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USING S CORPORATIONS AS ACQUISITION VEHICLES

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PART ONE: INTRODUCTION

ACQUISITIONS AND DISPOSITIONS INVOLVING S CORPORATIONS

PART TWO

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PART ONE: INTRODUCTION

I. INTRODUCTION

This Outline considers various methods in which S corporations can be used to acquire and hold active businesses. PART ONE contains introductory material. PART TWO addresses the use of S corporations as acquisition vehicles.

II. RECENT LEGISLATION AFFECTING THE USE OF S CORPORATIONS

The Internal Revenue Code of 1986, as amended, (the "Code"), as introduced by the Tax Reform Act of 1986 (P.L. No. 99-514, 99th Cong., 2d. Sess. 1986) (hereinafter, the "1986 Act" or "TRA '86"), discourages the use of C corporations as a means of acquiring and holding active businesses. Instead, the Code encourages the use of S corporations (as well as partnerships and other pass-through entities) as the new means of acquiring and holding active businesses. As indicated below, the bias toward S corporations created by the 1986 Act was initially mitigated to a certain extent by the enactment of the Omnibus Budget Reconciliation Act of 1993 (P.L. No. 103-66, 103rd Cong., 1st Sess., 1993) (hereinafter, the "1993 Act"). However, the Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836, 107th Cong., 1st Sess., 2001) (hereinafter, the "2001 Act") will almost restore the original bias toward S corporations created by the 1986 Act. Thus, it still remains more expensive to operate an active trade or business in a C corporation than in almost any other form of business entity.

A. Factors That Encourage the Use of S Corporations

1. Noncorporate Rate Compared to the Corporate Rate

a. The 1986 Act reversed the historical relationship between corporate and noncorporate tax rates. For the first time since 1913, the top corporate rate of 34 percent exceeded the current 31 percent rate generally applicable to noncorporate taxpayers.

b. The 1993 Act once again reversed this relationship (with the maximum individual income tax rate of 39.6 percent after taking into account the surtax on high-income taxpayers exceeding the maximum corporate income tax rate of 35 percent). The spread, however, between the noncorporate rate and the corporate rate was not as great as in the past.

c. The 2001 Act will gradually eliminate the spread between the top noncorporate rate and the corporate rate over five years. In tax years starting in 2006, the top noncorporate rate will equal the corporate rate, i.e. the top noncorporate rate will be 35% in 2006.

2. The Capital Gains Preference

a. Currently, the net capital gain of a corporation is taxed at the same rate as ordinary income, and is subject to tax at graduated rates up to 35 percent. Section 1201(a)[1]. The maximum capital gains tax rate for individual investors is 20 percent for investments held for one year or longer. Section 1(h). Gain from the sale of collectibles, certain small business stocks, and from the sale of real estate attributable to straight-line depreciation continue to be taxed at the 28 percent rate. Id.

b. Legislative history

(i) The 1986 Act repealed the capital gains preference. However, with the enactment of the 1993 Act, long term capital gains became taxable at a significantly lower rate (28 percent) than ordinary income (39.6 percent). Although the capital gains repeal was not confined to C corporations, C corporations and their shareholders were affected by this change because of the concurrent repeal of General Utilities discussed below.

(ii) The Taxpayer Relief Act of 1997, P.L. No. 105-34 ("TRA '97"), reduced the capital gains tax rate for individuals (the maximum tax rate becoming 20 percent) for capital assets held for more than eighteen months. The maximum 28 percent rate continued to apply for capital assets held for more than one year but not more than eighteen months. TRA '97 further reduced the capital gains tax rates for individuals for capital assets held more than five years, although this reduction takes effect in taxable years beginning after December 31, 2000. Finally, TRA '97 authorized the Internal Revenue Service (the "Service") to issue regulations (including regulations requiring reporting) for sales and exchanges of capital gain assets subject to the reduced tax rates in the case of sales and exchanges by pass-through entities (including S corporations) and of interests in such entities.

(a) The Service issued final regulations regarding the sale and exchange of interests in pass-through entities on September 20, 2000, which are effective for transfers of interests in partnerships, S

[1] This Outline generally uses "Section" to refer to provisions of the Code and to portions of this Outline, and uses "section" to refer to provisions of Public Laws and legislation.

corporations, and trusts occurring on or after September 21, 2000. Treas. Reg. § 1.1(h)-1.

(b) The regulations state, "When stock in an S corporation held for more than one year is sold or exchanged, the transferor may recognize ordinary income (e.g., under sections 304, 306, 341, 1254), collectibles gain, and residual long-term capital gain or loss." Treas. Reg. § 1.1(h)-1(a). Generally, the regulations require a selling S shareholder to apply the 28% capital gains rate to the portion of the capital gain recognized on the sale or exchange of S stock allocable to certain collectibles owned by the S corporation or deemed to be owned by the S corporation through the operation of a special tiered entity rule. Treas. Reg. § 1.1(h)-1(b), -1(d). The operation of the rules in these regulations could convert a small, long-term capital gain on the sale of S stock into a long-term capital loss and a long-term capital gain attributable to the deemed sale of certain collectibles. See Treas. Reg. § 1.1(h)-1(f), ex. 4.

(iii) In the summer of 1998, the Congress approved the Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act"), P.L. 105-206, which eliminated the eighteen month holding period. Now, individuals must hold an asset for only twelve months in order to qualify for the 20 percent capital gains tax rate.

3. Repeal of the "General Utilities" Doctrine

Perhaps the most significant change to arise from the 1986 Act was the repeal of the General Utilities doctrine.

a. Any liquidating sale or distribution of corporate assets triggers the corporate tax on all of the inside appreciation of such assets, not just the recapture items. In addition, the same appreciation is taxable to the corporation's shareholders (to the extent reflected in stock appreciation). Thus, any appreciation in the corporation's assets could be taxed at up to a 48 percent combined tax rate (i.e., 35 percent in the corporation, plus 20 percent to the noncorporate distributee), instead of the 20 percent rate applicable to noncorporate taxpayers.

b. A transitional rule was provided for long term capital gain realized by certain small, closely-held corporations liquidated before 1989. See P.L. 99-514, section 633(d).

4. The Alternative Minimum Tax

a. The 1986 Act greatly increased the burden of the alternative minimum tax ("AMT"). While the reach of the AMT has been significantly expanded with respect to both individuals and C corporations, C corporations were saddled with a greater portion of the increased burden. For example, the adjusted current earnings ("ACE") adjustment is imposed only on C corporations, not on partnerships or S corporations.

b. TRA '97 effectively repealed the corporate AMT for small business corporations (generally, C corporations that meet certain maximum gross receipts requirements). This repeal is effective for tax years beginning after December 31, 1997.

5. Former C Corporations Taxed on Built-In Gain

a. To protect the revenue expected from the repeal of the General Utilities doctrine, the 1986 Act limited the ability of C corporations to elect S corporation status for the purpose of avoiding the corporate level tax on the disposition of their appreciated property.

b. In general, under Section 1374, a corporate level tax is imposed on the S corporation's built-in gains (existing at the effective date of the S election) recognized with respect to any asset during the 10 year period beginning with the first day of the corporation's first taxable year as an S corporation.

c. The Section 1374 tax generally does not apply to corporations that have always been S corporations. Thus, newly-formed corporations may pay a high price if they operate as C corporations, even if only for a short period of time.

d. Section 1374 is discussed in greater detail below in PART TWO.

B. Types of Pass-Through Entities

A great deal of new interest has arisen with respect to the use of S corporations and partnerships to operate new businesses, to hold existing businesses, and to acquire target businesses. Indeed, all types of pass-through entities are being re-examined as potential tools for acquiring and holding income producing activities.

1. In addition to S corporations and partnerships, the Code explicitly recognizes other types of pass-through entities. These include such special purpose pass-through entities as trusts, estates, regulated investment companies ("RICs"), real estate investment trusts ("REITs"), real estate mortgage investment conduits ("REMICs"), financial asset securitization investment trusts ("FASITs"), and cooperatives.

    a. Special purpose pass-through entities are designed to serve specific investment functions.

    b. Most of these entities are allowed to deduct distributions (or deemed distributions) of income. Such deductions help ensure that only one level of tax is paid on income generated within such entities. Losses generally do not pass-through.

    c. Unfortunately, because of certain restrictions placed upon such entities, these special purpose pass-through entities generally appear ill-suited to the conduct of many active trades or businesses and, therefore, for use as acquisition vehicles.

2. The Code also provides – though not expressly – for the existence of what may be thought of as "practical" pass-through entities. These entities are C corporations that shelter essentially all of their income (i.e., sheltered C corporations).

    a. One example of a sheltered C corporation would be a personal service C corporation that pays most of its income to its owner-employees as reasonable compensation. Since such compensation is deductible, this type of corporation would pay little or no corporate level tax. Instead, all the corporation's income is taxed to its shareholder-employee.

    b. A second example is a C corporation that has substituted a large portion of debt for equity in its capital structure. Leveraging as a means of integrating the corporate and shareholder levels of tax (i.e., the "practical" pass-through effect) may offer the greatest flexibility for many C corporations.

        (i) Leveraging can arise from actual cash borrowings.

(a) A corporation can engage in a leveraged buy-out: the borrowed money is used to acquire a target business, the interest due on the debt shelters income used to pay the debt.

(b) Alternatively, the corporation can engage in a leveraged recapitalization: the borrowed money is used to cash-out shareholders.

(ii) Leveraging effects can also be created without cash borrowing. For example, a corporation can distribute its own debt obligations to its shareholders.

c. While sheltering corporate income from double tax has long been the goal of the owners of closely-held C corporations, the benefits of such shelter for larger corporations are now sufficiently great to warrant rethinking the role of the sheltered C corporation. Clearly, the 1986 Act encouraged the use of this pass-through entity as an acquisition vehicle.

3. S corporations, partnerships, single-member limited liability companies ("LLCs") and sheltered C corporations appear to be the most viable types of pass-through entities for purposes of acquiring and conducting an active trade or business. Although the use of partnerships, single-member LLCs and C corporations as acquisition vehicles is beyond the scope of this Outline, the use of S corporations as an acquisition vehicle will be covered in detail.

C. Taxpayers' Reaction to the '86 Act

Taxpayers responded quickly to the Code's new anti-C corporation bias. During the final weeks of 1986, 200,000 C corporations made S elections. In the first two weeks of 1987 there were approximately 220,000 S corporation filings, compared to 70,000 in all of 1985. See Leonard, A Pragmatic View of Corporate Integration, 35 Tax Notes 889, 895-896 (June 1, 1987); see also, Brooks, A Proposal to Avert the Revenue Loss from Disincorporation, 36 Tax Notes 425 (July 27, 1987). In 1986, a total of 826,214 corporate income tax returns were filed by S corporations. In 1987, the total increased to 1,127,905. Of the 301,691 increase in the number of 1120S returns for 1987, nearly 43 percent was attributable to regular corporations that converted to S Corporation status. IRS Statistics of Income Bulletin, p. 85 (Fall 1990). In 1988, the total number of 1120S returns increased to 1,257,191. Not surprisingly, for the same year, the total number of returns filed by C corporations dropped for the first time since the end of World War II. IRS Statistics of Income Bulletin, p. 47 (Fall 1991).

D. Congress Responds to the Taxpayers

1. The Omnibus Budget Reconciliation Act of 1987, P.L. 100-203 (hereinafter "OBRA '87"), amended a number of provisions that apply to S corporation shareholders.

2. The Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647 (hereinafter "TAMRA"), in large part, provided technical corrections to the 1986 Act and other recently enacted tax legislation. See also Staff, Joint Comm. on Taxation, Description of the Technical Corrections Act of 1988 (1988) (hereinafter "TCA 88 Gen. Expl.").

3. The Revenue Reconciliation Act of 1989, P.L. 101-239 (hereinafter "RRA '89"), made a number of minor modifications to the rules affecting S corporations.

4. The Omnibus Budget Reconciliation Act of 1990, P.L. 101-508 (hereinafter "OBRA '90"), increased the maximum tax rate on individuals from 28 percent to 31 percent, though the maximum tax rate on capital gains remained at 28 percent.

5. As previously noted, the 1993 Act included a number of changes that, although not directly involving subchapter S of the Code, will nevertheless affect S corporations and their shareholders.

6. As discussed below, the Small Business Job Protection Act of 1996, P.L. 104-188 (hereinafter the "1996 Small Business Act"), contains numerous and significant changes to the Code's S corporation provisions that should make the use of S corporations even more popular.

7. Also as discussed below, TRA '97 made additional changes to the rules affecting S corporations.

8. The Community Renewal Tax Relief Act of 2000 (P.L. 106-554, 106th Cong., 2nd Sess., Dec. 21, 2000) (hereinafter the "Renewal Act of 2000") expanded the type of permitted beneficiaries of an electing small business trust.

9. The Installment Tax Correction Act of 2000 (P.L. 106-573, 106th Cong., 2nd Sess., Dec. 28, 2000) (hereinafter the "Installment Act of 2000") retroactively repealed the repeal of the installment sale method for accrual method taxpayers. As a result, the installment sale method applies to accrual method taxpayers as if it was never repealed.

10. As previously noted, the 2001 Act provided gradual tax rate reductions for noncorporate taxpayers. Lower noncorporate tax rates make S corporations and their pass-through tax regime more attractive.

E. American Bar Association ("ABA") Tax Section Task Force

1. In 1991, the ABA Tax Section Task Force on Taxable and Tax-Free Acquisitions Involving S Corporations prepared a Report on Taxable and Tax-free acquisitions involving S corporations ("Task Force Report"), reprinted in 45 Tax Lawyer 435 (1992).

2. The Task Force Report includes a number of recommendations pertaining to the use of S corporations in the acquisition context, which are discussed in detail in PART TWO of this outline.

III. COMPARISON OF S CORPORATIONS WITH C CORPORATIONS AND PARTNERSHIPS AS ACQUISITION VEHICLES

S corporations have advantages and disadvantages which may encourage or discourage their use as an acquisition vehicle. In many cases, the choice of entity will depend on the individual preferences of each taxpayer and his advisor. Some, but not all, of these advantages are outlined below.

A. Advantages

1. Compared with C Corporations

S corporations offer many of the advantages of partnerships, but within a corporate framework.

a. S corporations pass-through separately stated items of income, loss, deduction or credit and nonseparately stated income or loss to the shareholders. Thus, in general, only a single tax is imposed on

S corporation income and the single tax is determined under noncorporate tax rates.

b. S corporation shareholders may withdraw earnings with greater ease.

c. S corporations are not subject to the accumulated earnings tax or the personal holding company tax.

d. S corporations are not subject to the corporate alternative minimum tax. However, TRA '97 effectively extends this benefit to small business corporations (generally, small C corporations that meet certain maximum gross receipts requirements), effective for taxable years beginning after December 31, 1997.

e. S corporations may also use the cash method of accounting (unless the entity is viewed as a "tax shelter").

f. S corporations may generate passive income, which can be used by shareholders to offset their passive losses under Section 469.

g. Former C corporations, now S corporations, that incurred a passive activity loss carryover in a C year may dispose of their entire interest in the passive activity during an S year and, thus, trigger a flow-through passive activity loss deductible against passive and ordinary income of the shareholder. See St. Charles Investment Co. v. Comm'r, 232 F.3d 773 (10th Cir. 2000).

h. Unlike certain closely-held C corporations, the at risk rules of Section 465 do not apply at the entity level.

i. S corporations generally can avoid reasonable compensation issues as to shareholder salaries, and can generally avoid the golden parachute rules under Section 280G.

j. Like C corporations, S corporations generally may issue incentive stock options and non-qualified stock options as long as they are not "deep in the money."

2. Compared with Partnerships

a. Like partnerships, S corporations offer pass-through treatment for most income items. They also offer:

(i) Certainty of entity classification (i.e., partnership vs. corporation), although similar certainty is largely provided to partnerships under the "check-the-box" entity classification regulations. See Treas. Reg. § 301.7701-3;

(ii) Limited liability and continuity of life; and

(iii) Ease of disposition (stock is probably easier to sell than a partnership interest).

b. S corporation shareholders do not receive deemed distributions upon reduction in corporate liabilities, as is the case with partners.

c. No constructive termination exists if 50 percent or more of the stock of an S corporation is sold, distributed, or exchanged within a 12 month period.

d. Distributions of property result in fair market value basis (although gain is recognized at the corporate level and passed through to shareholders).

e. S corporations may take advantage of the reorganization provisions of the Code.

f. Capital gain from the sale or exchange of S corporation stock and from the distribution of property or money to a shareholder is not partially recharacterized as ordinary income when the S corporation owns unrealized receivables and inventory items.

g. Unlike partnerships, the determination of whether cancellation of indebtedness income ("COD income") may be excluded from gross income is made at the entity level under Section 108. Unlike partners in a partnership, the tax attributes of an S corporation shareholder are not relevant for purposes of applying Section 108 to an S corporation's COD income. Thus, COD income of an insolvent S corporation, which is excludable from gross income under Section 108, flows through to shareholders untaxed and increases their bases in S stock. The increase in stock basis enables shareholders to utilize previously suspended S corporation losses and deductions.

B. Disadvantages

1. S corporations are subject to strict eligibility requirements that can hinder financing ability and structural flexibility. For example, S corporations are limited both in the number and type of permissible shareholders, and may not have more than one class of stock. These restrictions may limit the S corporation's ability to raise capital.

2. In contrast to partnerships, special allocations of income or loss are generally not permitted.

3. S corporations cannot create outside stock basis by incurring inside debt.

4. A general partner may increase the basis in its partnership interest when the partnership borrows from third parties. However, an S corporation shareholder generally cannot increase its stock basis when the S corporation borrows from third parties.

5. Gain on appreciated S corporation assets is locked inside the corporation. Gain will be recognized when assets are distributed or sold. In addition, S corporations may be subject to a corporate level tax under Sections 1374 and 1375.

6. Excessive net passive income may trigger a corporate level tax under Section 1375 and may terminate a corporation's S election.

7. A corporation using the LIFO method of accounting may be required under Section 1363(d) to recapture LIFO benefits upon conversion to S status.

8. S corporations may be subject to state income and franchise taxes.

9. Most S corporations will be required to use a calendar year unless an election under Section 444 is made.

10. In contrast to C corporations, debt held by S corporations does not automatically qualify for business debt classification for purposes of the bad debt deduction under Section 166. Thus, the S corporation's bad debt deductions might only generate short term capital losses, instead of ordinary losses. Furthermore, S corporations may not be able to claim a bad debt deduction when the underlying debt is only partially worthless.

IV. SUMMARY OF OTHER RELEVANT PROVISIONS

The following Section of this PART ONE contains a brief description of some of the various Code provisions relevant to the use of S corporations in acquisitions. The discussion herein is intended merely to describe the general outline of each Section.

A. Investment Interest Deduction Limitation – Section 163(d)

1. Noncorporate taxpayers may not deduct investment interest paid or accrued during the taxable year in excess of net investment income for the taxable year. Section 163(d)(1). Any excess carries over to the succeeding taxable year. Section 163(d)(2).

2. Investment interest is any interest otherwise allowable as a deduction for the taxable year which is paid or accrued on indebtedness "properly allocable to" property held for investment (other than qualified residence interest and interest taken into account for purpose of the passive loss limitation). See Section 163(d)(3). See also Treas. Reg. § 1.163-8T(b)(3) and (6).

3. Net investment income is the excess of investment income over investment expenses. Section 163(d)(4)(A). As a result of changes made by the 1993 Act, investment income no longer includes net capital gain attributable to the disposition of the investment property, except to the extent the taxpayer elects to have such gain taxed as ordinary income. See Section 163(d)(4)(B)(iii). Investment expenses means deductions, other than for interest, that are directly connected with the production of investment income. Section 163(d)(4)(C). However, investment income and investment expenses do not include any income or expenses taken into account under Section 469 in computing income or loss from a passive activity. Section 163(d)(4)(D).

B. Acquisitions to Avoid Tax – Section 269

1. If a "person," including a trust, estate, company, partnership, or corporation, acquires 50 percent or more of the stock (by voting power or value) of a corporation, and the principal purpose for such acquisition was to evade or avoid federal income tax by securing the benefit of an allowance not otherwise available, then the Secretary may disallow or reallocate, wholly or partially, such allowance.

2. If any corporation acquires property of another corporation, not controlled immediately before such acquisition by such acquiring corporation or its stockholders, in a carryover basis transaction, and the principle purpose for such acquisition was to evade or avoid federal income tax by securing the benefit of an allowance not otherwise available, then the Secretary may disallow or reallocate, wholly or partially, such allowance.

   a. An "allowance" is anything in the federal tax law which has the effect of diminishing tax liability. Treas. Reg. § 1.269-1(a).

   b. A purpose is a "principal purpose" if it exceeds in importance any other purpose. Treas. Reg. § 1.269-3(a).

3. Section 269 will apply to a transaction where giving effect to the form of the transaction would distort the tax liability of the taxpayer in light of Congress's original purpose for the particular allowance. Treas. Reg. § 1.269-2(b).

4. Section 269 does not apply to disallow any deduction, credit, or other allowance resulting from a corporation electing S status because enjoyment of these allowances by shareholders of S corporations is consistent with the intent of Congress to allow shareholders of S corporations to be taxed directly on the corporation's earnings and to report corporate income as their own for tax purposes. Rev. Rul. 76-363, 1976-2 C.B. 90.

C. Limitation on the Use of the Cash Method of Accounting – Section 448

1. C corporations, partnerships with C corporation partners, and "tax shelters" (as defined in Section 461(i)(3)) may not use the cash method of accounting.

2. Exceptions are made for:

   a. small businesses (i.e., businesses which meet a $5 million gross receipts test),

   b. certain personal service corporations, and

   c. certain farming businesses.

3. S corporations do not fall within the purview of Section 448 unless they meet the definition of a "tax shelter." See Section 448(d)(3).

D. At Risk Rules – Section 465

1. Certain persons are limited in their ability to deduct amounts not at risk in an activity. These persons are:

   a. individuals (including individual partners and S corporation shareholders), and

   b. closely held C corporations (i.e., C corporations more than 50 percent of the value of which is owned by 5 or fewer individuals at any time during the last half of the taxable year).

2. A taxpayer is at risk in an activity to the extent of the amount of money and the adjusted basis of property contributed to the activity.

3. In addition, a taxpayer is at risk with respect to amounts borrowed for use in an activity, but only if the lender is not a person with an interest in the activity (other than as a creditor), the lender is not related to a person (other than the taxpayer) with an interest in the activity (other than as a creditor), and

   a. the taxpayer is personally liable with respect to the borrowed amounts, or

   b. the taxpayer has pledged property not used in the activity as security for the borrowed amounts (to the extent of the net fair market value of the taxpayer's interest in the property).

4. With respect to the activity of holding real estate, a taxpayer will be considered at risk with respect to certain qualified nonrecourse financing.

5. Losses disallowed in one taxable year because of the at risk limitation are treated as deductions allowable with respect to the same activity in the next taxable year.

6. Query: Does the decision in St. Charles Investment Co. v. Commissioner, 232 F.3d 773 (10th Cir. 2000), provide substantial authority under Section 6662 to a former closely-held C corporation that has previously suspended losses, by operation of the at risk rules, when it passes those losses to its shareholders after electing S status? See discussion at Part One: V. D. below.

7. The at risk rules should be applied after the basis limitation rules, but before the passive activity loss rules.

E. Passive Loss Limitation – Section 469

1. Certain persons are limited in their ability to currently deduct losses from passive activities, including S corporation shareholders. Generally, an S corporation shareholder may deduct losses from all passive activities only to the extent of income from all passive activities. The excess is deemed a "passive activity loss" that is disallowed for the taxable year.

   a. Income from passive activities does not include portfolio income earned by the taxpayer.

   b. Portfolio income generally includes gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business, reduced by non-interest expenses directly allocable to such gross income, and any interest expense properly allocable to such gross income.

   c. The character of each item of gross income and deduction allocated to a taxpayer from an S corporation is determined by reference to the participation of the taxpayer in the activity that generated such item. See Temp. Treas. Reg. § 1.469-2T(e)(1).

