of T, a calendar year C corporation.
3. HC then merges T into itself.
4. Since HC is newly formed, it may terminate its year by closing its books on April 30, 2001. An S election may be made for the next short period May 1 through December 31, 2001.

Sale of Portion of QSub Stock (Section III.H.4.)



Facts:

Corporation P, an S corporation, owns all of the outstanding stock of S, a corporation for which a QSub election has been made. The aggregate fair market value of S's assets is \$100, and their aggregate adjusted basis is \$50. P sells 50 percent of its S stock to X corporation, an unrelated party, for \$50 cash.

Tax Consequences:

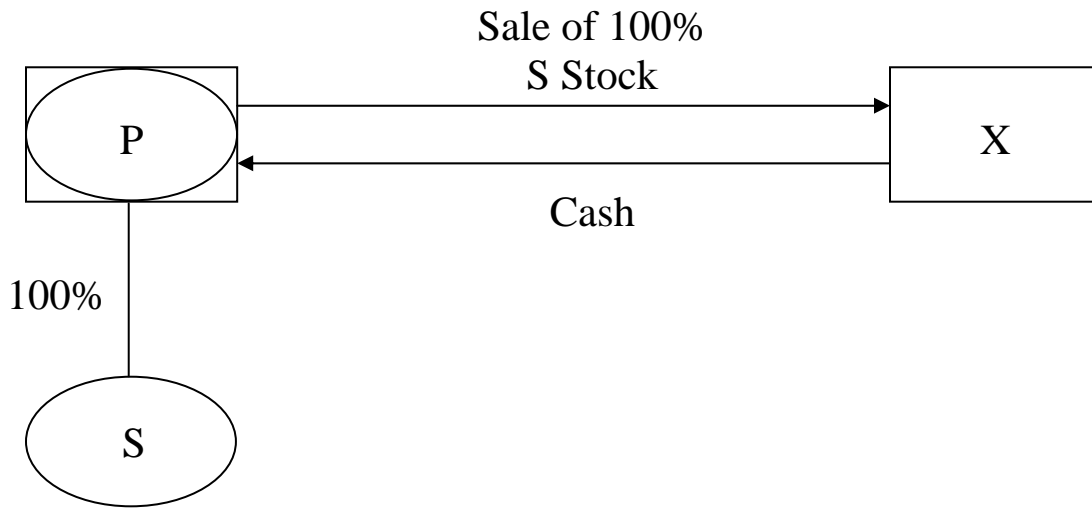
1. Under Section 1361(b)(3) and the QSub regulations, a QSub is not treated as a separate corporation, and all assets and liabilities of the QSub are treated as assets and liabilities of its parent corporation. See Treas. Reg. § 1.1361-4(a)(1). Upon the sale by P of any of its S stock, S ceases to be a QSub, and, for sale occurring in taxable years beginning on or before December 31, 2006, P is treated as if it transferred the S assets and liabilities to a newly formed corporation (new S), and then sold the new S stock to X. See Section 1361(b)(3)(c)(ii); Treas. Reg. § 1.1361-5(b).
2. The tax treatment of this deemed exchange will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. See Treas. Reg. § 1.1361-5(b)(1)(i). For sales occurring in taxable years beginning on or before December 31, 2006, when more than 20 percent of the S stock is being sold, the deemed exchange should not qualify as a Section 351 exchange, because P will not be in "control" of new S within the meaning of Section 368(c). See Section 1361(b)(3)(c)(ii); Treas. Reg. § 1.1361-5(b)(3) ex. 1; see also Rev. Rul. 70-140, 1970-1 C.B. 73.
3. Thus, P must recognize all of the gain attributable to the S assets (\$50), even though it only sold one-half of S's stock. See Treas. Reg. § 1.1361-5(b)(3) ex. 1; Section 1239. If P had

incurred a loss upon the constructive transfer of assets to new S, such loss would have been subject to the limitations of Section 267. See Treas. Reg. § 1.1361-5(b)(3) ex. 1.