2. A "passive activity" is any activity which involves the conduct of any trade or business and in which the taxpayer does not "materially participate" (i.e., is not involved on a regular, continuous, and substantial basis).

   a. Temporary regulations dealing with the passive loss rules provide seven tests for determining material participation in an activity. Under Temp. Treas. Reg. § 1.469-5T(a)(1), an individual who participates in an activity for more than 500 hours during the taxable year will be treated as materially participating.

b. The material participation tests are applied to each shareholder each year.

3. A passive activity loss from one taxable year is treated as a deduction allocable to the same passive activity in the next taxable year. In addition, any passive activity loss that arises in a prior year or the current year is generally deductible when the taxpayer disposes of his/her entire interest in the activity to an unrelated person. See Section 469(g).

a. Under temporary regulations, the character of the gain or loss on the disposition of S corporation stock must be determined by allocating the gain or loss among the S corporation's trade or business, rental, and investment activities. Thus, the gain or loss on S corporation stock is treated as gain or loss from the disposition of interests in which the S corporation has an interest. See Temp. Treas. Reg. § 1.469-2T(e)(3).

b. If all of a taxpayer's stock in an S corporation is sold under the installment sale method, allocable passive activity losses are not fully deductible in the year of sale. Instead, the losses are deductible over the same period that installment gain is recognized.

4. The character of passive and portfolio income earned by an S corporation and items of deduction pass through the corporation to its shareholders.

5. The passive loss restrictions will apply after the basis limitation rules of Section 1366(d) and the at risk rules are applied.

F. Estate Freezes

1. The Repeal of Section 2036(c)

a. Section 2036(c), added to the Code by OBRA '87, imposed the estate tax on the value of property transferred in a typical "estate freeze" transaction by including the value of the transferred interest in the transferor's gross estate for estate tax purposes if:

(i) The transferor held a substantial interest in the enterprise, and such person,

(ii) "In effect," transfers after December 17, 1987, a disproportionately large share of the potential appreciation in that interest to another person and retains a disproportionately large share of the income, or rights in, the enterprise.

b. However, Section 2036(c) also created a number of problems, chiefly because of the broad scope and the vagueness of the statute.

c. As a result, in OBRA ’90, Congress repealed Section 2036(c) effective for transfers after December 17, 1987 and adopted Sections 2701-2704, which are more narrowly drafted to minimize the potential abuses of estate freeze transactions.

2. Sections 2701-2704

a. Sections 2701-2704 are intended to assure that the parties to a transfer of an interest in a corporation or partnership more accurately value the interest being transferred for gift tax purposes.

b. The new estate freeze rules include:

(i) Special valuation rules in the case of transfers of certain interests in corporations or partnerships (Section 2701);

(ii) Special valuation rules in the case of transfers of interests in trusts (Section 2702);

(iii) Rules concerning the valuation of certain rights and restrictions (Section 2703); and

(iv) Rules concerning the treatment of certain lapsing rights and restrictions (Section 2704).

V. RECENT DEVELOPMENTS RELATING TO S CORPORATIONS

A. The Small Business Job Protection Act of 1996

President Clinton signed the 1996 Small Business Act into law in August 1996. It contained many of the provisions included in other legislation that was proposed but not enacted over several years prior to 1996. See The S Corporation Reform Act of 1995, S. 758 and H.R. 2039, 104th Cong.; The Tax Simplification and Technical Corrections Act of 1993, H.R. 3419, 103rd Cong.; and The S Corporation Reform Act of 1993, H.R. 4056, 103rd Cong. The 1996 Small Business Act made numerous changes to the tax treatment of S corporations that are discussed throughout this outline. The changes, which generally became effective for taxable years beginning after December 31, 1996, included the following:

1. Number of Permitted Shareholders

The 1996 Small Business Act increased the number of shareholders an S corporation may have from 35 to 75. Section 1361(b)(1)(A).

2. Authority of the IRS to Validate Certain Invalid Elections

a. The 1996 Small Business Act granted the Service statutory authority to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (or both). Section 1362(f).

b. In addition, the 1996 Small Business Act authorized the Service to treat a late S election as timely where it determines that there was reasonable cause for the failure to make the election timely. The legislative history to this provision states that a standard similar to the one currently set forth in Treas. Reg. § 1.9100-1 should be adopted for this purpose. Section 1362(b)(5).

c. These provisions apply with respect to elections for taxable years beginning after December 31, 1982.

d. The Service subsequently issued Rev. Proc. 97-40, 1997-2 C.B. 488, to provide procedures by which taxpayers can request relief for a late S election. That Revenue Procedure has since been superseded by Rev. Proc. 98-55, 1998-2 C.B. 645. Under Rev. Proc. 98-55, (i) a valid S election must be filed within twelve months of the original due date for the election (but in no event later than the due date for the tax return (excluding extensions) for the first year the corporation intended to be an S corporation) and

(ii) the corporation must have had reasonable cause for failing to make a timely election.

e. Rev. Proc. 98-55 also provides procedures by which taxpayers can request relief for late qualified subchapter S subsidiary ("QSub") elections, qualified subchapter S trust ("QSST") elections, and electing small business trust ("ESBT") elections.

3. Treatment of Distributions by S Corporations During Loss Years

a. As discussed more fully below, the 1996 Small Business Act clarified the S corporation distribution rules so that basis adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. (The loss limitation is discussed below at PART TWO: IV. B.) Thus, distributions during a year reduce the adjusted basis for purposes of determining the allowable loss for the year. Conversely, the loss does not reduce the adjusted basis for purposes of determining the tax status of such distributions. This provision conformed the S corporation rules regarding distributions to the partnership rules.

b. The 1996 Small Business Act also provided that in determining the amount of the accumulated adjustment account for purposes of determining the tax treatment of distributions made by an S corporation having accumulated earnings and profits, net negative adjustments for the year are disregarded. Section 1368(e)(1)(C). (The accumulated adjustment account is discussed below at PART TWO: IV.C.)

4. ESBTs Eligible to Hold the Stock of an S Corporation

a. The 1996 Small Business Act allowed stock in an S corporation to be held by an "electing small business trust" ("ESBT"). Section 1361(e).

b. An ESBT is a trust

(i) whose beneficiaries are all (i) individuals, (ii) estates, (iii) charitable organizations described in Section 170(c)(2)-(5) that hold a contingent remainder interest (although the requirement that such organizations hold only a contingent remainder interest has since been deleted for tax years beginning after December 31, 1997), or (iv) charitable organizations described in Section 170(c)(1) that hold a contingent interest and do not meet the definition of a "potential current beneficiary";

(ii) in which no interest in the trust was acquired by purchase; and

(iii) that made an election to be so treated. Section 1361(e) and section 1302 of the 1996 Small Business Act.

c. The intent of this provision was to facilitate family financial planning by allowing an individual to establish a trust to hold S corporation stock and to "spray" current or accumulated income among the beneficiaries of the trust.

d. TRA '97 clarifies that a charitable remainder annuity trust and a charitable remainder unitrust (as defined in Section 664(d)) cannot be an electing small business trust (effective for taxable years beginning after December 31, 1996). Section 1361(e)(1)(B).

e. The Renewal Act of 2000 provided that a permitted ESBT beneficiary includes a charitable organization described in Section 170(c)(1), such as a state, as long as the charitable organization merely holds a contingent interest in the ESBT and it does not meet the definition of a "potential current beneficiary" of the ESBT. Section 1361(e)(1)(A)(i). This provision is effective for tax years beginning after December 31, 1996.

f. The Service issued Notice 97-49, 1997-2 C.B. 304, to provide guidance on the use of ESBTs. Notice 97-49 is discussed below in PART TWO: Section II.A.4.a.(ix).

g. The Service issued Notice 97-12, 1997-1 C.B. 385, to provide the procedures for making an ESBT election.

h. The Service issued Rev. Proc. 98-23, 1998-1 C.B. 662, to provide procedures for the conversion of a qualified subchapter S trust ("QSST") to an ESBT and vice versa.

i. Finally, the Service issued proposed regulations on December 29, 2000 that covered the ESBT issues previously covered by Notice 97-49, Notice 97-12 and Rev. Proc. 98-23. The preamble to the proposed regulations states that the preceding documents will be superseded on the date final regulations are published. See Prop. Treas. Reg. §§ 1.641(c)-1, 1.1361-1, 1.1362-6, 1.1362-7, 1.1377-1, 1.1377-3, 65 Fed. Reg. 82963, 82966 (Dec. 29, 2000).

5. Treatment of S Corporations as Shareholders in C Corporations

a. The 1996 Small Business Act repealed Section 1371(a)(2), which treated an S corporation in its capacity as a shareholder of another corporation as an individual.

b. Thus, the 1996 Small Business Act made clear that the liquidation of a C corporation into an S corporation is governed by the generally applicable subchapter C rules. Moreover, an S corporation also is eligible to make a Section 338 election (assuming all the requirements are otherwise met).

c. In the 1996 Small Business Act, Congress amended Section 1361 of the Code to allow an S corporation to own 80 percent or more of the stock of a C corporation. Sections 1361 and 1362, and section 1308 of the 1996 Small Business Act.

d. Although an S corporation may now own an 80 percent interest or greater in the stock of a C corporation, the S corporation is still prevented from filing a consolidated return with its C corporation subsidiaries. However, if an S parent owns an 80 percent interest or greater in the stock of a C corporation that, in turn, holds an 80 percent interest or greater in the stock of another C corporation, the two C corporations can elect to file a consolidated return.

e. Issues raised by an S corporation's ownership of a C corporation subsidiary are discussed throughout this Outline. See, e.g., PART TWO: Sections II.B.2.b and III.D (discussing the application of the passive investment income rules).

6. Qualified Subchapter S Subsidiaries

a. Introduction

(i) If an S corporation (the "S parent") owns 100 percent of the stock of a C corporation that would qualify for S status if its stock were held directly by the S parent's shareholders, the S parent may elect to treat such subsidiary as a "qualified subchapter S subsidiary" (a "QSub"). See Section 1361(b)(3)(B).

(ii) When an S corporation makes a valid QSub election, the separate existence of the QSub is ignored and the subsidiary is treated for federal tax purposes as a division of the S corporation. Upon making the QSub election, the subsidiary is considered to have liquidated into the S parent.

(iii) Note, however, that section 1601 of TRA '97 contained a technical correction to the 1996 Small Business Act's QSub rules. That technical correction authorizes the Service to issue regulations providing instances under which a QSub may be treated as a separate corporation. The legislative history to the technical correction specifically states the

expectation that such regulations would treat a bank that has elected QSub treatment as a separate legal entity for purposes of those Code provisions that apply specifically to banks (e.g., Section 582). This technical correction is effective for taxable years beginning after December 31, 1996.

(a) A corporation that elects to be treated as an S corporation may also elect QSub status for certain foreign subsidiaries if the corporation made an election under Section 1504(d) to treat the foreign subsidiaries as domestic corporations. See PLR 200120033.

b. QSub regulations

(i) On April 21, 1998, the Service issued proposed QSub regulations under Sections 1361 and 1362. These regulations were issued as final regulations on January 20, 2000 (the "final QSub regulations"). See T.D. 8869, 65 Fed. Reg. 3843-3856 (January 25, 2000).

(ii) The final QSub regulations generally apply to tax years that begin on or after January 20, 2000. However, taxpayers may elect 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.

c. Electing QSub status

(i) The preamble to the final QSub regulations provides that taxpayers should follow the QSub election procedures set forth in Notice 97-4, 1997-1 C.B. 351, rather than the QSub election procedures set forth in the final QSub regulations until the QSub election form is published. T.D. 8869, 65 Fed. Reg. at 3844. The Service issued the new Qsub election form, Form 8869, on May 20, 2000. Thus, taxpayers should follow the Qsub election procedures set forth in the final Qsub regulations. See I.R.S. Announcement 2000-83, 2000-21 I.R.B. 348 (May 20, 2000).

(ii) The final QSub regulations provide that a QSub election can be made at any time of the taxable year. Treas. Reg. § 1.1361-3(a)(3). Note that, in contrast, an S election must

be made no later than the 15th day of the third month of the taxable year for which the election is to be effective.

(iii) The QSub election may be effective retroactively up to two months and 15 days prior to the day the QSub election is made, or on any day not more than 12 months after the date of the election. Treas. Reg. § 1.1361-3(a)(4). Note that this time period is a change from that in Notice 97-4, which provides that the election cannot be made effective more than 75 days before the filing date. The change to 2 months and 15 days in the final QSub regulations conforms the QSub election time period to that of the subchapter S election.

(iv) An extension to file a QSub election may be available under Treas. Reg. §§ 301.9100-1 and 301.9100-3, which provide that the Commissioner has the discretion to grant a reasonable extension of time. Treas. Reg. § 1.1361-3(a)(6). An example of such an extension being granted can be seen in PLR 9834101. In that ruling, a company was formed to facilitate the consolidation and reorganization of business operations that had previously been conducted by three subsidiaries, A, B, and C. The company's shareholders filed an election to be treated as an S corporation. The shares of A, B, and C were contributed to the company under Section 351, but the company failed to file elections to treat the subsidiaries as QSubs. The company subsequently formed subsidiary D, for which it also failed to file an election to treat D as a QSub. The Service determined that the requirements of Treas. Reg. § 301.9100-3 – which require that the Commissioner be satisfied that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government – had been met. See also PLR 200026014; PLR 200021023; PLR 199931025.

d. The effect of a QSub election

(i) Under the final QSub regulations, when an S corporation makes a valid QSub election, the subsidiary is deemed to have liquidated into the S parent. Treas. Reg. § 1.1361-4(a)(2)(i).

(a) In general, the liquidation into the S parent takes place at the close of the business day before the QSub election becomes effective. Treas. Reg. § 1.1361-4(b)(1).

(b) If the S parent does not own 100 percent of the stock of the subsidiary on the day prior to the QSub election becoming effective, the liquidation occurs directly after the time at which the S parent first owns 100 percent of the stock. Treas. Reg. § 1.1361-4(b)(3)(i).

(c) If an S corporation makes QSub elections for a tiered group of subsidiaries that are effective on the same date, the S corporation may specify the order of the liquidations. If no order is specified, the liquidations are deemed to occur in order from the lowest tier subsidiary to the highest tier subsidiary, i.e., a bottom-up liquidation order. Treas. Reg. § 1.1361-4(b)(2).

i) A bottom-up liquidation order effectively causes the S parent to acquire all of the assets of the subsidiaries in the liquidating chain in a single transaction subject to Section 1374(d)(8); a top-down liquidation order effectively causes the S parent to acquire separately the assets of each subsidiary in the liquidating chain in multiple transactions subject to Section 1374(d)(8), limiting the S parent's ability to utilize tax attributes of one liquidating subsidiary against tax attributes of another liquidating subsidiary in a Section 1374 context.

ii) A bottom-up liquidation order helps avoid the triggering of income from an excess loss account held by an upper-tier subsidiary in respect of stock in a lower-tier subsidiary. See Treas. Reg. § 1.1502-19.

(d) Although a QSub election may be made for an insolvent corporation, Section 332 will not apply to the deemed liquidation. Thus, the QSub election may trigger gain or loss recognition to the QSub and the S parent. See Treas. Reg. § 1.1361-4(d) ex. 5.

(ii) The final QSub regulations provide that the tax treatment of the deemed liquidation (or of a larger transaction that includes the liquidation) is to be determined under general

principles of tax law, including the step transaction doctrine. Treas. Reg. § 1.1361-4(a)(2)(i).

(iii) Thus, if an S corporation forms a subsidiary and makes a valid QSub election for that subsidiary effective the same day, the transfer of assets to the subsidiary and the deemed liquidation are disregarded and the subsidiary is deemed to be a QSub from its inception. Id.

(iv) Note that there are special rules for banks. If, in a valid QSub election, the S parent or the subsidiary is a bank, any special rules in the Code that are applicable to banks continue to apply separately to the bank parent or bank subsidiary as if the deemed liquidation had not taken place. Treas. Reg. § 1.1361-4(a)(3).

(v) The stock of a QSub will be disregarded for all federal tax purposes, except for purposes of the special rules for banks and for purposes of determining that 100 percent of the stock of the subsidiary is held by the S parent under Treas. Reg. § 1.1361-2(a)(1). Treatment of a QSub as a disregarded entity applies for all federal tax purposes, and is not limited to federal income tax purposes. See Notice 99-6, 1999-3 I.R.B. 12 (addressing the payment of employment taxes for QSub employees, as discussed below).

(vi) The final QSub regulations contain a special transition rule that applies if (1) an S corporation acquires stock of an already related corporation (as defined by Section 267(b)) and (2) thereafter makes a QSub election for that corporation. See Treas. Reg. § 1.1361-4(a)(5). Under the special transition rule, the step transaction doctrine will not apply to the stock acquisition and the subsequent QSub election if the QSub election is effective before January 1, 2001. Id.

(a) The final QSub regulations give the following as an example of a situation in which the special transitional relief would apply: Individual A owns 100 percent of the stock of X, an S corporation. X owns 79 percent of the stock in Y, a solvent corporation. A owns the remaining 21 percent of Y stock. On May 4, 1998, A contributes its Y stock to X in exchange for X stock. X makes a QSub election with respect to Y effective immediately following the transfer. The liquidation is respected

as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under Section 332 and 337. The contribution by A of the Y stock qualifies under Section 351, and no gain or loss is recognized by A, X, or Y. Treas. Reg. § 1.1361-4(a)(5)(ii) ex. 1.

(vii) The Service announced in the preamble to the proposed QSub regulations that special rules may apply when a QSub election is made following the transfer of an S corporation's stock to another S corporation. The Service gave the following example: If an S corporation were to acquire the stock of another S corporation in a transaction in which the acquiring S corporation's basis in the stock received was determined by reference to the transferor's basis, and the acquiring S corporation made a QSub election with respect to the acquired corporation effective on the day of acquisition, any losses disallowed under Section 1366(d) with respect to a former shareholder of the QSub would be available to that shareholder as a shareholder of the acquiring S corporation. See 63 Fed. Reg. 19864 (April 22, 1998). The final QSub regulations adopt the special rule regarding Section 1366(d). See Treas. Reg. §§ 1.1361-4(c), 1.1366-2(c)(1).

(viii) In Notice 99-6, 1999-3 I.R.B. 12, the Service addressed whether a QSub or the owner of the QSub should pay the employment taxes of employees of the QSub. Until the Service provides further guidance, Notice 99-6 provides that the Service generally will accept reporting and payment of employment taxes with respect to QSub employees if made in one of two ways:

(a) First, calculation, reporting, and payment of all employment tax obligations are made by the owner of the QSub (as though the QSub employees are employed directly by the owner) and under the owner’s name and taxpayer identification number; or

(b) Second, separate calculation, reporting, and payment of all employment tax obligations by the QSub with respect to its employees are made under its own name and its own taxpayer identification number. However, if this second method is chosen, the owner retains ultimate responsibility for the

employment tax obligations incurred with respect to the QSub employees. Cf. ILM 199922053 (concluding that the sole owner of a single member limited liability company is personally liable for the employment taxes incurred by the limited liability company).

An owner of multiple QSubs may choose the first method with respect to one QSub and the second method with respect to its other QSub. If the owner uses the first method with respect to a given QSub for a return period that begins on or after April 20, 1999, the taxpayer must continue to use the first method unless and until otherwise permitted by the Commissioner.

e. Election procedure

(i) Notice 97-4 – pre May 20, 2000 elections

(a) Notice 97-4, 1997-1 C.B. 351, provides a temporary QSub election procedure. The preamble to the final QSub regulations provides that taxpayers should follow the election procedure in Notice 97-4, rather than the election procedure in the final QSub regulations, until the QSub election form is published. T.D. 8869, 65 Fed. Reg. at 3844.

(b) On May 20, 2000, the Service released the Qsub election form, Form 8869. Thus, the temporary Qsub election procedures in Notice 97-4 may not be used on or after May 20, 2000.

(c) Prior to May 20, 2000, the S parent should file a Form 966 with the Service Center to make a Qsub election. The S parent should follow the instructions for that form with the following modifications:

i) At the top of the form, the following statement should be printed: "FILED PURSUANT TO NOTICE 97-4."

ii) In the box "employer identification number," ("EIN") the subsidiary's EIN should be entered. If the subsidiary does not have an EIN because it was not in existence prior to the election, enter "QSSS" (former

abbreviation for qualified subchapter S subsidiary) in the EIN box.

iii) The effective date for the election should be entered in Box 4. The election may be effective on the date the form is filed or up to 75 days prior to the filing of the form, provided that date is not before the effective date of section 1308 of the 1996 Small Business Act and that the subsidiary otherwise qualified as a QSub for the entire period for which the retroactive election is in effect. The requirement that Form 966 be filed within 30 days of the date indicated in Box 4 is ignored.

iv) In Box 7c on the form, enter the name of the parent. Include the parent's EIN in Box 7d.

v) Enter "§ 1361(b)(3)(B)" in Box 10.

vi) A corporate officer authorized to sign the S parent's tax return must sign the form.

(ii) Final QSub Regulations and Form 8869

i) The final QSub regulations provide that a QSub election may be effective retroactively up to two months and 15 days prior to the day the election is made, or on any day not more than 12 months after the date of the election. Treas. Reg. § 1.1361-3(a)(4). Note that this time period is a change from the time period in Notice 97-4, which provided that a QSub election cannot be made effective more than 75 days before the filing date. The change to two months and 15 days in the regulations conforms the election time period to that of the subchapter S election.

ii) The final QSub regulations provide that a QSub election is made by filing a completed election form, Form 8869. The election form must be signed by a person authorized to sign the S corporation's tax return. Treas. Reg. § 1.1361-3(a)(2).

iii) The final Qsub regulations and Form 8869 provide that Form 8869 should be filed at the Service Center where the subsidiary filed its most recent return. However, if the S parent forms a subsidiary, and makes a valid QSub election effective upon formation, Form 8869 should be filed at the Service Center where the S parent filed its most recent return. See Treas. Reg. § 1.1361-3(a)(2); see also Form 8869.

f. Termination of a QSub election

(i) A corporation's QSub status will continue until terminated. Upon termination, the corporation will be 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. The tax treatment of a termination, or of any larger transaction in which it occurs, will be determined under the Code and general principles of tax law, including the step transaction doctrine. Treas. Reg. § 1.1361-5(b)(1)(i).

(ii) If the terminating event is a sale of more than 20 percent of the stock of the QSub, the former S parent must recognize any gain on all assets transferred, because the nonrecognition provisions of Section 351 will not apply. Treas. Reg. § 1.1361-5(b)(3), ex. 1. This results from the application of the step transaction rule – the former S parent's deemed contribution of assets to the "new corporation" is stepped together with the sale of stock, so that the former S parent is not treated as being in control immediately after the contribution. As a result, the asset contribution does not satisfy the requirements of Section 351(a), and the entire deemed asset contribution is taxable to the former S parent. Treas. Reg. § 1.1361-5(b)(1)(i).

(iii) The magnitude of the gain recognized in the above scenario may be reduced by merging the QSub into a single member LLC owned by the S parent and then selling more than 20 percent (for example, 21 percent) of the interest in the LLC. In this structure, the former S parent should be treated as selling an undivided 21 percent interest in all the assets of the LLC to the buyer of the 21 percent interest in the LLC followed by a Section 721 partnership formation transaction by the buyer and the former S parent. In this transaction, Section 1001 requires the S parent to recognize

gain or loss from the deemed sale of only 21 percent of each asset of the LLC, as opposed to 100 percent of each asset in the prior scenario. Compare Treas. Reg. § 1.1361-5(b)(3) ex. 2 with Treas. Reg. § 1.1361-5(b)(3) ex. 1; see also Rev. Rul. 99-5, 1999-6 I.R.B. 8.

(iv) The termination of the election is effective on the date included in the revocation statement (if the election is revoked under Treas. Reg. § 1.1361-3(b)), 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 Treas. Reg. § 1.1362-2, or at the close of the day on which an event occurs that renders the subsidiary ineligible for QSub status under Section 1361(b)(3)(B). Treas. Reg. § 1.1361-5(a)(1).

(a) Revocation under Treas. Reg. § 1.1361-3(b)(1) is accomplished by filing a statement with the service center where the S parent's most recent tax return was properly filed. The statement must include the names, addresses, and taxpayer identification numbers of the S parent and the subsidiary, and must be signed by a person authorized to sign the S parent's tax return.

(b) The revocation is effective on the date specified in the statement, or if no date is specified, on the date the statement is filed. The effective date of the revocation may not be more than 2 months and 15 days prior to the date on which the statement is filed. Also, the effective date may not be more than 12 months after the date on which the statement is filed. Treas. Reg. § 1.1361-3(b)(2).

(v) If a QSub terminates because the S parent distributes the QSub stock to some or all of the S parent's shareholders in a transaction to which Section 368(a)(1)(D) applies by reason of Section 355, any loss or deduction disallowed under Section 1366(d) with respect to a shareholder of the S parent immediately before the distribution is allocated between the S parent and the former QSub with respect to the shareholder. Treas. Reg. §§ 1.1361-5(b)(2), 1.1366-2(c)(2). Such allocation may be made according to any reasonable method, including:

(a) a method based on the relative fair market value of the shareholder's stock in the S parent and the former QSub immediately after the distribution;

(b) a method based on the relative adjusted basis of the assets in the S parent and the former QSub immediately after the distribution; or

(c) in the case of losses and deductions clearly attributable to either the S parent or the former QSub, any method that allocates such losses and deductions accordingly. Treas. Reg. § 1.1366-2(c)(2).

(vi) The QSub regulations do not contain a provision analogous to Section 1362(f) that allows the IRS to determine that a corporation is a QSub during a period when the corporation does not satisfy the requirements of Section 1361(b)(3)(B). For example, if the S parent inadvertently transfers one share of QSub stock to another person, the QSub election terminates. See Explanation of Provisions, 65 Fed. Reg., at 3847.

(vii) If the QSub election terminates because the S parent inadvertently terminated its S election, Section 1362(f) may provide relief to the QSub as a consequence of the S parent obtaining relief under that provision. See Explanation of Provisions, 65 Fed. Reg., at 3847-48.

(viii) A corporation whose QSub election has terminated generally may not make an S election or have a QSub election made with respect to it for five taxable years following termination unless the Commissioner consents. Section 1361(b)(3)(D); Treas. Reg. § 1.1361-5(c)(1). In the case of QSub elections effective after December 31, 1996, if a corporation's QSub election terminates, the corporation may, without requesting the Commissioner's consent, make an S election or have a QSub election made with respect to it before the expiration of the five-year period if:

(a) immediately following the termination, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it, and

(b) the relevant election is made effective immediately following the termination of the QSub election. Treas. Reg. § 1.1361-5(c)(2).

(ix) A corporation whose QSub election has been revoked effective on the first day the Qsub election was to be effective will not be treated as a termination of a QSub election for purposes of the 5 year reelection rule in Section 1361(b)(3)(D). Treas. Reg. § 1.1361-3(b)(4).

(x) If a corporation's QSub election terminates, the new corporation formed as a result of the termination must use its own EIN for Federal tax purposes. If the new corporation had an EIN before the effective date of its QSub election or during its QSub status, it should use that EIN. Otherwise, the new corporation must apply for a new EIN. Treas. Reg. § 301.6109-1(i)(3).

7. Miscellaneous Provisions

a. Section 1311 of the 1996 Small Business Act (amending Sections 1362 and 1375 of the Code) permitted an S corporation to reduce any accumulated earnings and profits by the earnings and profits accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an S corporation.

b. Section 1313 of the 1996 Small Business Act (amending Section 1367(b) of the Code) provided that a person acquiring S corporation stock from a decedent will treat as income in respect of a decedent ("IRD") the pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent.

c. Section 1313 of the 1996 Small Business Act (amending Section 1361(b)(1)(B) of the Code) permitted certain tax-exempt organizations to be eligible shareholders.

d. Section 1315 of the 1996 Small Business Act (amending 1361(b)(2) of the Code) permitted banks (as defined in Section 581) that are not using a reserve method of accounting for bad debts to elect S status.

e. The 1996 Small Business Act expanded the definition of "straight debt" (which is not treated as a second class of stock) to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money. Section 1361(c)(5)(B), as amended by section 1304 of the 1996 Small Business Act.

f. The 1996 Small Business Act applied the present-law capital gains presumption for land held by a noncorporate taxpayer to land held by S corporations. The legislative history indicates that it is expected that rules similar to the attribution rules for partnerships will apply to S corporations. Section 1237(a), as amended by section 1314 of the 1996 Small Business Act.

B. The Tax Relief Act of 1997

President Clinton signed the Tax Relief Act of 1997 ("TRA '97") into law on December 2, 1997, and it became Public Law 105-134. TRA '97 includes various changes to the S corporation rules that are discussed throughout the outline.

C. Recent Court Decisions

1. Gitlitz v. Commissioner

In Gitlitz v. Comm'r, 531 U.S. 206 (2001), the Supreme Court recently settled a conflict between several Circuits and the Tax Court regarding the treatment of COD income of an insolvent S corporation. In Gitlitz, two shareholders each owned 50% of an insolvent S corporation. The S corporation realized COD income in 1991. As a result of the S corporation's insolvency, the two shareholders treated the flow-through COD income as excludable from their gross income and increased their stock bases accordingly. The increase in stock basis allowed the shareholders to utilize previously suspended S corporation losses and deductions.

a. The Commissioner determined that the shareholders could not use their allocable portion of flow-through COD income to increase their stock bases. The Tenth Circuit agreed with the shareholders' position, but also ruled that the required tax attribute reduction under Section 108 for COD income excluded from gross income should be applied prior to passing through any remaining COD income to the shareholders.

b. The Supreme Court reversed the Tenth Circuit and held as follows:

(i) The plain language of Sections 61 and 108 establish that excluded COD income is an "item of income," which passes through to shareholders and increases their bases in S corporation stock; and

(ii) Section 108 expressly directs that excluded COD income is passed through to shareholders before Section 108 reduces an S corporation's tax attributes.

c. The Supreme Court also noted: "[C]ourts have discussed the policy concern that, if shareholders were permitted to pass through the discharge of indebtedness before reducing any tax attributes, the shareholders would wrongly experience a 'double windfall': They would be exempted from paying taxes on the full amount of the discharge of indebtedness, and they would be able to increase basis and deduct their previously suspended losses. Because the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern." Id. at 709-10.

d. Justice Breyer wrote the lone dissenting opinion. Justice Breyer wrote that Section 108 required that the COD income exclusion and the tax attribute reduction must be applied only at the corporation level. Thus, excluded COD income should never flow through to shareholders. Justice Breyer stated, "The arguments from plain text on both sides here produce ambiguity, not certainty. And other things being equal, we should read ambiguous statutes as closing, not maintaining, tax loopholes....Here, other things are equal, for, as far as I am aware, the Commissioner's literal interpretation of [Section 108] as exclusive would neither cause any tax-related harm nor create any statutory anomaly." Id. at 711.

e. Query: Does Gitlitz suggest that Treas. Reg. § 1.1366-1(a)(2)(viii) may be invalid?

(i) Treas. Reg. § 1.1366-1(a)(2) states, "The separately stated items of the S corporation include, but are not limited to, the following items- .... (viii) The corporation's tax-exempt income. For purpose of subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Internal Revenue Code applies. For example, income that is excludible from gross income under section 101 (certain death benefits)...is tax-exempt income, while income that is excludible from gross income under section 108 (income from discharge of indebtedness)...is not tax-exempt income."

(ii) Gitlitz involved a tax year (1991) prior to the effective date of the above regulation. The above regulation applies to taxable years of an S corporation beginning on or after August 18, 1998. Treas. Reg. § 1.1366-5. However, Treasury published the regulation on December 21, 1999, more than one year prior to the Supreme Court decision in Gitlitz.

(iii) The Court's language may support the view that the regulation is invalid. The Court wrote: "Second, the Commissioner argues that excluded discharge of indebtedness is not 'tax-exempt' income under § 1366(a)(1)(A), but rather 'tax-deferred' income....Implicit in the Commissioner's labeling of such income as 'tax deferred,' however, is the erroneous assumption that § 1366(a)(1)(A) does not include 'tax deferred' income. Section 1366 applies to "items of income." This section...is worded broadly enough to include any item of income, even tax-deferred income.... Thus, none of the Commissioner's contentions alters our conclusion that discharge of indebtedness of an insolvent S corporation is an item of income for purposes of § 1366(a)(1)(A)." Gitlitz, 531 U.S. at 707-08.

2. St. Charles Investment Co. v. Commissioner

a. Brief Facts:

(i) In 1991, St. Charles was a closely held C corporation under Section 469(j)(1). During 1988-1990, St. Charles engaged in the real estate rental business. St. Charles's real estate rental business qualified as a passive activity under Section 469(c). In each of the years from 1988-1990, St. Charles's passive activities generated non-deductible passive activity losses (PALs) under Section 469(a), which St. Charles suspended and carried forward pursuant to Section 469(b).

(ii) On January 1, 1991, St. Charles converted to an S corporation. In the same year, St. Charles sold several of its rental properties which had suspended PALs. St. Charles, pursuant to Section 469(g)(1)(A), claimed a deduction on its 1991 tax return in the amount of the suspended PALs allocable to the sold rental properties. In 1995, St. Charles converted back to a C corporation.

b. Prior Determinations: The Commissioner disallowed the deductions for 1991, arguing that Section 1371(b)(1) prohibits S corporations from carrying forward PALs created in its C years to S years. The Tax Court agreed that Section 1371(b)(1) trumped the application of the PAL carryover provision of Section 469(b).

c. Court of Appeals Holding: The U.S. Court of Appeals for the Tenth Circuit reversed the Tax Court. The court held that Section 469(b) permits St. Charles to use its C year PALs to offset income

in its 1991 S year (i.e., Section 1371(b)(1) does not limit Section 469(b)).

d. Reasoning of the Court of Appeals:

(i) Although Congress enacted Section 1371(b)(1) to prevent corporate losses incurred prior to S status from inuring to the benefit of corporate shareholders after an S status election is made, Section 469(b) provides that the only exceptions to the PAL carryover rule are those exceptions within Section 469. Because Section 1371(b)(1) is not an express exception to Section 469(b), Section 1371(b)(1) does not apply to suspended PALs.

(ii) The Court rejected the argument that a windfall would be created in favor of the shareholders of St. Charles by allowing one taxpayer (the shareholders) to offset income with the losses of a different taxpayer (the corporation), stating "While we have sympathy for the Commissioner's position, we find that in this case the language of Section 469 is sufficiently unequivocal to require this result."

D. Electing Small Business Trusts

1. Proposed Treasury regulations under Sections 1361 and 641(c) were issued on December 29, 2000. These proposed regulations significantly affect the taxation of electing small business trusts. See PART TWO: II.4.a.(ix).

PART TWO: ACQUISITIONS AND DISPOSITIONS INVOLVING S CORPORATIONS

I. INTRODUCTION

A. This Part of the Outline will discuss acquisitions and dispositions involving S corporations. Although the focus of this Part will be on transactions involving S corporations, a brief review of the subchapter S provisions is necessary.

1. Accordingly, the Outline will first review the eligibility requirements for electing S status and the mechanics of filing an S election. The consequences of such an election on the corporation and its shareholders then will be briefly reviewed and analyzed.

2. Finally, using this material as a background, this Part of the Outline will explore and analyze various transactions involving S corporations.

B. The term "S corporation" as used herein means any qualifying corporation for which an S election is in effect. See Section 1361(a)(1). The term "C corporation" means a corporation which is not an S corporation. Section 1361(a)(2).

C. For those requiring a more detailed discussion of the topics discussed in this Part of the Outline, several treatises and research materials are available. See Eustice & Kuntz, Federal Income Taxation of S Corporations (Warren, Gorham & Lamont (3d ed., 1993)); Starr, 730 T.M. S Corporations: Formation and Termination; William R. Christian & Irving M. Grant, Subchapter S Taxation (Warren, Gorham & Lamont (4^{th} ed., 1998)).

II. THE S ELECTION

The benefits of subchapter S are available only if an S election is in effect. In planning transactions involving S corporations, pressure is accordingly placed upon making or preserving a valid S election. In this regard, compliance with the eligibility requirements and the filing mechanics is absolutely essential. This Section will review the salient features of these topics.

A. Eligibility

An S election may only be made by a "small business corporation," which is a corporation meeting the following requirements.

1. Domestic Corporation

The corporation must be a "domestic" corporation. Section 1361(b)(1). The regulations define a domestic corporation by reference to Treas. Reg. § 301.7701-5 as a domestic corporation created or organized in the United States or under the laws of the United States or of any state or territory. Treas. Reg. § 1.1361-1(c).

2. Ineligible Corporation

The corporation must not be an "ineligible corporation."

a. In general

(i) Section 1361(b)(2) defines an "ineligible corporation" as any corporation which is:

(a) a financial institution using the reserve method of accounting for bad debts described in Section 585;

(b) an insurance company subject to taxation under subchapter L;

(c) a Section 936 corporation; or

(d) a DISC or former DISC.

(ii) Prior to the enactment of the 1996 Small Business Act, the list of ineligible corporations also included

(a) a member of an affiliated group (determined under Section 1504 without regard to Section 1504(b)) and

(b) banks (as defined in Section 581) that are not using a reserve method of accounting for bad debts.

(iii) Because the 1996 Small Business Act permits an S corporation to be a member of an affiliated group, an S corporation may own up to 100 percent of the stock of a C corporation. The S corporation may not, however, be included in a group filing a consolidated return. Thus, as discussed above, if an S corporation holds 100 percent of the stock of a C corporation that, in turn, holds 100 percent of the stock of another C corporation, the two C corporations may elect to file a consolidated return, but the S corporation may not join in the election. See Section 1504(b)(8); H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 244 (1996).

b. Member of an affiliated group prior to the 1996 Small Business Act

As discussed in detail below, prior to the 1996 Small Business Act, acquisitions and dispositions of S corporations and their assets required special planning to ensure that the S corporation did not become a member of an affiliated group. See Sections V. through VII., below. As a practical matter, because Section 1361(b)(1) prevents a small business corporation from having corporate shareholders, the restriction on affiliation generally came into play when an S corporation was the acquiring entity.

(i) A corporation will be a member of an affiliated group if it owns at least 80 percent of the voting power of the stock of another corporation, and at least 80 percent of the value of the stock of such other corporation. Section 1504(a)(2).

(a) In general, stock which is nonvoting, nonparticipating, nonconvertible, limited and preferred as to dividends, and which does not carry an unreasonable redemption or liquidation premium

will be disregarded for this purpose. Section 1504(a)(4).

(b) However, regulations issued under Section 1504(a)(5) treat other interests (such as options or warrants) as "stock."

(ii) Prior to the 1996 Small Business Act, a small business corporation could own stock in another corporation so long as such ownership did not meet the 80 percent vote/value test just described.

(a) This could be accomplished, for example, if the S corporation owned only 79 percent of the voting power of a target corporation.

(b) Affiliated status could be broken if voting preferred stock in the subsidiary were held by unrelated parties that entitled the preferred shareholders to a 21 percent vote on all matters. See PLR 8441009.

(iii) Prior to the 1996 Small Business Act, however, an exception existed for stock in certain inactive subsidiaries. Under Section 1361(c)(6) (repealed by section 1308(d)(1) of the 1996 Small Business Act), a corporation was not treated as a member of an affiliated group by reason of its stock ownership in a subsidiary if the subsidiary had not begun business at any time on or before the close of the taxable year and the subsidiary did not have gross income for such period.

(a) The determination of when a corporation begins business was based on all the facts and circumstances of the particular case. Treas. Reg. § 1.1361-1(d)(3)(ii).

(b) Mere organizational activities – such as obtaining a corporate charter or incorporating to reserve a corporate name – were not sufficient. Id.

(c) However, a corporation was considered to have begun business if its activities had advanced to the extent necessary to establish the nature of its business operations, such as acquiring operating assets necessary for the intended operation. Id.

(d) The election terminated on the first day that the subsidiary either begins business or realizes gross

income under its method of accounting. Treas. Reg. § 1.1361-1(d)(3)(iii).

(iv) 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.

(a) In Rev. Rul. 72-320, 1972-1 C.B. 270, 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.

(b) In Rev. Rul. 73-496, 1973-2 C.B. 313, 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).

(c) These rulings provided needed flexibility in planning the acquisition or division of a business by an S corporation. However, the Tax Court, in Haley Bros. Construction Corp. v. Commissioner, 87 T.C. 498 (1986), 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.

(d) The Service, relying on both Rev. Rul. 72-320 and Rev. Rul. 73-496, has continued to issue rulings that ignore transitory stock ownership. See, e.g., 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; TAM 9245004.

(v) Importantly, old Section 1361(b)(2)(A) (repealed by section 1308 of the 1996 Small Business Act) only prevented an S corporation from being a member of an affiliated group. An S corporation could, however, be a

member of a controlled group, so long as there was no overlap with the affiliated group definition (i.e., brother-sister corporations were not prevented from making an S election).

3. Number of Shareholders

A small business corporation may not have more than 75 shareholders. Section 1361(b)(1)(A) (as amended by section 1301 of the 1996 Small Business Act). Prior to enactment of the 1996 Small Business Act, the limit was 35 shareholders. The Subchapter S Revision Act of 1982, P.L. 97-354 (the "SSRA"), had increased the number of permitted shareholders from 25 to 35 in order to correspond to the private placement exemption contained in federal securities laws. S. Rep. No. 97-640, 97th Cong., 2d Sess. 7 (1986).

a. For purposes of determining the number of shareholders, a husband and a wife (and their estates) are treated as one shareholder. Section 1361(c)(1). See Treas. Reg. § 1.1361-1(e)(2). For purposes of allocating income (loss) items under Section 1366, a husband and wife should be treated as separate shareholders.

b. The beneficial owner of stock will generally be treated as the shareholder. The shareholder will be the person who would have to include in gross income the dividends distributed with respect to the S corporation stock. Treas. Reg. § 1.1361-1(e)(1).

(i) Thus, where stock is owned by joint tenants or tenants in common, each tenant is considered a shareholder.

(ii) However, stock owned by a partnership will be treated as being owned by the partnership and not the partners.

c. The attribution rules do not apply. Rev. Rul. 59-187, 1959-1 C.B. 224.

d. A corporation may have more than 75 shareholders during the year, so long as there are not more than 75 at any one time. See Rev. Rul. 78-390, 1978-2 C.B. 220.

e. In Rev. Rul. 77-220, 1977-1 C.B. 263, the shareholders attempted to avoid the numerical restrictions by forming three corporations, each having the then maximum number of 10 shareholders. The three corporations in turn formed a partnership to conduct a business.

(i) The Service initially ruled that solely for purposes of determining whether an S election could be made, the three separate corporations would be treated as one corporation. As a single corporation, an S election could not be made because the number of shareholders in such corporation exceeded the maximum number permitted.

(ii) Subsequently (albeit 14 years later), in Rev. Rul. 94-43, 1994-2 C.B. 198 (July 5, 1994), the Service reversed its position in Rev. Rul. 77-220, and concluded that the S election of the three separate corporations should be respected notwithstanding that the principal purpose for the formation of the separate corporations was to avoid the shareholder limitation. The Service concluded that administrative simplicity in the administration of the S corporation's tax affairs is not affected by the corporation's participation in a partnership with other S corporation partners.

(iii) Prior to the official revocation of Rev. Rul. 77-220, the Service was in effect limiting its applicability. For example, where valid business reasons support use of a partnership, the S election of corporate partners should be respected. See PLR 9409027; PLR 9017057; PLR 8916057; PLR 8823027; PLR 8823023; PLR 8819040; PLR 8804015; PLR 8711020; PLR 8536017; PLR 8527081. See also Keyes, "Using Partnerships to Avoid S Corporation Restrictions," Journal of Small Business Taxation (Nov/Dec 1988) at p. 102.

4. Type of Shareholder

a. In general

Under Section 1361(b)(1)(B), the stock of a small business corporation can be held only by certain types of shareholders.

(i) An individual (other than a nonresident alien individual) is a permissible shareholder. Section 1361(b)(1)(B) and (C).

(ii) An estate of an individual is a permissible shareholder. Section 1361(b)(1)(B).

(a) However, if the administration of the estate is unduly extended, the Service may argue that the estate is in reality a testamentary trust. See Old

Virginia Brick Co. v. Commissioner, 367 F.2d 276 (4th Cir. 1966).

(b) An estate also includes an estate of an individual in bankruptcy. See Section 1361(c)(3).

(iii) A trust all of which is treated as owned by an individual who is a citizen or resident of the United States (i.e., a grantor trust) is permissible. Sections 1361(c)(2)(A)(i) and 1361(c)(2)(B)(i); Treas. Reg. § 1.1361-1(h)(1)(i).

(iv) Prior to the 1996 Small Business Act, a grantor trust which continues in existence after the death of the deemed owner is permissible but only for a period of 60 days (two years if the entire corpus is included in the deemed owner's gross estate). Old Section 1361(c)(2)(A)(ii). Treas. Reg. § 1.1361-1(h)(1)(ii). Section 1303 of the 1996 Small Business Act amended this provision to provide a two-year period for all such grantor trusts. Section 1361(c)(2)(A)(ii).

(v) Prior to the 1996 Small Business Act, a trust to which stock is transferred pursuant to the terms of a will is permissible, but only for a period of 60 days from date of transfer. Old Section 1361(c)(2)(A)(iii); Treas. Reg. § 1.1361-1(h)(1)(iv). Section 1303 of the 1996 Small Business Act amended this provision to provide a two-year period. Section 1361(c)(2)(A)(iii).

(vi) A trust created primarily to exercise the voting power of the stock transferred to it (i.e., a voting trust) is permissible. Section 1361(c)(2)(A)(iv); Treas. Reg. § 1.1361-1(h)(3)(v); PLR 9410010.

(vii) A qualified subchapter S trust (a "QSST") is permissible if the beneficiary makes an election under Section 1361(d)(2) to treat the trust as a grantor trust and to treat the beneficiary of the trust as the owner of the S corporation stock held in trust. Section 1361(d)(1); Treas. Reg. § 1.1361-1(h)(1)(iii). For the definition of a QSST, see Section 1361(d)(3). A trust can be treated as a QSST notwithstanding that the beneficiary may be treated as the owner of the trust. PLR 9420030.

(a) A provision in a trust agreement that authorizes the trustee to accumulate trust income in the event that the trust does not hold any shares of an S corporation does not preclude the trust's

qualification as a QSST. Rev. Rul. 92-20, 1992-1 C.B. 301.

(b) Similarly, a provision in a trust agreement that requires the trustee to distribute the income for the period after the last distribution date and before the date of the beneficiary's death to either the estate or to the successor beneficiary does not preclude the trust's qualification as a QSST. Rev. Rul. 92-64, 1992-2 C.B. 214.

(c) However, a trust that qualifies as a charitable remainder trust under Section 664 cannot qualify as a QSST. Rev. Rul. 92-48, 1992-1 C.B. 301.

(viii) A trust that qualifies as an individual retirement account is not a permitted shareholder under Section 1361. Rev. Rul. 92-73, 1992-2 C.B. 224.

(ix) Section 1302 of the 1996 Small Business Act also allowed an "electing small business trust" (an "ESBT") to be a shareholder.