4. For a sale of stock of a QSub occurring in taxable years beginning after December 31, 2006, where such sale results in the termination of the QSub election, the sale is treated (for all purposes of the Code) as a sale of an undivided interest in the assets of the QSub (based on the percentage of stock sold) followed by an acquisition by a new corporation of all of the QSub assets and liabilities in a transaction to which Section 351 applies. Section 1361(b)(3)(C)(ii); see also Section 8234 of the Iraq Act of 2007.

Accordingly, in the example above where P sells 50 percent of the stock of S to X, such sale will now be treated as follows: (i) a sale by P to X of a 50 percent interest in all of the assets of S, (ii) followed by an acquisition by a new corporation of all of the S assets and liabilities in a transaction to which Section 351 applies. Accordingly, P now will recognize gain or loss associated with the sale of only 50 percent of each S asset (rather than 100 percent of each S asset).

Sale of All of QSub Stock (Section III.H.4.)



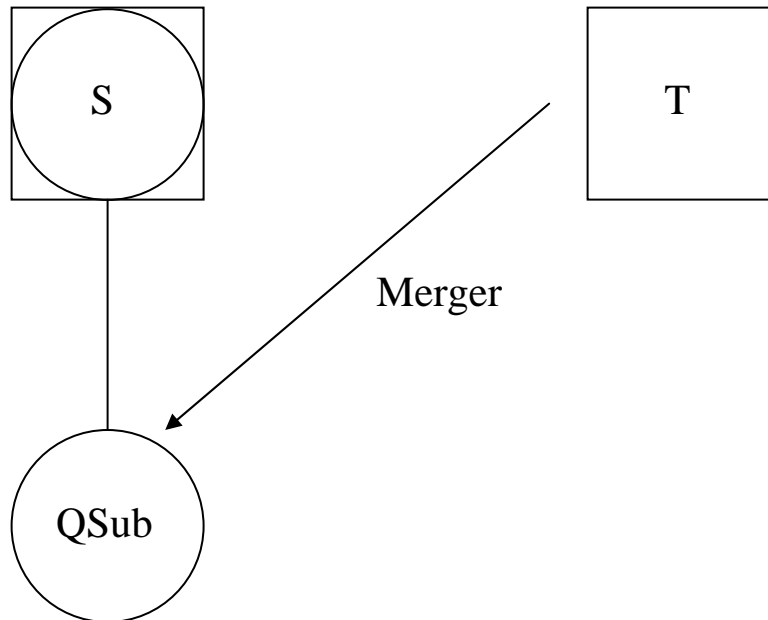
Facts:

Same facts as above, except P sells 100 percent of its S stock to X for \$100 cash.

Tax Consequences:

1. As noted in the previous example, under the general rule provided in the QSub regulations, upon the sale by P of any of its S stock, S ceases to be a QSub, and P is treated as if it transferred the S assets and liabilities to a newly formed corporation (new S), and then sold the new S stock to X. See Treas. Reg. § 1.1361-5(b)(1).
2. However, the QSub regulations provide that if 100 percent of the stock of a QSub is sold to an unrelated corporation, the deemed formation of a new corporation (as a consequence of the termination of the QSub election) is disregarded for federal income tax purposes. The transaction is treated as a transfer of the S assets by P to X, followed by X's transfer of those assets to the capital of a new C corporation subsidiary in exchange for its stock. See Treas. Reg. § 1.1361-5(b)(3) ex. 9.
3. P will have \$50 of gain on the deemed sale of the S assets.

Merger of Target Corporation into QSub (Section III.H.5.)