(a) To qualify, all beneficiaries of the trust must be individuals, estates or charitable organizations described in Section 170(c)(2)-(5) that are eligible to be S corporation shareholders. Furthermore, the charitable organizations can hold only contingent interests and cannot be "potential current beneficiaries" of the trust. In addition, no interest in the trust may be acquired by purchase (i.e., acquired with a cost basis determined under Section 1012). Thus, interests in the trusts must be acquired by gift, bequest, or other non-Section 1012 transactions.

i) Section 1316 of the 1996 Small Business Act amended the above rule by providing that charitable organizations described in Section 170(c)(2)-(5) may hold an interest other than a contingent interest in the ESBT and may be "potential current beneficiaries." Section 1316 applies to tax years beginning after December 31, 1997.

ii) The Renewal Act of 2000 amended the above rules by providing that permitted beneficiaries of an ESBT include an

organization described in Section 170(c)(1) as long as it holds a contingent interest in the ESBT and it does not meet the definition of a "potential current beneficiary" of the ESBT. This provision is effective for tax years beginning after December 31, 1996.

iii) Proposed regulations issued on December 29, 2000 clarify that an interest in the trust will be treated as acquired by purchase if any portion of a beneficiary's basis in the interest is determined under Section 1012. Thus, an acquisition of an interest in the trust treated as part-sale and part-gift will terminate the trust's status as an ESBT. Prop. Treas. Reg. § 1.1361-1(m)(1)(iii).

(b) The Service issued Notice 97-49, 1997-2 C.B. 304, to provide guidance as to the definition of an ESBT "beneficiary." Notice 97-49 provides the following rules:

i) Distributee trusts: The term "beneficiary" does not include a distributee trust (other than a trust described in Section 170(c)(2)-(3)), but does include persons who have a beneficial interest in such a distributee trust. For example, suppose an intended ESBT provides for discretionary distributions of income or principal to A for life, and upon A's death the division of the remainder into separate trusts for the benefit of A's children. Under Notice 97-49, the beneficiaries of the intended ESBT are A and A's children, and not the separate trusts for the benefit of A's children. Because all the beneficiaries are individuals, the intended ESBT qualifies as an ESBT. See PLR 199930035.

ii) Power of appointment: The term "beneficiary" does not include a person in whose favor a power of appointment could be exercised. Such a person becomes a beneficiary only when the power is exercised in such person's favor.

iii) Remote interests: The term "beneficiary" does not include a person whose interest is so remote as to be negligible (e.g., a State's contingent interest under its escheat laws).

iv) The proposed regulations issued on December 29, 2000 do not alter the above definitions. However, the proposed regulations provide that a person's interest in either the corpus or income of a trust is negligible when the probability that such person will ever receive a distribution from the trust is less than 5 percent, taking into consideration the interests of other entities and other individuals living at that time. See Prop. Treas. Reg. § 1.1361-1(m)(1)(ii).

(c) A trust must elect to be treated as an ESBT.

i) The trustee of the ESBT must make the ESBT election.

ii) Under Notice 97-12, 1997-1 C.B. 385, the Service provided interim guidance on how a trust elects to be treated as an ESBT. Under the Notice, the trustee must sign and file a statement of election with the service center in which the S corporation whose stock is owned by the trust files its income tax return. If a trust owned stock in several S corporations, the above rule would require a trustee to file a statement of election with each service center handling the income tax return for a particular S corporation whose stock was held by the trust. Proposed regulations issued on December 29, 2000 change this requirement. Under the proposed regulations, the trustee must sign and file the statement of election with the service center where the trust files its income tax return. Thus, only one ESBT election need be made for a trust regardless of the number of S corporations whose stock is held by the ESBT. See Prop. Treas. Reg. § 1.1366-1(m)(2).

iii) Under the Notice and the proposed regulations, the ESBT election generally must be filed within the time requirements prescribed in Treas. Reg. § 1.1366-1(j)(6)(iii) for QSST elections. See Prop. Treas. Reg. § 1.1361-1(m)(2)(iii).

iv) Under the proposed regulations and contrary to the rules for QSSTs, a trustee cannot file a protective ESBT election. A protective ESBT election is an election made that will be effective only if the trust does not qualify as a permitted shareholder under any other provision. The Treasury accords different treatment to QSST and ESBT protective elections because, unlike a protective QSST election, a protective ESBT election could result in a change in the incidence of taxation from the owner of the trust to the trust itself. See Prop. Treas. Reg. § 1.1361-1(m)(2)(v).

(d) Each potential current beneficiary of the trust is counted as a shareholder for purposes of the 75-shareholder limitation. Section 1361(c)(2)(B)(v). If there are no such beneficiaries, the trust is treated as the shareholder. Id.

i) A potential current beneficiary generally means, with respect to any period, any person who during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. Section 1361(e)(2).

ii) If a trust disposes of all of the stock that it holds in an S corporation, the term "potential current beneficiary" does not include any person who otherwise first became a potential current beneficiary during the 60-day period ending on the date of such disposition. Thus, if on a certain date a 76th person otherwise becomes a potential current beneficiary, the trust has 60 days to dispose of the S corporation stock before the corporation's S status terminates. Id.

iii) Notice 97-49 provides the following guidance as to the definition of a "potential current beneficiary:" (i) If a distributee trust of an intended ESBT becomes entitled to, or at the discretion of any person may receive, a distribution from principal or income of the intended ESBT, then the S election will terminate unless the distributee trust is itself a trust eligible to be an S corporation shareholder (e.g., an ESBT or a QSST); (ii) If the distributee trust is such a trust, the persons described in Section 1361(c)(2)(B) are treated as shareholders of the corporation for purposes of determining whether the applicable shareholder restrictions are met; and (iii) A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a "potential current beneficiary" until such time or the occurrence of such event.

iv) Notice 97-49 further states that whether a person to whom a distribution is or may be made during a period pursuant to a power of appointment is a potential current beneficiary is "currently under study."

v) Proposed regulations issued on December 29, 2000 reaffirm the above rules regarding potential current beneficiaries and also clarify issues left unanswered by prior administrative guidance.

a) Under the proposed regulations, a person to whom a distribution is or may be made during a period pursuant to a power of appointment is a potential current beneficiary. Thus, if any person has a general lifetime power of appointment over the trust, the corporation's S election will terminate because the number of potential current beneficiaries will approach infinity. See Prop. Treas. Reg. § 1.1361-1(m)(4)(vi).

b) The deemed owner of a grantor trust, which is also an ESBT, is a potential current beneficiary. See Prop. Treas. Reg. § 1.1361-1(m)(4)(ii).

c) The proposed regulations alter the treatment of distributee trusts by providing that a distributee trust does not include a trust that has no assets and no items of income, loss, deduction, or credit (e.g., a trust providing for another trust to be funded at some future time). See Prop. Treas. Reg. § 1.1361-1(m)(4)(iv).

d) A person is counted only once even though that person may be treated as a shareholder of the S corporation by direct ownership and through one or more eligible trusts in Section 1361(c)(2)(A). Also, a husband directly owning stock and a wife indirectly owning stock as a potential current beneficiary of an ESBT are treated as one shareholder. See Prop. Treas. Reg. § 1.1361-1(m)(4)(vii).

e) The right of a beneficiary to assign the beneficiary's interest to a third party does not result in the third party being a potential current beneficiary until that interest is actually assigned. See Prop. Treas. Reg. § 1.1361-1(m)(4)(viii).

(e) A potential current beneficiary is not necessarily a beneficiary of the ESBT for purposes of meeting the definition of an ESBT. For example, a person in whose favor property could currently be appointed, but to whom no such appointment has been made, is a potential current beneficiary, but not a beneficiary. See Preamble to Prop. Treas. Reg. § 1.1361-1(m), 65 Fed. Reg. 82963 (Dec. 29, 2000).

(f) Under the proposed regulations issued on December 29, 2000, Treasury provided that grantor trusts may

also elect to be treated as an ESBT because grantor trusts are common family estate planning tools. See Prop. Treas. Reg. § 1.1361-1(m)(1)(iv), -1(m)(9), Ex. 3.

(g) Unlike the other trusts permitted to be shareholders of an S corporation, an ESBT pays a trust level income tax separate from its beneficiaries. Notice 97-49 and Section 641(c) provide rules for the taxation of ESBTs. Proposed regulations issued on December 29, 2000 significantly expand the rules for the taxation of ESBTs.

i) Under Section 641(c), the portion of any ESBT that consists of stock in one or more S corporations is treated as a separate trust ("S portion"). The S portion of an ESBT is taxed differently than the rest of the ESBT. The differences are as follows:

a) Except for net capital gains, the taxable income of the S portion is subject to the highest rate of tax applicable to trust income. Section 641(c)(2)(A).

i. This provision may dissuade shareholders from handling their estate planning affairs through ESBTs.

ii. Pursuant to the 2001 Act, the top trust income tax rate gradually drops to 35% by 2006. However, the top rate will jump back to 39.6% in 2011.

b) The exemption amount for the alternative minimum tax is zero.

i. This particular adjustment may cause the S portion to generate additional tax liability, which may require the ESBT to take a cash distribution from the S

corporation in order to pay its S portion tax liability.

ii. If any portion of the cash distribution is treated as an ordinary dividend, the proposed regulations allocate the income to the non-S portion. As a result, the cash distribution used to pay the S-portion tax liability may generate tax liability to the non-S portion. See Prop. Treas. Reg. § 1.641(c)-1(f)(2), -1(k) ex. 1.

c) The only items of income, loss, deduction, or credit to be taken into account by the S portion are the following: (i) the pass through items of the S corporation, (ii) any gain or loss on the disposition of the stock of the S corporation, and (iii) to the extent provided in regulations, state or local income taxes and administrative expenses allocable to the items in (i) or (ii). No other deduction or credit is allowed.

i. This particular adjustment may also cause the tax liability problem mentioned above in b).

d) If the ESBT borrowed to purchase the stock in the S corporation, the interest paid by the trust is allocated to the S portion, but it is not deductible. Apparently, the interest expense is not considered a deductible administrative expense. See Prop. Treas. Reg. § 1.641(c)-1(d)(4)(ii).

i. This particular adjustment may also cause the tax

liability problem mentioned above in b).

ii. Comment: This provision of the proposed regulations may be inconsistent with the statute. Because the interest expense is not allocable to any of the items in Section 641(c)(2)(C)(i) or (ii), the interest expense should continue to be deductible by the non-S portion. Section 641(c)(2)(C)(iii) authorizes Treasury regulations regarding the deductibility of interest expense only to the extent the expense is allocable to items in Section 641(c)(2)(i) or (ii).

e) Capital losses can only be offset against capital gains.

f) No items taken into account for purposes of the S portion may be apportioned to any ESBT beneficiary.

g) For purposes of determining the tax from the non-S portion of the ESBT and for purposes of determining the treatment of distributions from an ESBT, the items of income, loss, deduction and credit taken into account by the S portion of the ESBT are disregarded.

(h) Rev. Proc. 98-23, 1998-1 C.B. 662, provides special procedures for the conversion of a QSST to an ESBT and an ESBT to a QSST. Proposed regulations issued on December 29, 2000 partially modify these procedures. See Prop. Treas. Reg. § 1.1361-1(j)(12), -1(m)(7).

(i) The proposed regulations provide that generally a trustee must seek the consent of the Commissioner

to revoke its ESBT election by obtaining a private letter ruling. See Prop. Treas. Reg. § 1.1361-1(m)(6).

(j) The proposed regulations further provide that an ESBT election terminates when either of the following occur: (i) The trust ceases to meet the definition of an ESBT; or (ii) The trust disposes of all S corporation stock unless the trust uses the installment sale method to report gain. See Prop. Treas. Reg. § 1.1361-1(m)(5).

(x) As discussed above, section 1308 of the 1996 Small Business Act provides that an S corporation may own 100 percent of the stock of another S corporation if the parent S corporation (the "S parent") elects to treat the subsidiary S corporation as a "qualified subchapter S subsidiary" (a "QSub").

(a) Under the election, the QSub is not treated as a separate corporation, and all of the subsidiary's assets, liabilities, and items of income, deduction, and credit are treated as the assets, liabilities, and items of income, deduction, and credit of the S parent. Section 1361(b)(3)(A).

(b) TRA '97 authorized the Service to issue regulations under which a QSub may be treated as a separate corporation (e.g., in the case of a QSub that is a bank).

(c) TRA '97 also authorized the Service to issue regulations relating to certain consolidated return issues that may arise in connection with a QSub.

(d) As discussed above, final QSub regulations were issued by the Service on January 20, 2000. These regulations are discussed in detail in PART ONE: Section V.A.6.

b. Transitory ownership by ineligible shareholders

(i) It is unclear whether momentary ownership of stock by an ineligible shareholder will disqualify the corporation as a small business corporation. Compare Rev. Rul. 80-169, 1980-1 C.B. 188; Rev. Rul. 77-155, 1977-1 C.B. 264; Rev. Rul. 69-168, 1969-1 C.B. 24; Rev. Rul. 59-235, 1959-2 C.B. 192.

(ii) The Service has ruled privately on numerous occasions that transitory ownership of S corporation stock by a corporation will not result in the termination of the S election. See, e.g., G.C.M. 39768 (Dec. 1, 1988) (stating that "an S corporation that momentarily has a corporate shareholder in the course of a reorganization is not disqualified from being an S corporation under Section 1361(b)(1)(B)"); PLR 9414016; 9405014; 9404014; 9403031; 9402029; 9350039; 9344034; 9344022; 9338038.

(iii) One of the recommendations contained in the ABA Task Force Report is that G.C.M. 39768 should be issued as a published ruling. Task Force Report at 468.

c. Incorporating a partnership

(i) In general, the incorporation of a partnership may occur in three ways. See Rev. Rul. 84-111, 1984-2 C.B. 88, revoking Rev. Rul. 70-239, 1970-1 C.B. 74.

(a) The partnership can transfer its assets to the corporation in exchange for stock, followed by a termination of the partnership.

(b) The partnership can terminate by distributing its assets to the partners, who then contribute assets to the corporation in exchange for its stock.

(c) The partners can transfer their partnership interests to the corporation in exchange for its stock.

(ii) If the incorporation proceeds under the first alternative, the S election technically could not be effective immediately because the corporation had an ineligible shareholder (the partnership) during a portion of its initial taxable year – an election would be effective for the next succeeding year. The Service, however, may disregard the transitory ownership of an ineligible shareholder.

5. Only One Class of Stock

a. A small business corporation cannot have more than one class of stock. Section 1361(b)(1)(D).

b. On October 5, 1990, the Service issued proposed regulations pertaining to the single class of stock requirement. In response to the numerous comments and concerns raised by practitioners and taxpayers concerning the regulations, on August 8, 1991, the

Service issued new proposed regulations (PS-4-73) (the "proposed regulations"). The Service adopted the proposed regulations as final regulations, with certain revisions, in T.D. 8419 on May 28, 1992 (the "final regulations"). The final regulations are analyzed below.

c. The final regulations – more than one class of stock

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. Treas. Reg. § 1.1361-1(l)(1). Differences in voting rights among shares of stock are disregarded in determining if a corporation has more than one class of stock.

(i) Thus, an S corporation may have voting and nonvoting common stock without violating the single class of stock requirement. See PLR 9323033.

(ii) A class of stock that votes only on certain issues or in accordance with an irrevocable proxy agreement is not a second class of stock.

(iii) Similarly, shares that differ with respect to the right to elect members of the Board of Directors do not give rise to a second class of stock.

(iv) Identical rights with respect to distribution and liquidation proceeds

(a) The determination of whether shares of stock confer identical rights with respect to distribution and liquidation proceeds is made based on an analysis of the rights conferred to the shareholders by the "governing provisions." Treas. Reg. § 1.1361-1(l)(2)(i). The term "governing provisions" refers to the terms and provisions set forth in the following items:

i) corporate charter;

ii) articles of incorporation;

iii) bylaws;

iv) applicable state law; and

v) any other binding agreement that relates to distribution and liquidation proceeds.

(b) Thus, commercial contractual agreements, such as leases, employment contracts, or loan agreements, will not give rise to a second class of stock unless a principal purpose of the agreement is to circumvent the single class of stock requirement. Id. See e.g., PLR 9318007 (split-dollar life insurance agreement does not create a second class of stock); PLR 9309046 (same); PLR 9248019 (same).

(c) In PLR 199918050, a C corporation acquired an S corporation in a reverse subsidiary cash merger. In the transaction, a subsidiary of the C corporation merged into the S corporation, and the S corporation shareholders received cash from the C corporation rather than stock. The parties intended to make a section 338(h)(10) election. The agreement provided that the C corporation would make a payment to each S corporation shareholder to compensate them for any increased liability for federal and state income taxes resulting from that election (i.e., a gross-up payment). The amounts of these gross-up payments varied on a per-share basis among the shareholders. The Service concluded that solely for purposes of the single class of stock requirement of section 1361(b)(1)(D), the transaction was treated as a sale of stock by the S corporation shareholders to the C corporation, and not as a sale of assets followed by a liquidation of the S corporation. (If treated as an asset sale and a liquidation, the shareholders could have been deemed to receive unequal amounts per share due to the differing per share gross-up payments). Accordingly, the Service concluded that the unequal gross-up payments did not cause the S corporation to have a second class of stock. See PLR 199918050.

(d) Although a corporation is not treated as having more than one class of stock as long as the governing provisions provide for identical distribution and liquidation rights, any distribution (including actual, constructive or deemed distributions) that differs in timing or amount is "to be given appropriate tax effect in accordance with

the facts and circumstances." Treas. Reg. § 1.1361-1(l)(2)(i).

(e) Exceptions

In certain limited situations, differences in distribution and liquidation rights created by the governing provisions are nonetheless disregarded in determining if a corporation has more than a single class of stock. These exceptions are discussed below.

i) State law requirements for payment and withholding of income tax

a) State laws that require a corporation to pay or withhold state income taxes on behalf of some or all of its shareholders are disregarded in determining if a corporation has more than a single class of stock, provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. Treas. Reg. § 1.1361-1(l)(2)(ii).

b) A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock. Id.

c) Thus, if the governing provisions provide for the right to equal distributions after taking into account the income tax payments made on behalf of the nonresident shareholders, the corporation's shares of stock will be treated as conferring identical rights to distribution proceeds. Treas. Reg. § 1.1361-1(l)(2)(v), ex. 7.

ii) Buy-sell and redemption agreements

a) Buy-sell agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. Treas. Reg. § 1.1361-1(l)(2)(iii)(B).

b) In addition, buy-sell agreements among shareholders, agreements restricting the transferability of stock and redemption agreements also are disregarded 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. Treas. Reg. § 1.1361-1(l)(2)(iii)(A). See PLR 9404020; PLR 9308006.

c) Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock. Id.

d) A good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error or the determination of the value was not performed with reasonable diligence. Id.

e) A determination of book value will be respected if the book value is (i) determined in accordance with

GAAP or (ii) used for any substantial nontax purpose. Treas. Reg. § 1.1361-1(l)(2)(iii)(c).

iii) Varying interests

A corporation's shares of stock will be treated as conferring identical rights with respect to distribution and liquidation proceeds notwithstanding that the governing provisions provide that, as a result of a change in stock ownership, distributions in one taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the immediately preceding taxable year. Treas. Reg. § 1.1361-1(l)(2)(iv).

(v) Stock taken into account

In general, all outstanding shares of stock of a corporation are taken into account in determining whether the corporation's shares of stock confer identical rights to distribution and liquidation proceeds. Treas. Reg. § 1.1361-1(l)(3). Exceptions are provided for restricted stock, deferred compensation plans, and debt that meets the straight debt safe harbor of Section 1361(c)(5). These exceptions are discussed below.

(a) Restricted stock

For purposes of subchapter S, stock that is issued in connection with the performance of services and that is substantially nonvested (within the meaning of Treas. Reg. § 1.83-3(b)) is not treated as outstanding stock of the corporation. Treas. Reg. § 1.1361-1(b)(3).

i) Accordingly, the holder of such stock is not treated as a shareholder merely because he or she holds such stock. Further, such stock is not considered in determining if the corporation has a second class of stock. Id.

ii) However, if the holder makes an election under Section 83(b), the stock is treated as outstanding stock of the corporation, and the

holder is treated as a shareholder. Such stock will be viewed as a second class of stock if it does not confer identical rights as to distributions and liquidation proceeds. Id.

(b) Deferred compensation plans

i) An instrument, obligation, or arrangement is not treated as outstanding stock if it does not convey the right to vote, is an unfunded and unsecured promise to pay money or property in the future; is issued to an individual who is an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation; and is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income. Treas. Reg. § 1.1361-1(b)(4). See e.g., PLR 9406017; PLR 9317021; PLR 9317009; PLR 9247013.

ii) A deferred compensation plan that has a current payment feature is not treated as outstanding stock. Id.

(c) Straight debt

An instrument or obligation that satisfies the definition of straight debt contained in the final regulations is not treated as outstanding stock. The definition of straight debt is discussed in Section II.A.5.e., below.

(d) Special effective date provisions

i) The provisions in the final regulations pertaining to restricted stock, deferred compensation plans and straight debt generally apply to taxable years of a corporation beginning on or after May 28, 1992. Treas. Reg. § 1.1361-1(b)(6).

ii) However, a corporation and its shareholders may apply these rules to prior taxable years.

In addition, substantially nonvested stock issued on or before May 28, 1992, that has been treated as outstanding by the corporation is treated as outstanding for subchapter S purposes, and the fact that it is substantially nonvested and no Section 83(b) election has been made with respect to it will not cause the stock to be treated as a second class of stock. Id.

d. Other instruments treated as a second class of stock

(i) Debt instruments, obligations and other similar arrangements

(a) In general

Instruments, obligations, and other similar arrangements (collectively referred to as "debt arrangements") issued by an S corporation are not treated as a second class of stock unless the debt arrangement

i) constitutes equity or otherwise results in the holder being treated as the owner of stock under general tax principles, and

ii) a principal purpose of issuing or entering into the debt arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders of an S corporation. Treas. Reg. § 1.1361-1(l)(4)(ii)(A). See PLR 9308006 (S corporation's note did not create a second class of stock since it represented that it did not intend to circumvent the single class of stock rules).

(b) Exceptions

Some debt arrangements can never create a second class of stock, notwithstanding the general rule. Treas. Reg. § 1.1361-1(l)(4)(i). These exceptions are discussed below.

i) Short-term unwritten advances

a) Unwritten shareholder advances will not create a second class of stock if such advances (1) do not exceed $10,000 in the aggregate at any time, (2) are treated as debt by the parties, and (3) are expected to be repaid within a reasonable time. Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(1).

b) Unwritten shareholder advances that qualify under the safe harbor will not be treated as a second class of stock even if the advances are considered equity for Federal income tax purposes. Id.

c) Moreover, unwritten shareholder advances that fail to qualify for the safe harbor will result in a second class of stock only if such advances would be considered a second class of stock under the general rules applicable to debt arrangements. Id.

ii) Proportionately-held obligations

a) Debt arrangements that are owned solely by the shareholders of an S corporation in the same proportion as their respective percentage stock ownership interest will not create a second class of stock, regardless of whether the debt arrangements are considered equity for Federal income tax purposes. Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(2).

b) Obligations owned by the sole shareholder of a corporation are always held proportionately to the corporation's outstanding stock. Id.

c) As with unwritten shareholder advances, shareholder obligations that fail to qualify for the safe harbor

will result in a second class of stock only if such obligations would be considered a second class of stock under the general rules applicable to debt arrangements. Id.

(ii) Call options, warrants or other similar instruments

(a) In general

i) A call option, warrant, or similar instrument (collectively referred to as a "call option") issued by an S corporation will not be treated as a second class of stock unless the call option,

a) after taking into account all the facts and circumstances, is substantially certain to be exercised and

b) has a strike price substantially below the fair market value of the underlying stock. Treas. Reg. § 1.1361-1(l)(4)(iii)(A).

ii) The determination of whether a call option has a strike price substantially below the fair market value of the underlying stock is made: (1) at the time of issuance, (2) on the date of a transfer by an eligible shareholder to a person who is not an eligible shareholder of an S corporation, and (3) at the time of a material modification of the terms of the call option by the corporation. Id.

iii) If an option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with a modification of the terms of the loan, the extension of time is not considered a material modification. Id.

iv) A call option does not have a strike price substantially below fair market value if the price at the time of exercise cannot, pursuant to the terms of the instrument, be substantially below the fair market value of

the underlying stock at the time of exercise. Id.

(b) Exceptions

i) Options issued to lenders

A call option is not treated as a second class of stock if it is issued to a person that is actively and regularly engaged in the business of lending and is issued in connection with a loan to the corporation that is commercially reasonable. Treas. Reg. § 1.1361-1(l)(4)(iii)(B)(1).

ii) Options issued to employees

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 is not treated as a second class of stock if the call option

a) is nontransferable within the meaning of Treas. Reg. § 1.83-3(d), and

b) does not have a readily ascertainable fair market value (as defined in Treas. Reg. § 1.83-7(b)) at the time the option is issued. Treas. Reg. § 1.1361-1(l)(4)(iii)(B)(2).

(c) Safe harbor relief

i) A call option that conveys the right to acquire stock of the corporation at a specified strike price will not be treated as a second class of stock if the strike price of the call option is at least 90 percent of the fair market value of the stock with respect to which the call option may be exercised. Treas. Reg. § 1.1361-1(l)(4)(iii)(C).

ii) For this purpose, the test must be met at the time the option is issued, materially modified, or transferred by a person who is

an eligible shareholder to a person who is not an eligible shareholder. Id.

iii) For purposes of the safe harbor, a good faith determination of fair market value will be respected unless the value was substantially in error or the determination of the value was not performed with reasonable diligence. Id.

iv) A call option that fails to meet the safe harbor will not necessarily be treated as a second class of stock. Id.

(iii) Convertible debt

A convertible debt instrument is considered a second class of stock if it would be treated as a second class under

(a) the general rules applicable to debt arrangements, or

(b) the general rules applicable to call options. Treas. Reg. § 1.1361-1(l)(4)(iv).

e. The straight debt safe harbor rules

The final regulations adopt the statutory safe harbor definition of "straight debt" in determining if debt is to be treated as a second class of stock.

(i) In general

Any debt that is treated as "straight debt" will not be treated as a second class of stock. See PLR 9342019; PLR 9308006. Under Section 1361(c)(5) (prior to its amendment by section 1304 of the 1996 Small Business Act) and the final regulations, the term "straight debt" meant a written unconditional obligation to pay a sum certain on demand, or on a specified due date, which

(a) does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors,

(b) is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation, and

(c) is held by an individual (other than a nonresident alien), an estate, or a trust described in Section 1361(c)(2).

(ii) The 1996 Small Business Act

Section 1304 of the 1996 Small Business Act expanded the definition of "straight debt" in Section 1361(c)(5) of the Code to include otherwise-qualifying debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

(iii) Subordination

The fact that an obligation is subordinated to other debt of the corporation does not prevent the obligation from qualifying as straight debt. Treas. Reg. § 1.1361-1(l)(5)(ii).

(iv) Modification

An obligation that originally qualified as straight debt ceases to so qualify if the obligation is

(a) materially modified so that it no longer satisfies the definition of straight debt, or

(b) transferred to a third party who is not an eligible shareholder of an S corporation. Treas. Reg. § 1.1361-1(l)(5)(iii).

(v) Treatment of straight debt for other purposes

(a) An S corporation obligation that satisfies the straight debt safe harbor is not treated as a second class of stock. As a result, the obligation is treated as debt and is subject to the applicable rules governing indebtedness for all other tax purposes. Treas. Reg. § 1.1361-1(l)(5)(iv).

(b) Accordingly, interest paid or accrued with respect to a straight debt obligation is generally treated as interest and does not constitute a distribution to which Section 1368 applies. Id.

(c) However, if a straight debt obligation bears an interest rate that is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not

interest. Such a recharacterization does not result in a second class of stock. Id.

(vi) Treatment of C corporation "debt"

(a) If a C corporation has an outstanding obligation that satisfies the definition of straight debt, but which is considered equity under general tax principles, then the obligation will not be treated as a second class of stock if the C corporation converts to S status. Treas. Reg. § 1.1361-1(l)(5)(v).

(b) In addition, the conversion from C corporation status to S corporation status will not be treated as an exchange of debt for stock with respect to such an instrument. Id.

f. Miscellaneous provisions

(i) Inadvertent terminations

(a) An S corporation that is treated as having more than one class of stock loses its S election status on the date the corporation is treated as having more than one class of stock.

(b) In such cases, the S corporation may apply for inadvertent termination relief pursuant to Section 1362(f). Treas. Reg. § 1.1361-1(l)(6). If granted, the S corporation status will be restored retroactive to the date the S election was terminated.

(ii) Effective dates

(a) The final regulations generally apply to taxable years of a corporation beginning on or after May 28, 1992. Treas. Reg. § 1.1361-1(l)(7).

(b) However, the rules applicable to buy/sell agreements, redemption agreements, agreements restricting the transferability of stock, debt arrangements and call options do not apply to agreements, arrangements and options that were issued or entered into on or before May 28, 1992. Id.

6. Permitted Taxable Years

An S corporation's taxable year must be a "permitted year." Section 1378(a). Further, no election can be made for any taxable year unless such year is a permitted year. Temp. Treas. Reg. § 18.1378-1(a). A permitted year is either a calendar year or any other year for which the corporation establishes a "business purpose" to the satisfaction of the Secretary. Section 1378(b); Temp. Treas. Reg. § 18.1378-1(a).

a. Regulations

Temporary regulations under Section 1378 were published on January 26, 1983. T.D. 7872, 48 Fed. Reg. 3590 (1983).

(i) Under these regulations, an S corporation could automatically change to a calendar year to comply with the permitted year requirement if all of its principal shareholders are calendar year taxpayers (or if they concurrently change to a calendar year). Temp. Treas. Reg. § 18.1378-1(b)(1). A principal shareholder is one holding 5 percent of the issued and outstanding stock of the corporation. Id.

(ii) If a new corporation makes an S election (i.e., a corporation that has not yet adopted a taxable year), the filing of the election will constitute the adoption of a calendar year. Id.

(iii) If a fiscal year corporation qualifies for the automatic change to a calendar year, the mere filing of the election will constitute a change to the calendar year for the first year for which the election is effective, unless the corporation makes a request in the election to retain or adopt a fiscal year. Temp. Treas. Reg. § 18.1378-1(b)(2)(i) and (ii).

(iv) If an S corporation makes a request to retain or adopt a fiscal year in its S election, the S election will be effective if approval as to the chosen fiscal year is given. Temp. Treas. Reg. § 18.1378-1(b)(2)(ii). If the request is denied, the election will be ineffective unless a specific request is made in the alternative that the corporation be placed automatically on the calendar year (or the Service provides such result by waiver).

(v) A fiscal year C corporation filing an S election after October 19, 1982, that does not qualify for an automatic change to a calendar year must first secure and obtain a determination that it has a permitted year. Temp. Treas.

Reg. § 18.1378-1(d). Until such time, an S election will not be effective.

(vi) These regulations also contain procedures for the adoption, retention and change of accounting periods by corporations in existence on January 1, 1982 who make an election after October 19, 1982.

(vii) The Service announced that it is suspending application of those provisions within Temp. Treas. Reg. § 18.1378-1 that permit a taxpayer to change its year without permission or to utilize an expedited process. See Ann. 86-101, 1986-41 I.R.B. 14, as modified by Ann. 86-113, 1986-47 I.R.B. 46.

b. Prior administrative guidelines

The Service issued Rev. Proc. 83-25, 1983-1 C.B. 689, which described specific circumstances where a fiscal year would be a permitted year under old Section 1378 (i.e., prior to its amendment by TRA '86). Three general possibilities were set forth therein.

(i) The permitted year requirement would be satisfied if the chosen fiscal year conformed to the same taxable year as that of shareholders who held more than 50 percent of the shares of stock in the S corporation (as of the first day of the requested year). Rev. Proc. 83-25 (§ 4.02), supra. Shareholders could concurrently change their year to match the corporation's year only with the Service's consent.

(ii) The permitted year requirement was satisfied if shareholders holding more than 50 percent of the shares of stock in the S corporation used (or were concurrently changing to) a tax year which did not result in more than three months' deferral of income. Rev. Proc. 83-25 (§ 4.03), supra. In other words, if the required percentage of stock was held by calendar year taxpayers, the permitted fiscal years would be September 30, October 31 or November 30.

(iii) The permitted year requirement was satisfied if the fiscal year chosen corresponded to the S corporation's "natural business year." A selected fiscal year was deemed to be a natural business year if for the three final periods preceding the S election, 25 percent of the S corporation's gross receipts are recognized in the final two months of the 12-month period selected. Rev. Proc. 83-25 (§ 4.04), supra.

c. Effect of 1986 Act

Following the 1986 Act, the deferral of income does not constitute a business purpose. Section 1378(b) (as amended by P.L. 99-514, section 806(b)(2)). Thus, the Act essentially invalidates section 4.03 of Rev. Proc. 83-25, supra.

(i) However, the 1986 Act legislative history indicates that the 25-percent gross receipts test may still be used to establish a business purpose for a fiscal year. H.R. Rep. No. 99-841, 99th Cong., 2d Sess. II-319 (1986) (the "conference report").

(ii) The conference report also states that other tests may be prescribed by the Service, except that the following reasons will not be sufficient to establish a business purpose for a fiscal year:

(a) use of the fiscal year for regulatory or financial accounting purposes;

(b) hiring patterns of particular businesses (e.g., the hiring of staff occurs at certain peak times during the year);

(c) use of a fiscal year for administrative purposes such as the effective date for the admission or retirement of new shareholders, etc.; and

(d) the fact that a particular business involves the use of price lists, model years or other items that change on an annual basis.

(iii) The conference report also indicates that regulations should be issued to prevent tax avoidance through use of a 52-53 week taxable year. The Service has already responded. See Treas. Reg. §§ 1.441-2T(e) and -3T.

(iv) The changes are effective for taxable years beginning after December 31, 1986. P.L. 99-514, section 806(e)(1).

(v) Certain provisions were added to alleviate the bunching of income that may occur because of a shift to a calendar year. See P.L. 99-514, section 806(e)(2); Treas. Reg. § 18.1366-5.

d. Current administrative guidance

(i) The Service issued Rev. Proc. 87-32, 1987-2 C.B. 396, which provides guidance to S corporations and corporations electing to be an S corporation that desire to adopt, retain or change its tax year. Rev. Proc. 87-32 modifies Rev. Proc. 83-25 consistent with TRA '86 and supersedes Rev. Proc. 83-25 to the extent of any modification. (Rev. Proc. 87-32 has been modified by Temp. Treas. Reg. §§ 301.9100-1T to -3T as of June 27, 1996; the modification relates to applications for relief under Section 9100 for requests to change an accounting period.) Rev. Proc. 87-32 provides the following:

(a) Expeditious approval provisions for any partnership, S corporation, corporation electing to be an S corporation, or personal service corporation that desires to retain a tax year that coincides with its natural business year.

(b) Expeditious approval provisions for any partnership, S corporation, corporation electing to be an S corporation, or personal service corporation that desires to change to a tax year that coincides with its natural business year, and such tax year results in less deferral of income to the owners than its present tax year.

i) The Service released Notice 2001-35, 2001-23 I.R.B. 1, on May 11, 2001. This Notice proposes a revenue procedure that would expand the circumstances under which the Service would grant automatic approval for an adoption, change, or retention of an annual accounting period. This Notice also proposes to provide audit protection to taxpayers adopting, changing, or retaining an annual accounting period pursuant to the proposed revenue procedure.

ii) Notice 2001-35 proposes to relax the current rule by allowing any partnership, S corporation, corporation electing to be an S corporation, or personal service corporation to change to a tax year that coincides with its natural business year regardless of whether such year results in more deferral of income than its present tax year.

(c) Expeditious approval provisions for any S corporation or corporation electing to be an S corporation that desires to adopt, retain, or change to a tax year of a majority of its shareholders (ownership tax year).

i) Notice 2001-35 also proposes to disregard certain tax-exempt entities for purposes of determining the ownership tax year.

(d) Special notification provisions for any partnership, S corporation, corporation electing to be an S corporation, or personal service corporation that intends to adopt, retain or change its tax year as required by the 1986 Act.

(e) Special notification provisions for any partnership or S corporation that desires to retain a grandfathered fiscal year.

(f) Instructions for any partnership, S corporation, corporation electing to be an S corporation, or personal service corporation that desires to adopt, retain, or change its tax year but can do so only by establishing a business purpose that does not qualify for either the expeditious approval provisions or the special notification provisions.

i) The Service released Notice 2001-34, 2001-23 I.R.B. 1, on May 11, 2001. This Notice proposes a revenue procedure that would provide the procedures under Section 442 to establish a business purpose and request approval to adopt, change, or retain an annual accounting period. However, Notice 2001-34 does not expand the circumstances in which a partnership, S corporation, corporation electing to be an S corporation, or personal service corporation may use a fiscal year.

(ii) In Rev. Rul. 87-57, 1987-2 C.B. 117, the Service described eight situations and applied the provisions of Rev. Proc. 87-32 to determine if the taxpayer established a business purpose for adopting, retaining or changing its taxable year.

e. Additional changes

As set forth in the discussion above, an S corporation generally is required to conform its taxable year to that of its owners for taxable years beginning after December 31, 1986, although an exception is provided for S corporations that can establish a business purpose for a different year. However, in response to public outcry regarding these TRA '86 changes, section 10206 of OBRA '87 added to the Code Section 444, which allows an S corporation to elect to have a taxable year other than the required taxable year.

(i) Section 444 provides that an S corporation that is otherwise required to change to a calendar year can elect to retain the tax year it used for its last year beginning in 1986. Section 444(b)(3).

(ii) Also, an S corporation may adopt or change to a fiscal year, but only if the deferral period with respect to the new year generally is no longer than three months as compared to the otherwise required year. Sections 444(b)(1) and (4).

(a) For example, if a taxable year of December 31 is otherwise required under Section 1378, a fiscal year ending September 30 may be elected under Section 444. The deferral period of the elected taxable year is the maximum three months.

(b) However, where the S corporation is changing its taxable year, a further limitation applies. Under Section 444(b)(2), a Section 444 election may be made only if the deferral period is not longer than the deferral period currently enjoyed.

(c) For additional guidance, see Treas. Reg. §§ 1.444-1T, -2T and -3T; Notice 88-49, 1988-1 C.B. 532; Notice 88-10, 1988-1 C.B. 478.

(iii) The election is made at the entity level. Section 444(d). The trade-off for allowing such an election is that electing S corporations must make enhanced estimated tax payments under Section 7519. Section 444(c). The

enhanced payments are intended to represent the value of the tax deferral obtained by the owners of the S corporation through the use of a taxable year different from the required year. Notice 88-10, supra.

(iv) Section 444 does not apply to S corporations using a fiscal year which is permitted under the business purpose exception. See Section 444(a) and (c). In other words, the provision applies to S corporations that wish to elect a fiscal year but cannot demonstrate a good business purpose for the fiscal year.

(v) An S corporation wishing to terminate its Section 444 election and change to the required year does so by filing a tax return for the short tax year ending December 31. The short year return must be filed by the due date of the return; a willful failure to comply with the requirements of Section 7519 is not a method of terminating the Section 444 election. TAM 9419002.

f. Failure to adopt permitted year

Unless a Section 444 election is made, the effect of the 1986 Act changes is as follows:

(i) With respect to a new S corporation, the S election will not be effective if the corporation fails to adopt a permitted taxable year.

(ii) With respect to existing S corporations, the election will terminate if the S corporation fails to change to a permitted year.

B. Mechanics of the Election

The salient aspects of making, revoking and terminating an S election will be discussed in this Section.

1. Making the Election

The election is made by filing a completed Form 2553, Election by a Small Business Corporation. Treas. Reg. § 1.1362-6(a)(2)(i).

a. Timing

(i) Under Section 1362(b)(1), a small business corporation must make its S election for any taxable year either

(a) during the preceding taxable year, or

(b) before the 16th day of the third month of the taxable year (i.e., during the first two and one-half months of the year). Treas. Reg. § 1.1362-6(a)(2)(ii)(A).

(ii) An election made during the taxable year, but after the first two and one-half months, will be treated as having been made for the following year, provided that the corporation meets all the requirements of Section 1361(b) at the time the election is made. Treas. Reg. § 1.1362-6(a)(2)(ii)(A).

(iii) An election made for a taxable year of two and one-half months or less (i.e., a short year) will be effective if made within two and one-half months after the first day of the taxable year. Section 1362(b)(4). Thus, an election made at any time during such a short year will be effective for that year. Treas. Reg. § 1.1362-6(a)(2)(ii)(A), (iii) (ex. 2).

(iv) The timing rules for filing the election have been interpreted by the courts very strictly. See, e.g., Simons v. United States, 208 F. Supp. 744 (D. Conn. 1962) (election invalid where filed one day late); Pestcoe v. Commissioner, 40 T.C. 195 (1963). Prior to the 1996 Small Business Act, no extensions were permitted. Rev. Rul. 60-183, 1960-1 C.B. 625; PLR 8637062. As discussed below, the 1996 Small Business Act allows the Service to treat late filings as timely under certain circumstances, and the Service has issued Rev. Proc. 98-55, 1998-2 C.B. 645, to provide procedures under which it may do so.

b. Consent required

(i) An election will be valid only if all persons who are shareholders of the corporation on the day on which the election is made consent to the election. Section 1362(a)(2); Treas. Reg. § 1.1362-6(b)(3).

(a) If stock is held by an ESBT, then the trustee of the ESBT must consent to the S election, but the ESBT beneficiaries need not consent. See Notice 97-12, 1997-1 C.B. 385. Proposed regulations issued on January 22, 2001 also provide that if there is more than one trustee, the trustee or trustees with authority to legally bind the trust must consent to the S election. Furthermore, if the ESBT is also a grantor trust, the deemed owner must also consent

to the S election if the portion of the trust the person is deemed to own holds stock in the electing S corporation. See Prop. Treas. Reg. 1.1362-6(b)(2)(iv).

(ii) Where an election is made during the first two and one-half months of the year, any departing shareholders who held stock during such portion of year must give their consent to such election. If such consent is not obtained, the election will be treated as having been made for the following taxable year. Section 1362(b)(2); Treas. Reg. § 1.1362-6(a)(2)(ii)(B)(2).

c. The 1996 Small Business Act

(i) Section 1305 of the 1996 Small Business Act granted the Service the authority to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (or both). See Code Section 1362(f). Section 1305 of the 1996 Small Business Act also authorized the Service to treat a late S corporation election as timely where it determines that there was reasonable cause for the failure to make a timely election. See Code Section 1362(b)(5).

(ii) The Service issued Rev. Proc. 97-40, 1997-2 C.B. 488, to provide procedures by which taxpayers can request relief for late S elections. Rev. Proc. 97-40 was superseded by Rev. Proc. 98-55, 1998-2 C.B. 645. Under Rev. Proc. 98-55, a valid S election must be filed within twelve months of the original due date for the election (but in no event later than the due date for the tax return (excluding extensions) for the first year the corporation intended to be an S corporation) and the corporation must have had reasonable cause for failing to make a timely election.

(iii) Rev. Proc. 98-55 also provides procedures by which taxpayers can request relief for late qualified subchapter S subsidiary ("QSub") elections, qualified subchapter S trust ("QSST") elections, and electing small business trust ("ESBT") elections.

(iv) For recent examples of situations where the Service granted relief for an invalid S election that was inadvertent, see PLR 200010034; PLR 199933035; PLR 199918045.

(v) For recent examples of situations where the Service granted relief under the late S election rules, see PLR 200029045; PLR 200027033; PLR 200026018; PLR 200025033; PLR 199914039; PLR 199914021.

d. Qualification as a small business corporation

(i) If an election is made during the preceding taxable year, the corporation must be a small business corporation both at the time of the election and on the first day of the taxable year for which the election is to be effective. Section 1362(a)(1); Rev. Rul. 86-141, 1986-2 C.B. 151. Cf. Section 1362(d)(2) (election terminated if corporation becomes ineligible on or after first effective date).

(a) Where an election is made during the preceding year, a corporation may cease to qualify as a small business corporation any time after the day on which the election is filed and before the first effective date of the election. Treas. Reg. § 1.1362-2(b)(2).

(b) For example, if an election is made on November 15, 1999 to be effective in January 1, 2000, the electing corporation apparently may cease to qualify at any time from November 16 through December 31, 1999 without affecting the S election for 2000.

(ii) If an election for a taxable year is made during the first two and one-half months of the year, the corporation must qualify as a small business corporation on each day of the pre-election period of the year. If the corporation does not so qualify, the election will be treated as having been made for the following taxable year. Section 1362(b)(2); Treas. Reg. § 1.1362-6(a)(2)(ii)(B)(1).

2. Terminating the Election

A valid election is effective for the year made and all subsequent years until it is terminated. Section 1362(c). This Section of the Outline covers termination.

a. By revocation

(i) An S election may be revoked if (and only if) shareholders holding more than one-half of the shares of stock of the corporation – determined at the time such revocation is

made – consent to the revocation. Section 1362(d)(1)(B); Treas. Reg. § 1.1362-2(a)(1).

(ii) A revocation made during the first two and one-half months of the taxable year will be effective retroactively to the first day of such taxable year. Section 1362(d)(1)(C)(i). A revocation made after the close of the two and one-half month period will be effective on the first day of the following taxable year. Section 1362(d)(1)(C)(ii); Treas. Reg. § 1.1362-2(a)(2)(i).

(iii) However, Section 1362(d)(1)(D) provides that a revocation may be effective on or after the date on which the revocation is made if the revocation specifies such a date. See Treas. Reg. § 1.1362-2(a)(2)(ii).

(iv) Note, however, that a debtor corporation's right to make or revoke an S election may constitute "property" of the debtor corporation, so that a prepetition revocation of a corporation's S election can constitute a transfer of property that is voidable by the trustee under applicable bankruptcy laws. See Parker v. Saunders (In re Bakersfield Westar, Inc.), 226 B.R. 227, 234 (9th Cir. BAP 1998).

b. By generating passive investment income

(i) Under Section 1362(d)(3), an S election will be terminated if two conditions exist:

(a) the S corporation has "accumulated earnings and profits" at the close of each of three consecutive taxable years, and

(b) more than 25 percent of the "gross receipts" of the S corporation for each of such taxable years consists of "passive investment income." Section 1362(d)(3)(A)(i); Treas. Reg. § 1.1362-2(c)(1).

For purposes of determining the three-year period, only taxable years beginning after December 31, 1981 in which the corporation was an S corporation are included. Section 1362(d)(3)(A)(iii).

(ii) In general, the term "passive investment income" means "gross receipts" derived from royalties, rents, dividends, interest, annuities and sales or exchanges of stock or securities. Section 1362(d)(3)(C); Treas. Reg. § 1.1362-2(c)(5). However, the regulations to Section 1362(d)(3)

generally exempt from the definition of passive investment income gross receipts derived in the ordinary course of business.

(a) Thus, royalties are limited to those not derived in the ordinary course of a trade or business of licensing property. Treas. Reg. § 1.1362-2(c)(5)(ii)(A)(2).

(b) Similarly, rents do not include rents derived in the active trade or business of renting property. Rents are received in the active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(2). See PLR 200025042; PLR 200024044; PLR 200020013; PLR 200018042; PLR 200016011; PLR 200014011; PLR 200014031; 200007022; PLR 9420014; PLR 9419029; 9418005; PLR 9417021; PLR 9411034 (S corporation's distributive share of gross receipts attributable to a partnership's activities will not constitute passive investment income where the partnership provides significant services).