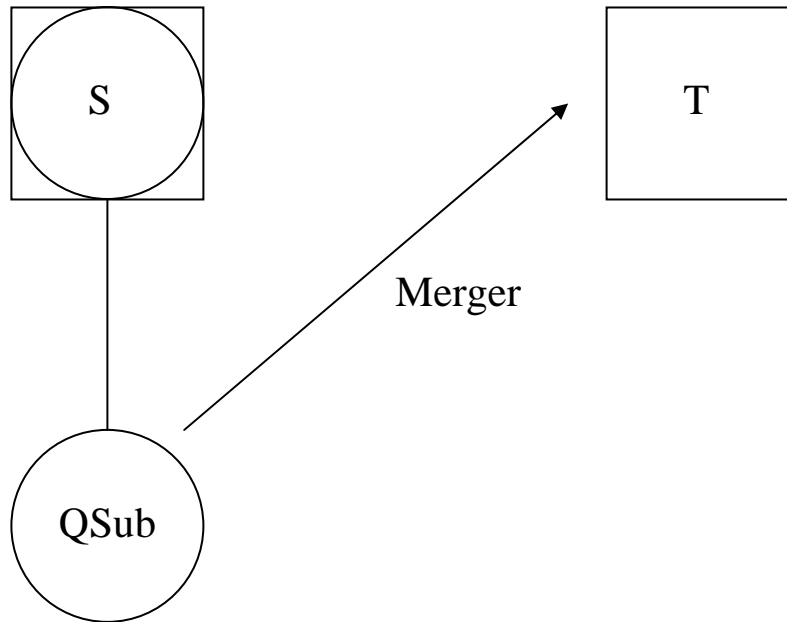
Facts:

S owns a QSub. T corporation, which is a domestic entity, merges into S's QSub. In the merger, T's shareholders receive only S voting stock.

Tax Consequences:

Pursuant to Treas. Reg. § 1.368-2(b)(1), S, T, QSub, and T shareholders may treat the merger as a transaction to which Section 368(a)(1)(A) applies. See Treas. Reg. § 1.368-2(b)(1)(iv) ex. 2. The result would be the same if T owned a disregarded entity and the disregarded entity's assets and liabilities were treated as assets and liabilities of S immediately after the merger (e.g., if the disregarded entity became a QSub). Id.

Merger of QSub into Target Corporation (Section III.H.5.)



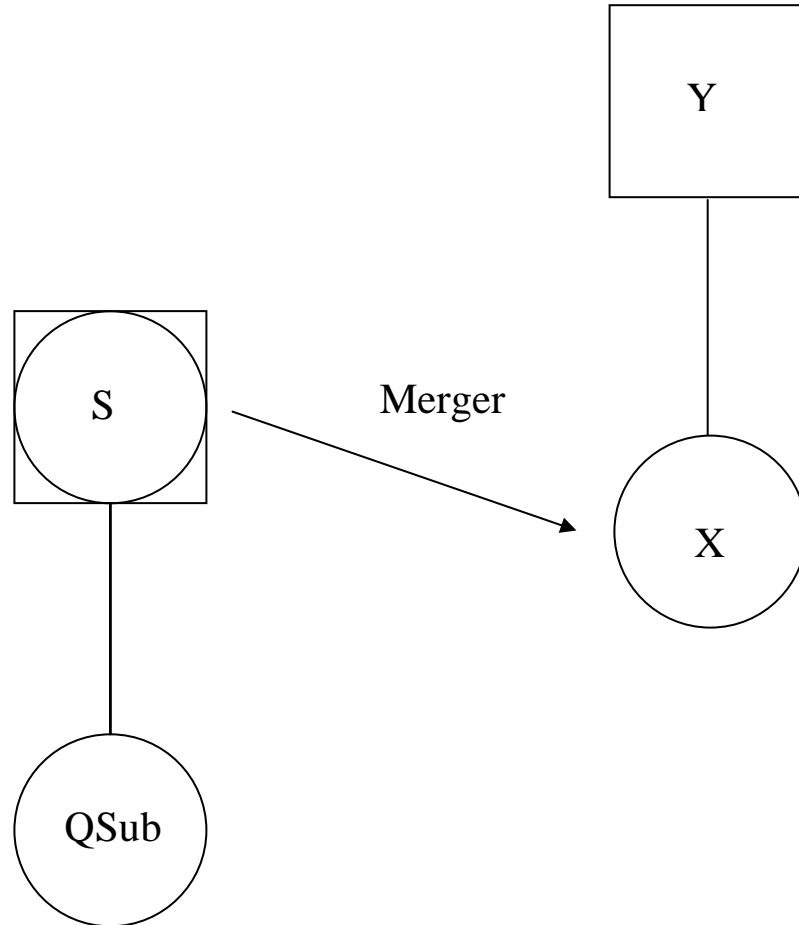
Facts:

S owns a QSub. QSub merges into T. In the merger, S receives only T voting stock.