(c) Passive investment income does not include gross receipts from dealer sales or exchanges of stock or securities. Treas. Reg. § 1.1362-2(c)(5)(ii)(F), (c)(5)(iii)(B)(1)(ii).

(d) Moreover, under section 1308(c) of the 1996 Small Business Act (amending Section 1362(d) of the Code), if an S corporation holds stock in a C corporation meeting the requirements of Section 1504(a)(2) (generally, 80 percent of the value and voting power of the C corporation stock), the passive investment income will not include dividends from the C corporation to the extent such dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.

i) The 1996 Small Business Act did not expressly require that such trade or business be conducted by the C corporation and did not provide guidance on determining the

attribution of dividends to an active trade or business.

ii) The Service addressed this issue in the final QSub regulations. Treas. Reg. § 1.1362-8(a). The final QSub regulations provide that the active earnings and profits of a C corporation subsidiary 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. Id.

iii) The S corporation may use any reasonable method to determine the amount of dividends that are not treated as passive investment income under Section 1362(d)(3). Treas. Reg. 1.1362-8(b)(1). The final QSub regulations also provide a safe harbor for determining the amount of the active earnings and profits that is deemed to be reasonable under all circumstances. Under this provision, a corporation may treat its earnings and profits for a year as active earnings and profits in the same proportion as the corporation's gross receipts derived from activities that would not produce passive investment income (if the C corporation were an S corporation). Treas. Reg. § 1.1362-8(b)(5).

iv) 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 that C corporation during the taxable year are considered active earnings and profits. Treas. Reg. § 1.1362-8(b)(3).

v) Thus, it appears that dividends from a parent of a consolidated group could be excluded from the definition of passive investment income if the parent had earnings and profits due to the earnings and profits of a subsidiary member that were derived from

the subsidiary's active conduct of a trade or business. See Treas. Reg. § 1.1362-8(c)(4)(i); Treas. Reg. § 1.1502-33(b) (tiering up earnings and profits within consolidated groups).

(iii) The term "gross receipts" includes the total amount received or accrued by the S corporation under its method of accounting without reduction for cost of goods, returns and allowances or other deductions. See Treas. Reg. § 1.1362-2(c)(4)(i). Thus, gross receipts is not synonymous with gross income.

(a) Gross receipts from the sale or exchange of capital assets (other than stock or securities) are taken into account only to the extent of net capital gain income. Section 1362(d)(3)(C); Treas. Reg. § 1.1362-2(c)(4)(ii)(A).

(b) Since the taxpayer's method of accounting controls when the gross receipts are included in the Section 1362(d)(3) test, the installment method can apply to defer recognition of the gross receipts on asset sales. Treas. Reg. § 1.1362-2(c)(4)(i). See also PLR 8243169; PLR 7827009.

(iv) An S corporation will not generate earnings and profits while it is an S corporation. Section 1371(c)(1). However, an S corporation may have "accumulated C earnings and profits" for several reasons.

(a) An S corporation may have earnings and profits due to prior status as a C corporation.

(b) Prior to the 1996 Small Business Act, an S corporation may have had earnings and profits from pre-1983 subchapter S years. The 1996 Small Business Act provided, however, that if a corporation is an S corporation for its first taxable beginning after December 31, 1995, the accumulated earnings and profits as of the beginning of that year are reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under Subchapter S.

(c) An S corporation may inherit earnings and profits of a C corporation or a former C corporation as a result of an acquisition described in Section 381.

(d) The S corporation may have had earnings and profits allocated to it under Section 312(h) (i.e., a Section 355 transaction).

(v) A termination due to prolonged passive investment income is effective on the first day of the first taxable year beginning after the close of the consecutive three-year period. Section 1362(d)(3)(A)(ii); Treas. Reg. § 1.1362-2(c)(2).

c. By ceasing to be a small business corporation

An S election will also terminate if the corporation ceases to be a small business corporation at any time on or after the first day of the first taxable year in which the S election took effect. Section 1362(d)(2)(A); Treas. Reg. § 1.1362-2(b)(1).

(i) Termination of S status for this reason is effective as of the date on which the event occurs. Section 1362(d)(2)(B); Treas. Reg. § 1.1362-2(b)(2).

(ii) In contrast, a revocation may be effective retroactively to the beginning of the year (if made within the first two and one-half months) or prospectively if the shareholders specify a future date. Section 1362(d)(1)(C) and (D).

(iii) Where a transfer of stock of an S corporation terminated the S election, but a court subsequently determined that the stock transfer was void ab initio, the S election did not terminate. PLR 9409023.

C. New Election After Termination

1. Five-Year Waiting Period

If an election for a small business corporation is terminated (under Section 1362(d)), that corporation and any "successor corporation" will not be eligible to make a new S election for any taxable year beginning before its fifth taxable year after the first year in which the termination is effective, unless the Secretary consents to an earlier election. Section 1362(g); Treas. Reg. § 1.1362-5(a). In other words, an S election is barred for the remaining portion of the year in which the terminating event took place and the next four taxable years as well.

a. For example, on July 1, 1998, an ineligible shareholder acquires stock of an S corporation. Assuming that ownership of the S stock is not disregarded as being transitory, the S corporation's election is terminated on July 1, 1998. Section 1362(d)(2)(B).

b. A new S election will not be effective before January 1, 2003, the fifth year beginning after the 1998 taxable year.

c. Consent to file earlier election

(i) The corporation requesting consent to make the election has the burden of establishing that, under the relevant facts and circumstances, the Commissioner should consent to a new election. See Treas. Reg. § 1.1362-5(a).

(ii) For purposes of determining whether consent should be granted to file an S corporation election within the five-year period of the termination of an S election, the fact that more than 50 percent of the stock in the corporation is owned by persons who did not own any stock in the corporation on the date of the termination tends to establish that consent should be granted. See Treas. Reg. § 1.1362-5(a).

2. Successor Defined

a. The statute does not define the term "successor corporation." However, the regulations under Section 1362(g) define a successor corporation 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 small business 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. Treas. Reg. § 1.1362-5(b).

b. As a result, a corporation generally 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. Thus, where more than 50 percent of the stock of the former S corporation is owned by new unrelated shareholders, the Service

has consented to an earlier S election. See PLR 200029043; PLR 200025022; PLR 200019007; PLR 199918031; PLR 199916032; PLR 9419010; PLR 934400; PLR 9340047.

c. The apparent purpose of restricting S elections by successor corporations is to prevent avoidance of Section 1362(g) by merely transferring assets to a newly established corporation which could elect S status.

(i) The regulations do not define the term "substantial" as used in reference to the assets held or acquired by the successor.

(ii) A terminated S corporation could not cleanse a Section 1362(g) taint by reincorporating under Section 368(a)(1)(F). See Ann. 86-128, 1986-51 I.R.B. 22.

(iii) An acquisitive D reorganization also would not avoid Section 1362(g).

(iv) It appears that a corporation can avoid successor status by issuing sufficient stock so that the 50 percent continuity of interest test is not met. Query whether a terminated S corporation could avoid Section 1362(g) by acquiring sufficient C corporation assets so that former S corporation assets no longer represent a substantial portion of the assets held.

d. The definition of "successor corporation" contained in the regulations differs from that contained in Section 381. A transferee of assets in a merger transaction qualifies as a successor under Section 381, but not under Section 1362 unless, in general, the target shareholders hold 50 percent or more of the acquiror (e.g., a reverse acquisition).

e. In Rev. Rul. 77-155, 1977-1 C.B. 264, the Service ruled that where the acquiring corporation bought stock of an S corporation from unrelated shareholders, and liquidated the target S corporation (under former Section 334(b)(2)), the acquiring corporation was not treated as a successor corporation, and could thus make an S election without the Service's consent.

f. Note that Section 1362(g) only prevents a new election by the former S corporation and its successors.

(i) Thus, if an S corporation's election is terminated, or is about to terminate (e.g., excess passive income), its assets may be transferred to a pre-existing corporation that has an

S election already in effect. Section 1362(g) would not affect the pre-existing corporation's S election.

(ii) However, if the termination in fact became effective and the assets were transferred to the existing S corporation in a carryover basis transaction, the transferee apparently would not be subject to Section 1362(g) but would be subject to Section 1374 as to the transferred assets. See Ann. 86-128, 1986-51 I.R.B. 22.

3. Inadvertent Terminations

If certain conditions are met, a corporation may continue as an S corporation despite the occurrence of a terminating event.

a. Section 1362(f) provides that a corporation will continue as an S corporation "during the period specified by the Secretary" if:

(i) the election was not terminated by revocation;

(ii) the Secretary determines that the termination was inadvertent;

(iii) no later than a "reasonable period of time" after discovery of the terminating event, steps were taken to requalify the corporation as a small business corporation; and

(iv) the corporation and each shareholder during the non-S-status period agree to make the adjustments specified by the Secretary. See Treas. Reg. § 1.1362-4; PLR 9301016; PLR 9253016.

b. For recent examples of situations where the Service granted relief under the inadvertent termination provision, see PLR 200028026; PLR 200027032; PLR 200026017; PLR 200024020; PLR 199913025; PLR 9821013; PLR 9818062; PLR 9723020; PLR 9634023; PLR 9634018; PLR 9420005; PLR 9419013; PLR 9417025; PLR 9417022; PLR 9417017; PLR 9416014; PLR 9416010; PLR 9413037.

c. In addition, the Service has ruled that where an S corporation became aware that its state corporate charter was revoked, and it reincorporated in the state in the following month, the corporation's status as a small business corporation was not terminated by reason of the revocation of the charter provided that the corporation qualified as a small business corporation prior to the revocation of the charter. See PLR 200123058; PLR 9411040; PLR 9231050.

d. Section 1362(f) may become important upon subsequent audit or later discovery of facts which jeopardize the S election, but should not be affirmatively relied upon as a planning tool.

4. Invalid Election

a. If the election is invalid, Section 1362(g) does not apply. See Treas. Reg. § 1.1372-5(a); Rev. Rul. 71-549, 1971-2 C.B. 319. Thus, in such a case, a new election could be filed within the five year waiting period of Section 1362(g) without the Service's consent.

b. However, as noted above, the 1996 Small Business Act provided that the Service may waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts), or both. This provision applies to elections for taxable years beginning after December 31, 1982. See Section 1362(f); PLR 200010034; PLR 200008021; PLR 200007016; PLR 199933035; PLR 199918045.

D. Treatment of S Termination Years

1. An "S termination year" means any taxable year in which a termination first takes effect (other than where it takes effect on the first day of the year). Section 1362(e)(4).

a. Thus, a revocation should not result in an S termination year, unless a prospective effective date (other than the first day of a future year) is selected by the shareholders.

b. Termination under Section 1362(d)(3) also should not give rise to an S termination year. Terminations under Section 1362(d)(3) are effective on the first day of the first year following the close of the relevant three-year period. Section 1362(d)(3)(A)(ii).

c. Thus, it appears that S termination years will arise primarily under Section 1363(d)(2) (ceasing to be a small business corporation).

2. Under Section 1362(e)(1), an S termination year is broken into two separate taxable years.

a. The portion of the year ending before the first day on which the termination is effective is treated as a short taxable year in which the corporation is an S corporation (i.e., an S short year).

b. The portion of the year beginning on the day on which the termination is effective is treated as a short taxable year in which the corporation is a C corporation (i.e., a C short year).

c. For example, individual (A) owns all of the stock of an S corporation. The S corporation uses a calendar year. On July 1, 1999, A sells 10 shares of his stock to his wholly-owned corporation, thus terminating the S election. Under Section 1362(e)(1), the period from January 1, 1999 through June 30, 1999 is treated as an S short year. The period from July 1, 1999 through December 31, 1999 is treated as a C short year.

3. It is unclear whether the income (loss) items of the S corporation pass through to the shareholders under Section 1366(a) at the close of the S termination year.

a. Although the statute is silent on this specific point, it would seem that income (loss) items pass through at the end of the S termination year since the income (loss) items for the entire S termination year must be allocated to the S short year and the C short year. Such an allocation is not possible until the close of the S termination year.

b. Even where the shareholders elect to close the books, the S short year return is not due until the C short year must be filed. See Section 1362(e)(6)(B).

c. However, one can also argue that income (loss) items should pass through at the close of the S short year on the theory that the S corporation should be treated the same as a partnership. See Section 706(c).

(i) The regulations provide that a shareholder must include in taxable income the shareholder's pro rata share of items for the S short year for the taxable year with or within which the S termination year ends. See Treas. Reg. § 1.1362-3(c)(6).

4. Special rules for allocated income (loss) apply in the case of an S termination year. See Section 1362(e)(2) and (3) discussed below at Section IV.A.3.c.

5. The tax for the C short year is computed on an annual basis. Section 1362(e)(5).

6. For carryover purposes, the S short year and the C short year are treated as one taxable year.

E. What is Not a Termination

A termination under Section 1362(d) should not occur where the S election terminates simultaneously with the corporation's existence.

1. In Rev. Rul. 64-94, 1964-1 C.B. 317, the Service ruled that a merger of an S corporation into another corporation did not terminate the S corporation's election for its final year. See also Rev. Rul. 70-232, 1970-1 C.B. 178.

2. The Service's apparent reasoning is that, under Section 381(b)(1), the target S corporation's year ends with the date of the merger. As to this final year, no termination occurred; during each day of such year, the corporation was an S corporation.

3. The favorable result is that S corporations may be acquired in statutory mergers without hindering the acquiring corporation's ability to make an S election. That is, Section 1362(g) would not apply since a termination has not occurred.

4. Also, in such cases, the final taxable year of the S corporation would not constitute an S termination year. Thus, the usual allocation rules of Section 1377(a) should apply.

III. EFFECT OF AN S ELECTION ON THE CORPORATION

A. Pass-Through of Income (Loss)

Once a valid S election is in effect, the corporation generally is not subject to tax, and all of its items of income, loss, deduction and credit are passed through to its shareholders.

1. The S corporation, with certain modifications, computes its income as if it were an individual. See Section 1363(b). Such income is passed through to the shareholders under Section 1366.

2. Subject to certain exceptions discussed below at Section III.C through F, an S corporation will not be subject to taxes imposed under chapter 1 of the Code. Section 1363; Treas. Reg. § 1.1363-1(a)(1).

   a. Thus, an S corporation is not subject to income tax under Section 11, the accumulated earnings tax under Section 531 nor the personal holding company tax under Section 541.

   b. In addition, an S corporation is not subject to the AMT. Instead, tax preference items are passed through to the shareholders under Section 1366. The book income adjustment and "ACE"

adjustment under Sections 56(f) and (g) do not apply to S corporations.

c. Similarly, the Service has ruled that when an S corporation sells its interest in a controlled foreign corporation to another corporation and reports some gross income from the sale as a dividend under Section 1248(a), the limitation under Section 1248(b) applies to the S corporation shareholders and Section 1248 applies at the shareholder level. See PLR 199908045.

d. Section 291 will apply to the computation of S corporation income if the S corporation (or any predecessor) was a C corporation for any of the 3 immediately preceding taxable years.

B. Distributions to Shareholder

1. Appreciated Property

If an S corporation distributes appreciated property, gain must be recognized by the S corporation as if it sold the property to the distributee at its fair market value. Sections 311(b)(1) and 336(a); PLR 8908016. Without this rule, appreciated assets could be distributed tax-free and sold by the shareholder at fair market value without a current tax on the appreciation being imposed.

a. TAMRA repealed the special distribution rules contained in old Sections 1363(d) and (e) as statutory deadwood. Thus, pursuant to Section 1371, the provisions of subchapter C apply to the recognition of gain and loss in the case of distributions by S corporations.

b. Where property distributed is subject to a liability, or a shareholder assumes a liability, Sections 336(b) and 311(b)(2) provide that the fair market value of such property shall be treated as not less than the amount of such liability.

(i) The fair market value of distributed property should not be less than the amount of nonrecourse liabilities to which the property is subject. Section 7701(g).

(ii) Although Treas. Reg. § 1.1001-2 includes recourse liabilities in the amount realized, Section 336 treats the corporation as if it sold the distributed property at fair market value, which may be less than the amount of recourse liabilities.

c. Sections 1239, 1245, and 1250 may convert capital gain to ordinary income. The character of gain on installment obligations should be the same as the gain on the sale of underlying property.

d. Sections 311(b)(1) and/or 336(a) (or former Section 1363(d)), do not contemplate special allocations of gain to contributing shareholders. Compare Section 704(c). Gain recognized by the S corporation on a distribution generally is allocated to the shareholders under Sections 1366 and 1377.

e. As discussed above, TAMRA repealed Section 1363(e), thus resulting in the subchapter C provisions relating to distributions being applied to S corporations.

f. Section 1374 may also apply to distributions of appreciated property. See Section III.C., below.

2. Depreciated Property

With respect to depreciated (loss) property, Sections 311 and 336 should control.

a. Under Section 311, losses generally are not recognized. PLR 8908016. The result is that a distribution of depreciated property will cause a step-down in basis without any benefit of loss recognition. Section 301(d).

(i) One apparent exception to this rule is Section 453B(a), which provides a loss may arise in a distribution of an installment note having a value less than its basis. However, loss recognition is uncertain in this case since Section 311(a) (as modified by TRA '86) does not explicitly carve out Section 453B, as did its predecessor.

(ii) Even if loss recognition is possible, the Section 267 hurdle must be overcome.

b. Under Section 336, losses are recognized unless the limitations on loss recognition contained in Section 336(d) apply.

3. Other Corporate Level Effects

Distributions by S corporations trigger other corporate level effects.

a. At the corporate level, Section 301(c) distributions should reduce the "accumulated adjustment account" ("AAA") by the fair market value of distributions. Gain resulting from a distribution will

increase the AAA. The AAA is discussed in detail below at Section IV.C.3.

b. In the case of a sale or exchange under Sections 302(a) or 303, the AAA is reduced in direct proportion to the number of shares redeemed. Section 1368(e)(1)(B).

c. Dividend distributions under Section 1368(c)(2) should reduce accumulated earnings and profits of the S corporation.

C. Corporate Level Tax on Built-In Gains – New Section 1374

New Section 1374 was added by TRA '86, and significantly modified by TAMRA, to prevent circumvention of the repeal of the General Utilities doctrine through conversion from C status to S status. The Service issued final regulations under Section 1374 on December 23, 1994. These regulations apply for tax years ending on or after December 27, 1994, but only in a return filed under an S election made on or after that date. Treas. Reg. § 1.1374-10.

1. General Rule

Section 1374(a) provides that if an S corporation has a "net recognized built-in gain" for any taxable year in the "recognition period," then a corporate level tax will be imposed on the income of the S corporation.

2. Computation of Tax

a. The term "net recognized built-in gain" generally means the lesser of: (1) the amount which would be taxable income for the S corporation's taxable year if only recognized built-in gains and losses were taken into account, or (2) the corporation's taxable income for such taxable year (as defined in Section 1375(b)(1)(B)). Section 1374(d)(2).

(i) If the net amount of the corporation's recognized built-in gains and losses exceeds its net taxable income for a taxable year, the excess is treated as recognized built-in gain in the succeeding year. Section 1374(d)(2)(B).

(ii) Although the untaxed built-in gain is carried forward, it apparently will escape Section 1374 if such gain is carried to years beyond the close of the recognition period.

(iii) The carryover applies only to S corporations for which an election was made after March 31, 1988.

b. The effect of computing the Section 1374 tax on net recognized built-in gain is that recognized built-in gain will be offset by post-

conversion, recognized built-in losses. In other words, Section 1374(d)(2)(A) segregates recognized built-in gains and losses in each taxable year and subjects the net amount to a tax at the corporate level.

c. The rate of tax used in the computation is the highest rate specified in Section 11(b). Section 1374(b)(1). However, if the asset is a capital asset held by the S corporation for the requisite holding period, then the rate of tax may be determined under Section 1201. See Section 1374(b)(4); H.R. Rep. No. 99-841, 99th Cong. 2d Sess. II-203 (1986).

3. Recognized Built-In Gain

a. The term "recognized built-in gain" means any gain recognized during the "recognition period" on the "disposition of any asset," except to the extent that the S corporation establishes that:

(i) the asset disposed of was not held on the beginning of the recognition period, or

(ii) the recognized gain exceeds the gain inherent as of the beginning of the recognition period. Section 1374(d)(3).

However, the regulations provide that recognized built-in gains apply only to gains recognized "in a transaction treated as a sale or exchange for federal income tax purposes." Treas. Reg. § 1.1374-4(a).

b. The term "recognition period" means the 10-year period beginning with the first day of the first taxable year for which the corporation was an S corporation. See Section 1374(d)(7). But see Section 1374(d)(9). (Section 1601(f) of TRA '97 amended Section 1374(d)(7) to provide special rules in the case of thrift institutions or former thrift institutions that become S corporations.)

c. Sales and distributions of assets should constitute a "disposition." Section 1374(d)(5)(A) (as added by TAMRA) provides that a "disposition" occurs when an income item is recognized in the recognition period and such item is attributable to periods before the first taxable year for which the corporation is an S corporation. See also Ann. 86-128, 1986-51 I.R.B. 22. The regulations provide a similar rule for "items of income," which are treated as recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period by a taxpayer using the accrual method of accounting. Treas. Reg. § 1.1374-4(b)(1).

(i) Thus, the collection of accounts receivable by a cash basis S corporation would constitute the "disposition" of an asset.

(ii) Similarly, a disposition occurs on the completion of a long-term contract by an S corporation on the completed contract method of accounting.

(iii) The Service has announced that the taxpayer's method of accounting will be used to identify whether inventory on hand at the time of conversion has been disposed of following the conversion. Ann. 86-128, supra. Thus, where LIFO is used, Section 1374 would not apply until inventory is sold from layers existing as of beginning of the recognition period. See also, Preamble to Prop. Treas. Reg. § 1.1363-2, 1993-2 C.B. 636 ("Whether goods are disposed of following a conversion from C to S corporation status depends upon the inventory method used by the taxpayer. Thus, a C corporation using the LIFO method of accounting will not be taxed on the built-in gain attributable to LIFO inventory to the extent it does not liquidate LIFO layers during the ten-year period following the conversion."); Treas. Reg. § 1.1374-7(b) ("[I]f a corporation changes its method of accounting for inventory (for example, from the FIFO method to the LIFO method or from the LIFO method to the FIFO method) with a principal purpose of avoiding the tax imposed under Section 1374, it must use its former method to identify its dispositions of inventory."); but see TCB 88 Gen. Expl. at 65 (stating that regulatory authority under Section 337(d) may apply where a corporation elects S status and adopts the LIFO method of accounting).

d. The statute presumes that gains recognized within the recognition period are subject to tax. Thus, an S corporation must keep detailed records and proof as to asset bases and fair market value as of the beginning of the recognition period.

4. Recognized Built-In Loss

a. Under Section 1374(d)(4) a "recognized built-in loss" is defined as any loss recognized during the recognition period on the disposition of any asset to the extent that the S corporation establishes that:

(i) such asset was held by the S corporation as of the beginning of the recognition period, and

(ii) the recognized loss does not exceed the loss inherent as of the beginning of the recognition period.

b. Pursuant to Section 1374(d)(5)(B) (as added by TAMRA and revised by RRA '89), accrued deductions arising before the recognition period and taken into account during the recognition period (determined without regard to any carryover) will be treated as recognized built-in losses. Thus, Sections 1374(d)(5)(A) and (B) now provide parity under Section 1374 for items of accrued income and expenses – both would give rise to recognized built-in gains and losses. The regulations continue the parity, and clarify that for purposes of Section 1374(d)(4), the limitations imposed by Sections 461(h)(2)(C) do not apply. Treas. Reg. § 1.1374-4(b)(2).