Tax Consequences:

Pursuant to Treas. Reg. § 1.368-2(b)(1), S, T, and QSub cannot treat the merger as a transaction to which Section 368(a)(1)(A) applies. See Treas. Reg. § 1.368-2(b)(1)(iv) ex. 6. Instead, the merger is treated as a taxable sale of QSub's assets by S to T.

Merger of Target S Corporation That Owns a QSub into Disregarded Entity (Section III.H.5.)



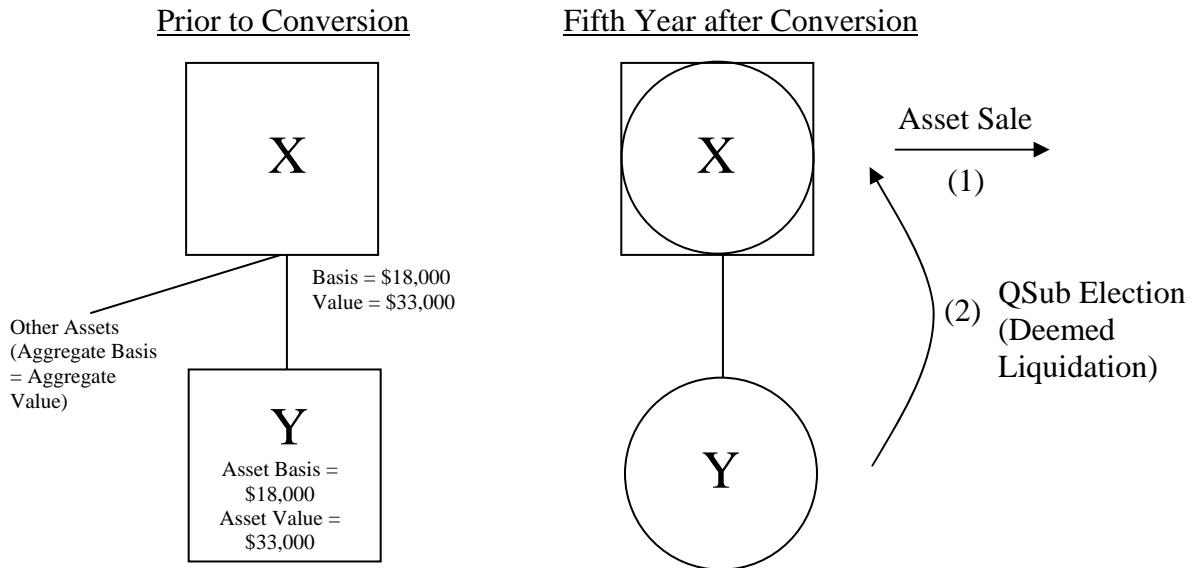
Facts:

S owns a QSub. Y corporation owns a disregarded entity, X (e.g., a wholly owned limited liability company). All entities are domestic. S merges into X. In the merger, the shareholders of S receive only Y voting stock.

Tax Consequences:

Treas. Reg. § 1.1361-5(b)(1)(i) generally would treat S as transferring its QSub's assets to a wholly owned C corporation subsidiary in exchange for stock immediately prior to the merger. Nevertheless, Treas. Reg. § 1.368-2 treats S as transferring the assets of its QSub to Y, and then treats Y as contributing those assets to a new C corporation subsidiary in exchange for stock. See Treas. Reg. § 1.1361-5(b)(3) ex. 9. Thus, pursuant to Treas. Reg. § 1.368-2(b)(1), the merger can be a transaction to which Section 368(a)(1)(A) applies. See Treas. Reg. § 1.368-2(b)(1)(iv) ex. 3.

Adjustment to NUBIG for Built-In Gain in Eliminated C Corporation Stock (Section IV.A.6.b.)



Facts:

X is a C corporation that wholly owns another C corporation, Y. X decides to convert to an S corporation and to preserve Y as a wholly owned corporate subsidiary. On the effective date of X's S election, X has a NUBIG ("Original NUBIG") of \$15,000. Among the assets held by X on such date is all of Y's stock, which has a fair market value of \$33,000 and an adjusted basis of \$18,000. Y owns one asset -- a parcel of real estate -- with a fair market value of \$33,000 and an adjusted basis of \$18,000.

On March 1 of the fifth year after X's conversion to an S corporation, X sells an asset that it owned on the date of conversion and, as a result, recognizes \$15,000 of RBIG. Effective June 1 of the same year, X elects under Section 1361 to treat Y as a QSub. The election is treated as a transfer of Y's assets and liabilities to X in a liquidation to which Sections 332 and 337(a) apply. See Treas. Reg. § 1.1361-4(a). Assume for such year that X has no other RBIG or RBIL, and its taxable income limitation under Section 1374(d)(2)(A)(ii) is \$50,000.

Tax Consequences -- Prior Rules:

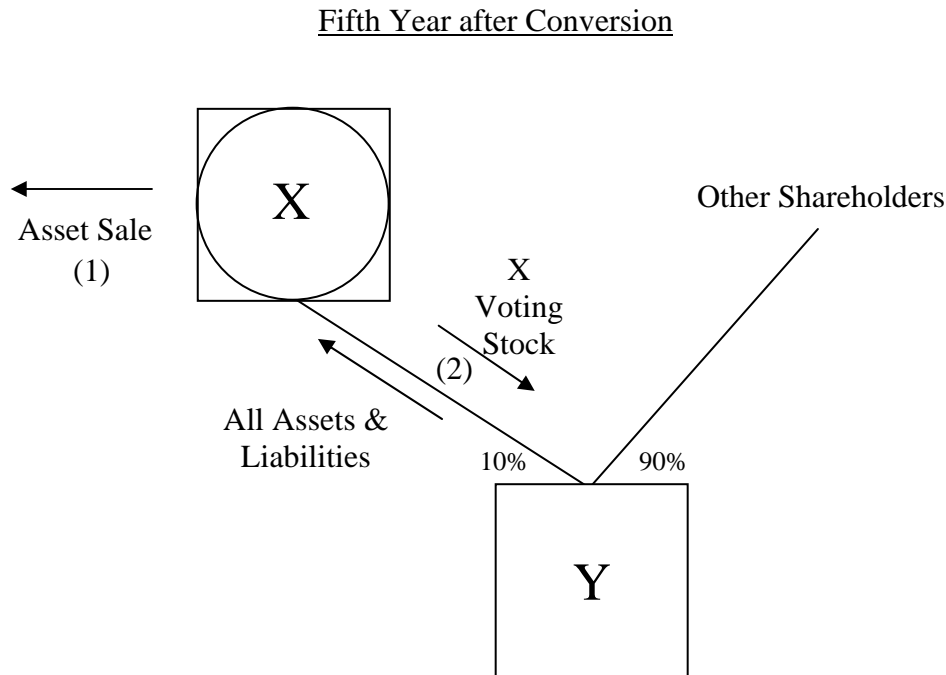
It appeared that the RBIG of \$15,000 would be subject to tax under Section 1374, because X's Original NUBIG presumably remained \$15,000. See Section 1374(b)(1), (c)(2), (d)(1)-(3). Further, with respect to the real estate, X had a separate net unrealized built-in gain ("Liquidation NUBIG") equal to \$15,000 and a separate ten-year recognition period, which started upon Y's liquidation pursuant to Section 1374(d)(8). Thus, X's Original NUBIG and Liquidation NUBIG reflected the same \$15,000 of built-in gain in the real estate, which may have caused a duplication of Section 1374 tax. Accordingly, if Y sold the real estate within ten years of the liquidation and recognized \$15,000 of gain on the sale, such gain would also have been taxed under Section 1374. In effect, a total of \$30,000 of gain would have been taxed under Section 1374.