5. The Regulations – Detailed Built-in Gain and Loss Rules

The regulations include detailed recognized built-in gain and loss rules with respect to the following items:

a. Section 267(a)(2) and Section 404(a)(5) deductions. Treas. Reg. § 1.1374-4(c);

b. a Section 481 adjustment taken into account during the recognition period. Treas. Reg. § 1.1374-4(d);

c. a deemed distribution of income from a DISC taken into account during the recognition period under Section 995(b)(2). Treas. Reg. § 1.1374-4(e);

d. discharge of indebtedness income or bad debt deductions taken into account during the first year of the recognition period. Treas. Reg. § 1.1374-4(f);

e. income taken into account during the recognition period under the completed contract method. Treas. Reg. § 1.1374-1(g);

f. income taken into account during or after the recognition period under the installment method of Section 453, discussed below at Section III.C.9; and Treas. Reg. § 1.1374-1(h);

g. certain net recognized built-in gains from an S corporation's interest in a partnership. Treas. Reg. § 1.1374-1(i).

6. Limitation – Net Unrealized Built-In Gain

a. Importantly, Section 1374(c)(2) and the regulations limit the amount of taxable built-in gains for any year to the total "net unrealized built-in gain" reduced by the "net recognized built-in gain" for prior taxable years within the recognition period.

b. The term "net unrealized built-in gain" means the amount (if any) by which the fair market value of the assets of the S corporation at the beginning of its first year as an S corporation exceeds the aggregate adjusted basis of such assets at such time. Section 1374(d)(1).

   (i) An appraisal will be required to determine fair market value.

   (ii) Query whether goodwill must be valued. If so, the potential Section 1374 tax will be reduced to the extent that value is assigned to goodwill. Valuing goodwill in this context does not affect the basis of tangible assets held as of the beginning of the recognition period. Note that the regulations include an example in which goodwill is valued. See Treas. Reg. § 1.1374-3(b), ex. 1.

c. Pursuant to Section 1374(d)(5)(C), appropriate adjustments to the net unrealized built-in gain shall be made where accrued income and expense items would be treated as recognized built-in gains or losses if such items were properly taken into account (or allowable as a deduction) during the recognition period.

d. The regulations define "net unrealized built-in gain" as the total of the following items:

   (i) the amount that would be the amount realized if on the first day of the recognition period the corporation sold all its assets at fair market value to an unrelated party which assumed all its liabilities; decreased by

   (ii) a liability of the corporation that would be included in the amount realized under (1) above, but only if the corporation would be allowed a deduction on payment of the liability; decreased by

   (iii) the aggregate adjusted bases of the corporation's assets on the first day of the recognition period; increased or decreased by

   (iv) the corporation's Section 481 adjustments on the first day of the recognition period; and increased by

(v) any recognized built-in loss that would not be allowed under Sections 382, 383 or 384. Treas. Reg. § 1.1374-3(a).

7. Scope of Provision

a. S corporations covered

Section 1374 applies only to S corporations that formerly were C corporations. A corporation that always was an S corporation generally will not be covered. Section 1374(c)(1).

(i) For this purpose, a corporation and its predecessors are treated as one corporation. Section 1374(c)(1). This rule may subject an S corporation to Section 1374 where it otherwise would be exempt.

(ii) To illustrate, assume that a newly-formed S corporation acquires a C corporation target in a Section 381 transaction (e.g., a merger or C reorganization). Although the S corporation itself has always been an S corporation, under Section 1374(a)(1) the S corporation and the C corporation would be treated as one corporation. The result is that the newly-formed S corporation would be treated as a former C corporation and would be subject to Section 1374 – as to the assets acquired from the C corporation.

b. Assets covered

In general, the assets covered by Section 1374 are those held at the beginning of the recognition period (assuming the taxpayer can overcome the presumption in Section 1374(d)(3)). However, special rules apply where an S corporation acquires appreciated assets in a carryover basis transaction. See Section 1374(d)(6) and (8). See also Ann. 86-128, supra.

(i) If an S corporation receives from a C corporation or former C corporation property with a transferred basis (Section 7701(a)(43) property), such property will be subject to Section 1374 even though the S corporation never was a C corporation and even though the assets were not held by the S corporation at the beginning of the recognition period. See e.g., PLR 9011042; PLR 9005021.

(a) The acquisition of such assets will be treated as a conversion from C to S status.

(b) The net unrealized built-in gain with respect to the property will be measured at the time of conveyance.

(c) The recognition period will begin on the date the property is received.

(d) It appears that the S corporation's pre-acquisition assets will not become subject to Section 1374 as a result of the acquisition, nor will they be used to compute net unrealized built-in gain. See Section 1374(d)(8). See also Ann. 86-128, supra.

(ii) If an S corporation acquires assets that already are subject to Section 1374, such assets will continue to be subject to Section 1374 in the hands of the transferee. The recognition period does not begin anew. See Ann. 86-128, supra; PLR 9414016.

(iii) Where property subject to Section 1374 is transferred in an exchanged basis transaction described in Section 7701(a)(44) (e.g., Section 1031), the net unrealized built-in gain of the transferred assets will carry over to the property received. The recognition period will be the same as that of the transferred property. See Section 1374(d)(6). See also Ann. 86-128, supra.

(iv) Where the S corporation acquires property in a carryover basis transaction (e.g., a reorganization) from another S corporation, Section 1374 should not apply if the acquired assets were not subject to Section 1374. See PLR 9340006; PLR 9319016; PLR 9318024; PLR 9310038; PLR 9306017.

(v) Query what result obtains where a C corporation acquires untainted assets from an existing S corporation and then elects S status itself. Have the former S corporation assets become subject to Section 1374?

(vi) The regulations provide that any tax attributable to a Section 1374(d)(8) transaction must be determined separately from (i) any tax resulting from any other Section 1374(d)(8) transaction and (ii) the assets the corporation held on the first day of the recognition period. Thus, any loss carryforward acquired in one Section 1374(d)(8) transaction can offset only the net recognized built-in gain attributable to assets acquired in the same transaction.

Treas. Reg. § 1.1374-8(b). For this purpose, the S corporation's taxable income limitation is allocated among each of the separate determinations based on the relative amounts of gain. Treas. Reg. § 1.1374-8(c).

8. NOL and Capital Loss Carryovers

Section 1374(b)(2) provides that a net operating loss carryover arising in a taxable year for which the S corporation was a C corporation can be used to offset net recognized built-in gains (viz., the amount described in Section 1374(b)(1)). In addition, under Section 1374(b)(2), capital loss carryovers can also offset net recognized built-in gains.

a. In cases where the S corporation undergoes an ownership change under Section 382(g)(1), it is unclear whether Section 1374(b)(2) overrides Section 382.

(i) In general, Section 382 allows prechange losses to offset recognized built-in gains, in full, provided certain threshold tests are satisfied. See Section 382(h)(3)(B). If this threshold test is not met, pre-change losses may offset recognized built-in gains only to the extent of the Section 382 limitation.

(ii) In contrast, Section 1374(b)(2) does not contain any threshold limitations.

(iii) Section 1371(a) states that subchapter C applies only to the extent that it is not inconsistent with the subchapter S rules. Query whether the application of the Section 382(h)(3)(B) threshold limit would be inconsistent with Section 1374(b)(2)?

b. To illustrate, assume that a loss corporation (L) is a C corporation with net operating loss carryovers of $1,000,000. L is owned by individual A. A sells all of the L stock to individual B for cash. Assume that L's Section 382 limitation, as computed under Section 382(b), is $100,000. B makes an S election for L. L subsequently sells assets which generate recognized built-in gain of $200,000.

(i) Section 1374(b)(2) apparently would allow L to use NOL carryovers to offset the recognized built-in gain in full, regardless of whether L met the threshold test under Section 382(h)(3)(B). Thus, no Section 1374 tax would be imposed.

(ii) If Section 1374(b)(2) operates in conjunction with Section 382, and if the threshold test is not met, recognized built-in

gains could be offset by NOL carryovers only to the extent of the Section 382 limitation. In this case, L could offset its recognized built-in gain with NOL carryovers to the extent of $100,000. Section 1374 then would apply to the remaining $100,000.

c. Regulations

(i) The regulations make clear that any limitations imposed by Sections 382, 383(b), and 384 on the use of a C corporation's net operating loss and capital loss carryforwards on the first day of the recognition period also limit their use as deductions against the S corporation's net recognized built-in gain. Treas. Reg. § 1.1374-5.

(ii) The regulations include the following example: X is a C corporation which has an ownership change under Section 382(g)(1) on January 1, 1994. On that date, X has a fair market value of $500,000, net operating loss carryforwards of $400,000 and a net unrealized built-in gain under Section 382(h)(3)(A) of $0. Assume X's Section 382 limitation under Section 382(b)(1) is $40,000. X elects to become an S corporation on January 1, 1998. On that date, X has net operating loss carryforwards of $240,000 (having used $160,000 of its pre-change net operating losses in its 4 preceding taxable years) and a Section 1374 net unrealized built-in gain of $250,000. In 1998, X has net recognized built-in gain of $75,000. X may use $40,000 of its net operating loss carryforwards as a deduction against its $75,000 net recognized built-in gain, because X's Section 382 limitation is $40,000.

9. Installment Sales

a. The Installment Tax Correction Act of 2000 (P.L. 106-573, 106th Cong., 2nd Sess., Dec. 28, 2000) (hereinafter the "Installment Act of 2000") retroactively repealed the repeal of the installment sale method for accrual method taxpayers. As a result, the installment sale method applies to accrual method taxpayers as if it was never repealed.

b. The Service concluded that the purposes underlying the General Utilities repeal and the related amendments to Section 1374 in TRA '86 could be circumvented if an S corporation disposes of an asset either prior to or during the recognition period in an installment sale reported under the installment method. Accordingly, the Service stated that it would issue regulations

governing the treatment of installment sales under Section 1374. Notice 90-27, 1990-1 C.B. 336.

c. Indeed, the regulations provide that if a corporation sells an asset either before or during the recognition period and reports income from the sale under the installment method (either during or after the recognition period), the income, when recognized, will be taxed under Section 1374 to the extent it would have been included in net recognized built-in gain during the recognition period if the entire amount of income to be reported from the sale was reported in the year of the sale and all provisions of Section 1374 and the proposed regulations applied. If the corporation sells the asset before the recognition period, the entire amount of income to be reported from the sale that was not reported before the recognition period is treated as having been reported in the first year of the recognition period. Treas. Reg. § 1.1374-4(h)(1). The regulations include the following example:

(i) X is a C corporation that elects to become an S corporation effective January 1, 1996. On that date, X sells Blackacre with a basis of $0 and a value of $100,000 in exchange for a $100,000 note bearing a market rate of interest payable on January 1, 2001. X does not make the election under section 453(d) and, therefore, reports the $100,000 gain using the installment method under section 453. In the year 2001, X has income of $100,000 on collecting the note, unexpired C year attributes of $0, recognized built-in loss of $0, current losses of $100,000, and taxable income of $0. If X had reported the $100,000 gain in 1996, X's net recognized built-in gain from 1996 through 2001 would have been $75,000 greater than otherwise. Under paragraph (h) of this section, X has $75,000 net recognized built-in gain subject to tax under section 1374. X also must treat the $25,000 excess of the amount reported ($100,000 over the amount subject to tax, $75,000) as income reported under the installment method in the succeeding taxable year(s) in the recognition period, except to the extent X establishes that the $25,000 was not subject to tax under section 1374 in the year 2001 because X had an excess of recognized built-in loss over recognized built-in gain in the taxable year of the sale and succeeding taxable year(s) in the recognition period. Treas. Reg. § 1.1374-4(h)(5) ex. 1.

d. For assets sold for installment notes prior to March 26, 1990, gain recognized beyond the recognition period due to Section 453 should not be subject to Section 1374. See Rev. Rul. 65-292,

1965-2 C.D. 319; PLR 8704042 (only installment payments actually received are taken into account for "old" Section 1374 purposes).

10. Effective Date

a. New Section 1374 applies to taxable years beginning after December 31, 1986, but only if the corporation's S election is filed after 1986.

b. New Section 1374 will not apply if the S election was made before January 1, 1987. See P.L. 99-514, section 633(b). See also section 1006(g)(1) of TAMRA (clarifying the effective date rule).

c. In addition, if a corporation does not make a valid S election prior to January 1, 1987, it may nevertheless qualify for partial relief from Section 1374 if such corporation qualifies for transitional relief under TRA '86 (i.e., certain small, closely-held corporations). See P.L. 99-514, section 633(d)(8); Notice 88-134, 1988-2 C.B. 559. Relief from Section 1374 in this case would extend only to long-term capital gains – not ordinary income or short-term capital gain – and only to the extent of the applicable percentage. See Rev. Rul. 86-141, 1986-2 C.B. 151; PLR 8809063.

D. Corporate Level Tax on Passive Investment Income - Section 1375

1. In General

Under Section 1375, a tax is imposed on an S corporation if it has both accumulated earnings and profits at the close of any taxable year and more than 25 percent of the S corporation's gross receipts consist of "passive investment income."

a. The tax is imposed on "excess net passive income." Section 1375(a).

(i) "Excess net passive income" (ENPI) is determined by multiplying the corporation's "net passive income" for the taxable year by the following quotient: "passive investment income" in excess of 25 percent of gross receipts divided by the total passive investment income for the taxable year. Section 1375(b)(1)(A).

(ii) ENPI for a taxable year cannot exceed the corporation's taxable income for the year as determined under Section 63(a) without regard to Sections 172, 241-247 and 249-250

(special deductions for corporations). Section 1375(b)(1)(B).

b. The rate of tax is the highest rate specified in Section 11(b). Section 1375(a).

2. Definitions

a. The term "net passive income" means "passive investment income" reduced by deductions which are directly connected with the production of such income. Section 1375(b)(2).

b. The terms "passive investment income" and "gross receipts" have the same meanings as under Sections 1362(d)(3)(D) and (C), respectively. See Section II.B.2.b. above. Section 1375(b)(4) clarifies that passive investment income does not include Section 1374 gain or loss.

3. Rules Relating to C corporation Subsidiaries

a. As was noted previously, the final QSub regulations provide rules for situations where S corporations hold certain C corporation subsidiaries. Section 1362(d)(3)(E) and the final QSub regulations provide that dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater interest are not treated as passive investment income for purposes of Sections 1362 and 1375 to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business. Treas. Reg. § 1.1362-8(a).

b. The S corporation may use any reasonable method to determine the amount of dividends that are not treated as passive investment income under Section 1362(d)(3)(E). Treas. Reg. § 1.1362-8(b).

c. The regulations also provide a safe harbor for determining the amount of the active earnings and profits that is deemed to be reasonable under all circumstances. Under this provision, a corporation may treat its earnings and profits for a year as active earnings and profits in the same proportion as the corporation's gross receipts derived from activities that would not produce passive investment income (if the C corporation were an S corporation). Treas. Reg. § 1.1362-8(b)(5).

d. Finally, the regulations also provide a de minimis exception where 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 would be considered active earnings and profits. Treas. Reg. § 1.1362-8(b)(3).

4. Special Rules Relating to QSubs

a. If an S corporation has a QSub, the calculations required by Section 1375 will be made only once, at the S parent's level, taking into account the tax items of all of the S parent's direct and indirect QSubs.

b. Note, however, that section 1601(c)(3) of TRA '97 (amending Section 1361(b)(3) of the Code) authorizes the Service to issue regulations pursuant to which QSubs may be treated as separate corporations.

E. Investment Credit Recapture

An S corporation continues to be liable for recapture taxes under Section 47 with respect to credits claimed during C corporation years. Section 1371(d)(2).

F. LIFO Recapture

1. As a result of OBRA '87, a LIFO-method C corporation that elects S status will be required to recapture the benefits of the LIFO election. See Section 1363(d).

a. Regulations under Section 1363(d), adopted in 1994, extend the LIFO recapture rules to apply to a C corporation if it used the LIFO method during its last taxable year before the transfer of the assets to an S corporation in a transaction where the S corporation's basis in the assets are determined in whole or in part by reference to the basis of the assets in the hands of the C corporation. Treas. Reg. § 1.1363-2(a)(2).

b. This rule applies to transfers made after August 18, 1993. Treas. Reg. § 1.1363-2(d)(2).

2. In general, the LIFO benefit is the excess of the corporation's inventory valued at FIFO over its value under LIFO. See Section 1363(d)(3).

3. Any increase in tax resulting from LIFO recapture will be payable in four annual installments. The first installment is due on the date of the C corporation's last return (without extensions). The three succeeding installments must be paid by the due date of the S corporation's return (without extensions) for such years. See Section 1363(d)(2); Treas. Reg. § 1.1363-2(b).

4. The inventory basis will be adjusted to reflect the LIFO recapture amount, thus apparently rendering Section 1374 inapplicable to future sales of inventory. See Section 1363(d)(1); Treas. Reg. § 1.1363-2(c).

5. Coggin Automotive Corp. v. Commissioner, 115 T.C. No. 28 (2000).

a. Facts: Petitioner was a holding company that held over 80 percent of the stock of five C corporations. The subsidiaries maintained their inventory under the dollar-value LIFO method. As a result of a series of transactions intended to convert the subsidiaries into partnerships, Petitioner acquired limited partnership interests in five partnerships that held the inventory formerly held by the subsidiaries. Then, Petitioner elected S corporation status. As a result of the above, the Commissioner determined that Petitioner's conversion to S status trigged the inclusion of the partnerships' LIFO reserves into Petitioner's gross income.

b. Issue: Whether a pro rata share of the partnerships' LIFO reserves should be attributable to Petitioner under the aggregate theory of partnerships for purposes of applying Section 1363(d) to Petitioner?

c. Holding: The court held that the aggregate approach (as opposed to the entity approach) to partnerships better serves the underlying purpose and scope of Section 1363(d). Accordingly, Petitioner was deemed to own a pro rata share of the partnerships' inventories. Consequently, upon Petitioner's S election, it was required to include its ratable share of the LIFO recapture amount in gross income.

G. Estimated Taxes

As a result of RRA '89, for taxable years beginning after 1989, S corporations are required to make estimated tax payments at the corporate level for income tax resulting from built-in gains, passive investment income, capital gains and investment tax credit recapture. See Section 6655(g)(4)(A).

IV. EFFECT OF AN S ELECTION ON THE SHAREHOLDERS

A. Pass-Through of Items

1. In General

a. The Service issued final regulations under Section 1366 relating to pass-through rules for S corporations on December 21, 1999. T.D. 8852, 64 Fed. Reg. 71641 (December 22, 1999). The regulations apply to S corporation taxable years beginning on or after August 18, 1998.

b. Under Section 1366(a), each shareholder must take into account his pro rata share of (1) separately stated items of income, loss, deduction and credit, and (2) nonseparately computed income or loss. Treas. Reg. § 1.1366-1(a). If the shareholder dies (or if the shareholder is an estate or trust, which terminates) before the end of the S corporation's taxable year, the shareholder's pro rata share of these items is taken into account on the shareholder's final return. Id.

(i) Separately stated items are those items which could affect the tax liability of shareholders. Section 1366(a)(1)(A). Items described in Sections 702(a)(4) or (6) are covered. For example, these items include, but are not limited to:

(a) capital gains and losses;

(b) Section 1231 gains and losses;

(c) charitable contributions;

(d) tax-exempt interest; and

(e) foreign taxes paid by the corporation.

(ii) Each shareholder must separately take into account the shareholder's pro rata portion of any income (including tax exempt income), loss, deduction, or credit of the S corporation that, if taken into account separately by any shareholder, could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately.

(iii) Nonseparately computed income or loss is gross income minus the allowable deductions, determined by excluding the separately stated items. Section 1366(a)(2); Treas. Reg. § 1.1366-1(a)(3). In other words, this amount represents "bottom line" income (loss).

(iv) This Outline may refer to separately stated items of income, loss, deduction or credit and nonseparately computed income or loss as "income (loss) items."

c. The recently finalized regulations provide that an S corporation must report, and each shareholder must take into account, the shareholder's pro rata share of the S corporation's items described above in Section V.A.1.a., for each of the corporation's activities defined in Section 469 and its corresponding regulations. Treas. Reg. 1.1366-1(a)(4).

d. The character of separately stated items is determined at the corporate level. Section 1366(b); S. Rep. No. 97-640, supra, at 17 (1982); Treas. Reg. § 1.1366-1(b)(1).

(i) The recently finalized regulations give the following example: If an S corporation has capital gain from the sale or exchange of a capital asset, a shareholder's pro rata share of that gain will also be characterized as a capital gain, regardless of whether the shareholder is otherwise a dealer in that type of property. Treas. Reg. § 1.1366-1(b)(1).

(ii) Note, however, that if an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of any shareholder or group of shareholders would not have produced any capital gain if sold or exchanged by the shareholder(s), then the gain recognized by the S corporation is not treated as a capital gain. Treas. Reg. § 1.1366-1(b)(2).

(iii) If an S corporation is formed or availed of by any shareholder or group of shareholders for a principal purpose of selling or exchanging contributed property that in the hands of the shareholder(s) would have produced a capital loss if sold or exchanged by the shareholder(s), then the loss on the sale or exchange of the property recognized by the corporation is treated as a capital loss to the extent that, immediately before the contribution, the adjusted basis of the property in the hands of the shareholder(s) exceeded the fair market value of the property. Treas. Reg. § 1.1366-1(b)(3).

e. The regulations under old law provided that the character of an item may be determined on the basis of the character of that item in the hands of a substantial shareholder. Old Treas. Reg. § 1.1375-1(d). The purpose of this rule was to prevent the conversion of ordinary income into capital gain by contributing property to an S corporation. The Service stated that this regulation may still apply. G.C.M. 38969 (March 9, 1983). However, it seems that Treas. Reg. § 1.1366-1(b)(2) addresses this concern.

f. If an S corporation is subject to the Section 1374 tax, such tax will be treated as a loss sustained by the S corporation during the year. The character of the loss is determined by allocating the loss

proportionately among the recognized built-in gains that gave rise to the tax. See Section 1366(f)(2).

g. In general, the amount of S corporation gain passed through to the shareholders is reduced by the amount of tax imposed on the S corporation under Section 1375. Specifically, if any tax is imposed under Section 1375 on excess net passive investment income, each item of passive investment income shall be reduced by an amount which bears the same ratio to the amount of the Section 1375 tax as the amount of each item bears to the total passive investment income for the taxable year. Thus, each item of passive investment income is reduced proportionally by the Section 1375 tax. Then, such items are passed through to the shareholders under Section 1366. See Section 1366(f)(3).

2. Taxable Year of Inclusion

a. Each S shareholder must report his pro rata share of S corporation items in the taxable year in which, or with which, the S corporation's taxable year ends. Section 1366(a)(1).

b. In the case of S termination years, it is unclear whether income (loss) items are passed through at the close of the S termination year or the S short year. The regulations indicate that pass-through is postponed until the S termination year closes. See Section II.D.3., above.

3. Allocation of Items

a. Per-share per-day rule

The general rule is that income (loss) items are allocated on a per-share per-day basis. That is, all items are allocated equally to each day of the year, and each of such allocated items then is assigned to shares outstanding on that day. Section 1377(a)(1). Compare Sections 382(b)(3) and (h)(5) (following an ownership change, certain recognized built-in gains not allocated on a daily basis) and Section 706(d).

(i) For example, on July 1, 1999, an S corporation sells assets to an unrelated buyer and recognizes $365,000 in gain. The S corporation has no other income for the year. On August 31, 1999, individual B buys 40 percent of the S corporation stock.

(ii) In 1999, the gain is assigned to each day of the year, or $1,000 per day. The per day amount is then allocated to the shares outstanding on that day. The actual shares

outstanding on July 1, 1999 are relevant only to the extent of gain assigned to that date.

(iii) Under the per-share per-day allocation rule, B will be assigned $49,200 in income ($123,000 (or 123/365 x $365,000) x 40%).