Adjustment to NUBIG for Built-In Gain in Eliminated C Corporation Stock (Section IV.A.6.b.) (Continued)

Tax Consequences -- New Regulations:

Recently issued regulations eliminate this duplication of built-in gain. Under Treas. Reg. § 1.1374-3(b)(1), X's Original NUBIG is adjusted to account for the elimination of the Y stock in the liquidation, thereby removing the duplication of built-in gain among X's Original NUBIG and Liquidation NUBIG. X's Original NUBIG is decreased by \$15,000 to \$0 in the taxable year of the liquidation. Accordingly, the \$15,000 of RBIG previously recognized in the same taxable year (or in later taxable years) is no longer subject to tax under Section 1374. See Section 1374(b)(1), (c)(2), (d)(2); Treas. Reg. § 1.1374-3(c) ex. 2. However, Section 1374(d)(8) will continue to apply to Y's real estate. Thus, if Y sells the real estate within ten years of the liquidation and recognizes \$15,000 of gain on the sale, such gain will be taxed under Section 1374.

Adjustment to NUBIG for Built-In Loss in Eliminated C Corporation Stock (Section IV.A.6.b.)



Facts:

X is a C corporation that owns 10 percent of the outstanding stock of another C corporation, Y. X decides to convert to an S corporation. On the effective date of X's S election, X's aggregate basis in its assets exceeds the aggregate fair market value of such assets by \$5,000. The Y stock owned by X has a fair market value of \$18,000 and an adjusted basis of \$33,000.

On March 1 of the fifth year after X's conversion to an S corporation, X sells an asset that it owned on the date of conversion and, as a result, recognizes \$8,000 of RBIG. Effective June 1 of the same year, in a transaction that meets the definition of a reorganization in Section 368(a)(1)(C), Y transfers all of its assets and liabilities to X in exchange for voting stock of X, and Y then liquidates. Assume for such year that X has no other RBIG or RBIL, and its taxable income limitation under Section 1374(d)(2)(A)(ii) is \$50,000.

Tax Consequences -- Prior Rules:

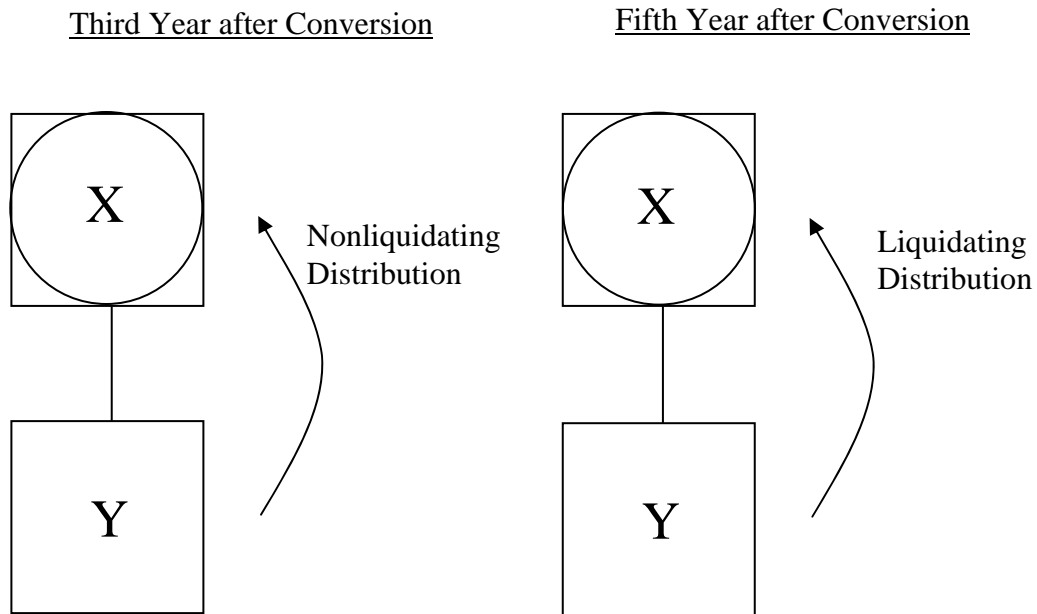
It appeared that the RBIG of \$8,000 was not subject to tax under Section 1374, because X's NUBIG was zero (or possibly negative under a literal reading of the regulations). See Section 1374(c)(2); Treas. Reg. § 1.1374-3(a).

Adjustment to NUBIG for Built-In Loss in Eliminated C Corporation Stock (Section IV.A.6.b.) (Continued)

Tax Consequences -- New Regulations:

Pursuant to recently issued regulations, X's NUBIG on the date of conversion is equal to negative \$5,000. See Treas. Reg. § 1.1374-3(c) ex. 3. In the fifth year after X's conversion to an S corporation, X's NUBIG will be increased by \$15,000 (from negative \$5,000 to \$10,000) to account for the elimination of the Y stock in the reorganization. See Treas. Reg. § 1.1374-3(b)(1). Accordingly, the \$8,000 of RBIG previously recognized in the same taxable year will become subject to tax under Section 1374. See Section 1374(b)(1), (c)(2), (d)(2); Treas. Reg. § 1.1374-3(c) ex. 3.

Adjustment to NUBIG for Built-In Gain in Eliminated C Corporation Stock - Exception for Prior Gain Recognition (Section IV.A.6.b.)



Facts:

X is a C corporation that wholly owns another C corporation, Y. X decides to convert to an S corporation. On the effective date of X's S election, X has a NUBIG of \$30,000. Among the assets held by X on such date is all the outstanding stock of Y, which has a fair market value of \$45,000 and an adjusted basis of \$10,000. Y has no current or accumulated earnings and profits.

On April 1 of the third year after X's conversion to an S corporation, Y distributes \$18,000 to X, \$8,000 of which is treated as gain to X from the sale or exchange of property under Section 301(c)(3). That \$8,000 gain constitutes RBIG under Section 1374(d)(3), and it results in \$8,000 of NRBIG taxable to X in such third year. Effective June 1 of the fifth year after X's conversion to an S corporation, Y transfers all of its assets and liabilities to X in a liquidation to which Sections 332 and 337(a) apply.

Tax Consequences - Prior Rules:

It appeared that neither the nonliquidating distribution nor the liquidating distribution would have reduced X's NUBIG, thereby creating the potential for the duplication of built-in gain subject to Section 1374. See, e.g., *supra* p. 28.

Adjustment to NUBIG for Built-In Gain in Eliminated C Corporation Stock - Exception for Prior Gain Recognition (Section IV.A.6.b.) (Continued)

Tax Consequences -- New Regulations:

Recently issued regulations help to alleviate this problem. Under Treas. Reg. § 1.1374-3(b)(1), X's NUBIG is reduced (presumably to negative \$5,000) to account for the elimination of the Y stock in the liquidation (\$30,000 NUBIG less \$35,000 built-in gain in Y stock). Cf. Treas. Reg. § 1.1374-3(c) ex. 3. However, under Treas. Reg. § 1.1374-3(b)(2)(i), the amount of the decrease to X's NUBIG is limited to the amount of built-in gain X had in the Y stock on the date of conversion that has not resulted in RBIG during the recognition period. Since X recognized earlier in the recognition period \$8,000 of the built-in gain it had in the Y stock at conversion, the amount of the decrease to X's NUBIG is reduced from \$35,000 to \$27,000. Therefore, as a result of the liquidation of Y, X's NUBIG is decreased from \$30,000 to \$3,000, and X's NUBIG limitation as of the fifth year after X's conversion to an S corporation is decreased from \$22,000 to \$0. See Section 1374(c)(2); Treas. Reg. § 1.1374-3(c) ex. 4. The tax consequences under Section 1374 of the Section 301(c)(3) distribution in the third year after X's conversion to an S corporation are not affected by the liquidation of Y.