(iv) In addition to stock sales, other changes such as redemptions or issuances of stock will affect the amount of income (loss) allocated under this rule.

b. Final regulations were issued under Section 1377 on December 20, 1996. These regulations apply to taxable years of an S corporation that begin after December 31, 1996. (Temp. Treas. Reg. § 18.1377-1 correspondingly was removed on December 20, 1996.).

c. Election to close the books

Section 1377(a)(2) provides that where a shareholder "terminates his interest" in the corporation during the taxable year, an election may be made to close the books as of the date the shareholder terminated his interest. The per-share per-day rule is applied separately to the two periods created with respect to the taxable year.

(i) Prior to the 1996 Small Business Act, all persons who were shareholders during the taxable year were required to agree to this election. Section 1377(a)(2). The 1996 Small Business Act amended Section 1377(a)(2) to require instead that all "affected shareholders" and the corporation agree to the election. See section 1306 of the 1996 Small Business Act. An "affected shareholder" is any shareholder whose interest is terminated and all shareholders to whom such a shareholder has transferred shares during the taxable year. If a shareholder transferred shares to the corporation, the term "affected shareholders" includes all persons who are shareholders during the taxable year. Section 1366(a)(2)(B).

(ii) The regulations state that the election is available for any taxable year in which any shareholder terminates his or her entire interest as a shareholder. Treas. Reg. § 1.1377-1(b). Apparently, a shareholder can remain in another capacity (e.g., as a creditor or employee).

(iii) Note that, under this election, the books are closed as of the date of termination. In contrast, in the case of an S termination year, the S short year closes on the day before the day the election is terminated. See Section 1362(e)(1).

d. Allocation in an S termination year

Special allocation rules apply in the case of an "S termination year." For the definition of an "S termination year," see Section II.D.1., above.

(i) Pro rata allocation between C and S short years

The general rule is that income items are assigned an equal portion to each day in the S termination year. Such items are then assigned to each day in the S short year and the C short year. Section 1362(e)(2).

(ii) Allocation based on actual results

In certain circumstances, the allocation of income (loss) items between the C and S short years in an S termination year are based on actual results.

(a) The pro rata method of allocating income items does not apply to Section 338 gain or loss. Section 1362(e)(6)(C).

(b) The pro rata method does not apply to an S termination year if there is a sale or exchange of 50 percent or more of the stock in the S corporation during the S termination year. Section 1362(e)(6)(D).

(c) Under Section 1362(e)(3), an election may be made to not use the pro rata allocation rules. Under this election, items of income (loss) are to be assigned to the S short year and the C short year based on the S corporation's normal tax accounting rules.

(d) An election under Section 1362(e)(3) is valid only if all persons who are shareholders in the corporation at any time during the S short year and all persons who are shareholders in the corporation on the first day of the C short year consent to the election. Section 1362(e)(3)(B).

(iii) Allocation within the S short year

Apparently, once items are assigned to the S short year – whether based on actual results or pro rata allocation – the items are allocated within the S short year according to the per-share per-day rule of Section 1377(a)(1).

4. Limitations on Deductibility of Losses

Although items of loss and deduction (loss items) pass through to the shareholder, deductibility at the shareholder level may be limited by several Code provisions. The shareholder must pass all of the following hurdles in order to deduct a loss incurred by the S corporation.

a. Allocation of loss items

As discussed above, loss items must first be allocated to the shareholder as provided under Sections 1362 or 1377.

b. Section 1366(d)

(i) Allocated loss items are deductible only to the extent of the shareholder's adjusted basis in stock in the S corporation and indebtedness owed by the S corporation to the shareholder. Section 1366(d)(1). See also Treas. Reg.

§ 1.1366-2(a)(1); Parrish v. Commissioner, 168 F.3d 1098 (8th Cir. 1999).

(a) The adjusted basis of stock is determined by taking into account only increases in basis under Section 1367(a)(1) for the taxable year and decreases in basis under Section 1367(a)(2)(A), (D) and (E) for the taxable year. Recently finalized regulations state that the shareholder disregards decreases in basis under Section 1367(a)(2)(B) and (C) for the taxable year. Treas. Reg. § 1.1366-2(a)(3).

(b) Recently finalized regulations further provide that the shareholder's adjusted basis in indebtedness of the corporation is determined without regard to any adjustment under Section 1367(b)(2)(A) for the taxable year. Treas. Reg. § 1.1366-2(a)(3)(ii).

(ii) Any loss or deduction which is disallowed by reason of the basis limitation contained in Section 1366(d)(1) may be carried forward indefinitely and treated as incurred by the corporation in the succeeding taxable year, and subsequent taxable years, with respect to that shareholder. Section 1366(d)(2); Treas. Reg. §1.1366-2(a)(2).

(iii) Recently finalized regulations provide that any disallowed losses or deductions are personal to the shareholder, and may not be transferred to another person. If a shareholder transfers some, but not all, of his or her stock in the corporation, the amount of any disallowed loss or deduction is not reduced and the transferee does not acquire any portion of the disallowed loss or deduction. If a shareholder transfers all of his or her stock, the disallowed loss or deduction is permanently disallowed. Treas. Reg. § 1.1366-2(a)(5).

(iv) If a shareholder has a suspended loss for the last year in which a corporation is an S corporation, such loss may be treated as incurred by the shareholder on the last day of the "post-termination transition period." See Section IV.D., below. The aggregate amount of losses cannot exceed the shareholder's adjusted bases in his stock (not debt) determined as of such last day. Section 1366(d)(3); Treas. Reg. § 1.1366-2(b)(2).

(a) Any losses and deductions in excess of the shareholder's adjusted stock basis are permanently disallowed. Treas. Reg. § 1.1366-2(b)(2).

(b) If the aggregate amount of losses and deductions incurred by the shareholder during the post-termination transition period exceeds the adjusted basis of the shareholder's stock, the limitation on losses and deductions under Section 1366(d)(3)(B) must be allocated among each loss or deduction. Treas. Reg. § 1.1366-2(b)(3).

(v) If a QSub terminates because the S parent distributes the QSub stock to some or all of the S parent's shareholders in a transaction to which Section 368(a)(1)(D) applies by reason of Section 355, any loss or deduction disallowed under Section 1366(d) with respect to a shareholder of the S parent immediately before the distribution is allocated between the S parent and the former QSub with respect to the shareholder. Treas. Reg. § 1.1361-5(b)(2); Treas. Reg. § 1.1366-2(c)(2). Such allocation may be made according to any reasonable method, including:

(a) a method based on the relative fair market value of the shareholder's stock in the S parent and the former QSub immediately after the distribution;

(b) a method based on the relative adjusted basis of the assets in the S parent and the former QSub immediately after the distribution; or

(c) in the case of losses and deductions clearly attributable to either the S parent or the former QSub, any method that allocates such losses and deductions accordingly. Treas. Reg. § 1.1366-2(c)(2).

(vi) <u>Carryover of disallowed losses and deductions in the case of liquidations, reorganizations, and divisions</u>

If a corporation acquires the assets of an S corporation in a transaction to which Section 381(a) applies, any loss or deduction disallowed under Treas. Reg. § 1.1366-2(a) with respect to a shareholder of the distributor or transferor S corporation is available to that shareholder as a shareholder of the acquiring corporation. Treas. Reg. § 1.1366-2(c)(1).

(a) Therefore, where the acquiring corporation is an S corporation, a loss or deduction of a shareholder of the distributor or transferor S corporation disallowed prior to or during the taxable year of the transaction is treated as incurred by the acquiring S corporation with respect to that shareholder if the shareholder is a shareholder of the acquiring S corporation after the transaction. Id.

(b) If the acquiring corporation is a C corporation, a post-termination transition period arises the day after the last day that an S corporation was in existence and the special rules for carryover of disallowed losses and deductions for the post-termination transition period, described above, apply with respect to any shareholder of the acquired S corporation that is also a shareholder of the acquiring C corporation after the transaction. Id.

(c) If an S corporation transfers part of its assets to another corporation in a D reorganization, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution or exchange to which Section 355 applies, any loss or deduction disallowed by Treas. Reg. § 1.1366-2(a) with respect to a shareholder of the distributing S corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation with respect to the shareholder. The amount allocated shall be based on any reasonable method. See Treas. Reg. § 1.1366-2(c)(2)(identifying nonexclusively certain possible methods).

c. Section 465

(i) Losses are deductible by the shareholder only if the shareholder is sufficiently "at risk." Section 465(a). See PART ONE: Section IV.D., above.

(ii) Losses disallowed under Section 465 may be carried forward. Section 465(a)(2).

(iii) The 1996 Small Business Act amended Section 1366(d)(3) of the Code to provide that losses of an S corporation that are suspended under the at-risk rules of Section 465 are

carried forward to the S corporation's post-termination transition period under rules similar to those applicable to disallowed losses generally.

d. Section 469

(i) If the losses are passive, Section 469 applies. See PART ONE: Section IV.E., above.

(ii) Losses disallowed under Section 469 may be carried forward. Section 469(b).

B. Basis Adjustments

A shareholder's basis in stock and debt is a major factor in determining the deductibility of losses passed through from the S corporation. Basis is also important for purposes of determining the extent to which distributions may be received tax-free under Section 1368. In 1992, the Service issued proposed regulations under Section 1367 that deal with the basis adjustment rules for stock and indebtedness of an S corporation. The final regulations, issued in January 1994, generally provide the same rules as the proposed regulations. In December 1999, the Service issued regulations amending the 1994 regulations by adding a section on the ordering of adjustments to the basis of a share of stock. This Section reviews the basis adjustment provisions of subchapter S, the final regulations of 1994 and the changes to those regulations adopted in 1999.

1. Increases

a. Under Section 1367(a)(1), the basis of each shareholder's stock in an S corporation is increased by the sum of the following:

(i) separately stated items of income;

(ii) nonseparately computed income; and

(iii) depletion deductions in excess of the basis of property subject to depletion. The basis adjustment for depletion does not include the depletion deduction attributable to oil or gas property. See Treas. Reg. § 1.1367-1(b)(1).

b. For items required to be shown on the shareholder's return as income, the increase in basis is contingent upon the inclusion of such items in the shareholder's gross income (either on his return or through a subsequent audit adjustment). Section 1367(b)(1).

c. The basis of a shareholder's share of stock is increased by an amount equal to the shareholder's pro rata portion of the items described in Section 1367(a)(1) that is attributable to that share,

determined on a per-share, per-day basis in accordance with Section 1377(a). Treas. Reg. § 1.1367-1(b)(2).

d. After years of uncertainty and conflicting court decisions, the Supreme Court recently ruled that where an S corporation realizes discharge of indebtedness income that is excluded from the corporation's gross income under section 108, the shareholder can increase its basis in the corporation's stock to reflect the shareholder's pro rata share of such excluded income. See Gitlitz v. Comm'r, 531 U.S. 206 (2001). See discussion at Part I.V.C.

2. Decreases

a. Under Section 1367(a)(2), the basis of each shareholder's stock in an S corporation is decreased (but not below zero) by the sum of the following:

(i) tax-free distributions under Section 1368;

(ii) separately stated items of loss and deduction and nonseparately computed losses;

(iii) nondeductible expenses that are not properly chargeable to a capital account; and

(iv) depletion deductions for oil and gas property held by an S corporation to the extent such deductions do not exceed the basis of the property.

b. The basis decrease for non-capital, nondeductible expenses relates to those items for which no loss or deduction is allowable and do not include items for which a deduction is deferred to a later taxable year. Treas. Reg. § 1.1367-1(c)(2).

c. The basis of a shareholder's share of stock is decreased by an amount equal to the shareholder's pro rata portion of the items described in Section 1367(a)(2) attributable to that share determined on a per-share, per-day basis in accordance with Section 1377(a). Treas. Reg. § 1.1367-1(c)(3).

d. If the amounts described above (other than distributions) exceed the shareholder's basis in his stock, the excess is applied to reduce (but not below zero) the basis of indebtedness of the S corporation to the shareholder. Section 1367(b)(2)(A).

e. Once the basis of the indebtedness has been reduced under Section 1367(b)(2)(A), any future net increase in basis is first applied to restore the basis of the debt before it increases the shareholder's

basis in his stock. Section 1367(b)(2)(B); Treas. Reg. §§ 1.1367-1(b)(1) and 1.1367-2(c)(1).

3. Timing of Adjustments

a. The basis adjustments of Section 1367(a) are determined as of the close of the corporation's taxable year, and the adjustments generally are effective as of that date. Treas. Reg. § 1.1367-1(d)(1).

b. However, if a shareholder disposes of stock during the taxable year, the adjustments with respect to that stock are effective immediately prior to the distribution. Id.

c. In addition, if an election is made under Section 1377(a)(2) (to terminate the year in the case of the termination of a shareholder's interest) or under Treas. Reg. § 1.1368-1(g)(2) (to terminate the year in the case of a qualifying disposition), the timing of the basis adjustments are made as if the taxable year consisted of separate taxable years, the first of which ends at the close of the day on which either the shareholder's interest is terminated or a qualifying disposition occurs, whichever the case may be. Treas. Reg. § 1.1367-1(d)(3).

4. Ordering Rules for the Basis Adjustments

a. General rule

(i) Taxable years beginning before January 1, 1997

Under Treas. Reg. § 1.1367-1(e), for taxable years beginning before January 1, 1997, the adjustments to basis generally are made in the following order:

(a) any increase in basis attributable to the income items described in Section 1367(a)(1)(A) and (B), and the excess of the deductions for depletions described in Section 1367(a)(1)(C);

(b) any decrease in basis attributable to nondeductible, noncapital expenses (under Section 1367(a)(2)(D)) and the oil and gas depletion deduction (under Section 1367(a)(2)(E));

(c) any decrease in basis attributable to items of loss or deduction described in Section 1367(a)(2)(B) and (C); and

(d) any decrease in basis attributable to a non-taxable distribution by the corporation in accordance with Section 1367(a)(2)(A).

See TAM 9304004 (current year's net income increases the shareholder's stock basis, thereby allowing the deduction of suspended losses from prior years until the stock basis equals zero, so that any later distributions result in gain).

Under section 1309 of the 1996 Small Business Act (amending Sections 1366 and 1368 of the Code), however, distributions during a year reduce the adjusted basis for purposes of determining the amount of loss a shareholder may take into account for a taxable year. However, the loss for a year does not reduce the adjusted basis for purposes of determining the tax status of distributions made during that year.

(ii) Taxable years beginning on or after August 18, 1998

Under Treas. Reg. § 1.1367-1(f), for taxable years beginning on or after August 18, 1998, the recently finalized regulations provide that adjustments to basis generally are made in the following order:

(a) any increase in basis attributable to the income items described in Section 1367(a)(1)(A) and (B), and the excess of the deductions for depletions described in Section 1367(a)(1)(C);

(b) any decrease in basis attributable to a distribution by the corporation described in Section 1367(a)(2)(A)(relating to distributions that were not includible in the shareholder's income under Section 1368);

(c) any decrease in basis attributable to noncapital, nondeductible expenses described in Section 1367(a)(2)(D), and the oil and gas depletion described in Section 1367(a)(2)(E); and

(d) any decrease in basis attributable to items of loss or deduction described in Section 1367(a)(2)(B) and (C).

(iii) Taxable years beginning on or after January 1, 1997, and before August 18, 1998

The transition rule in the recently finalized regulations provides that, for taxable years beginning on or after January 1, 1997, and before August 18, 1998, the basis of a shareholder's stock must be determined in a reasonable manner, taking into account the statute and legislative history. Treas. Reg. § 1.1367-3. Return positions consistent with the final regulations will be considered reasonable. Id.

b. Elective ordering rule

The recently finalized regulations provide an elective ordering rule – under this provision, a shareholder may elect to decrease basis for items attributable to separately and nonseparately stated losses and deductions prior to decreasing basis for nondeductible, noncapital expenses and oil and gas depletion deductions if the shareholder agrees that the noncapital, nondeductible expenses and the oil and gas depletion deductions in excess of basis will reduce basis in the succeeding taxable year. See Treas. Reg. § 1.1367-1(g).

C. Distributions from S Corporations

In general, the amount of a distribution from an S corporation to a shareholder will be equal to the sum of money and the fair market value of property distributed. Section 301(b)(1); S. Rep. No. 97-640, at 20. In January 1994, the Service issued final regulations under Section 1368 that dealt with the treatment of distributions from an S corporation. The final regulations under Section 1368 generally provided the same rules as the proposed regulations that were issued in June 1992. In response to the 1996 Small Business Act, the Service issued new final regulations amending Treas. Reg. § 1.1368-2 in December 1999. The final regulations issued in 1992 and the final regulations issued in 1999 are analyzed below.

1. S Corporation Having No Earnings and Profits

a. In the case of a corporation having no accumulated earnings and profits, a Section 301(c) distribution of property is treated as a tax-free distribution to the extent of the recipient shareholder's basis in the stock of the S corporation. Section 1368(b)(1).

b. The amount of the distribution that exceeds basis, if any, is treated as gain from the sale or exchange of property. Section 1368(b)(2).

(i) Presumably, the gain is either long-term or short-term capital gain, depending on the holding period of the stock.

(ii) If the corporation is collapsible, it is unclear whether the gain will be ordinary in nature.

c. As previously stated, the basis adjustment rules apply to each shareholder's pro rata portion of the items described in Section 1367(a) on a per-share, per-day basis. However, in determining the amount of decrease in the basis of individual shares, the regulations adopt a "spillover rule" – if the amount attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining basis of all other shares of stock in the corporation owned by the shareholder in proportion to the remaining basis of each of these shares. Treas. Reg. § 1.1367-1(c)(3).

(i) For example, individual A owned 50 shares of S corporation stock with a basis of $100 on December 31, 1993. On January 1, 1994, A buys an additional 25 shares of stock for $300. The S corporation subsequently distributes $375 to A.

(ii) Under the spillover rule adopted in the regulations, the adjusted basis of each share of stock is decreased by $5 ($375/75 shares). However, because the decrease in basis attributable to the original 50 shares exceeds the $2 per share basis of such stock. The $150 excess is applied to reduce the remaining basis of the purchased 25 shares by $6 per share. Thus, the original 50 shares have a zero basis, and the purchased 25 shares have a $1 basis (for an aggregate basis of $25). See Treas. Reg. § 1.1367-1(h), ex. 3.

2. S Corporation Having Earnings and Profits

Distributions from an S corporation having earnings and profits are treated as follows:

a. First layer

(i) To the extent the amount of the distribution does not exceed the "accumulated adjustment account" ("AAA"), the distribution is taxed in accordance with Section 1368(b). In other words, distributions from this layer are tax-free to the extent of basis and then treated as gain from the sale or exchange of property. Section 1368(c)(1).

(ii) Since the AAA is a corporate level account, this treatment apparently would apply regardless of when or how the

shareholder acquired his S corporation stock. See S. Rep. No. 97-640, at 20.

b. Second layer

(i) The portion of the distribution that exceeds the AAA is treated as a dividend to the extent that it does not exceed the accumulated earnings and profits of the corporation. Section 1368(c)(2).

(ii) The Service has ruled that distributions from this layer qualify as portfolio income under Section 469(e)(1)(A) (i.e., dividends) even though the S corporation's income or loss passed through to its shareholders would otherwise be treated as passive. See PLR 8752017; see also Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 231 n. 24.

c. Third layer

(i) The portion of the distribution still remaining, if any, is again treated according to Section 1368(b).

(ii) Thus, the remaining portion of the distribution is treated as a tax-free distribution which reduces the basis of stock in the S corporation, and any amount further remaining is treated as gain from the sale or exchange of property. Section 1368(c)(3).

d. S corporations with previously taxed income

(i) In the case of distributions made by an S corporation with both accumulated earnings and profits and previously taxed income ("PTI") (within the meaning of Section 1375(d)(2), as in effect prior to its amendment by the Subchapter S Revision Act of 1982), the portion remaining after the application of Section 1368(c)(1) (i.e., the first layer) is treated in accordance with Section 1368(b) (relating to S corporations without earnings and profits) to the extent that portion is a distribution of money and does not exceed the shareholder's net share of the corporation's previously taxed income. Treas. Reg. § 1.1368-1(d)(2).

(ii) Any distribution remaining after the application of the preceding provision is treated in the manner provided in Section 1368(c)(2) and (3). Id.

3. The Accumulated Adjustments Account

In general, the AAA is a device to keep track of undistributed post-1982 S corporation income that has already been taxed to the shareholder. As the priority system outlined above indicates, the AAA allows tax-free nondividend distributions to be made before dividend distributions. The 1999 final regulations amended Treas. Reg. §§ 1.1367-1 and 1.1368-2 to provide that for taxable years of the corporation beginning on or after August 18, 1998, the adjustments to the AAA are made in a different order than the adjustments to the basis of a share of stock. Compare Treas. Reg. § 1.1368-2(a)(5) (ordering rules for AAA) with Treas. Reg. § 1.1367-1(f) (ordering rules for stock basis).

a. The AAA is a corporate level account and is not apportioned among shareholders. Treas. Reg. § 1.1368-2(a)(1). Thus, with the exception of a redemption, the AAA is generally not affected by shareholder transfers of stock.

b. Increases to the AAA

The AAA is increased for the taxable year by the sum of the following items:

(i) the separately stated items of income under Section 1366(a)(1)(A) other than tax-exempt income;

(ii) any nonseparately computed income determined under Section 1366(a)(1)(B); and

(iii) the excess of the depletion deductions over the basis of the property subject to depletion (except for certain oil and gas property). Treas. Reg. § 1.1368-2(a)(2).

The AAA is increased for the items described above before it is decreased for the items listed in c., below, for the taxable year. Treas. Reg. § 1.1368-2(a)(4)(i) and (5)(i).

c. Decreases to the AAA

(i) Items other than distributions

The AAA is decreased for the taxable year by the sum of the following items:

(a) the separately stated items of loss or deduction under Section 1366(a)(1)(A);

(b) any nonseparately computed loss determined under Section 1366(a)(1)(B);

(c) any noncapital, nondeductible expense other than

i) federal taxes attributable to any taxable year in which the corporation was a C corporation, and

ii) expenses related to tax-exempt income; and

(d) the sum of the shareholders' deductions for depletion for any oil or gas property held by the corporation described in Section 1367(a)(2)(E). Treas. Reg. § 1.1368-2(a)(3)(i).

The AAA may be decreased below zero for items other than for distributions. Treas. Reg. § 1.1368-2(a)(3)(ii). The AAA is decreased by the entire amount of any loss or deduction even though a portion of the loss or deduction is not taken into account by a shareholder under Section 1366(d)(1). Id.

(ii) For distributions

(a) The AAA is decreased (but not below zero) by any portion of a distribution to which Section 1368(b) or (c)(1) applies. Treas. Reg. § 1.1368-2(a)(3)(iii).

(b) The AAA is decreased for items other than distributions before it is decreased for the distributions themselves. Treas. Reg. § 1.1368-2(a)(4)(ii) and (5)(ii).

(c) Under section 1309 of the 1996 Small Business Act (amending Sections 1366 and 1368 of the Code), in determining the amount in the AAA for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, a net negative adjustment (i.e., the excess of the decreases in the AAA other than for distributions over the increases in the AAA) for that taxable year is disregarded.

(iii) For distributions in excess of the AAA

(a) If an S corporation makes more than one distribution of property in a year in which the AAA

has a positive balance at the close of the year, and the sum of the distributions made during the corporation's taxable year exceeds the balance of the AAA at the close of the year, the AAA is allocated on a pro rata basis among the distributions made during the year. Treas. Reg. § 1.1368-2(b)(1).

(b) The amount of the AAA allocated to each distribution is determined by multiplying the balance of the AAA at the close of the current taxable year by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the amount of all non-dividend distributions made during the taxable year. Treas. Reg. § 1.1368-2(b)(2).

(iv) Distributions of money and loss property

If (1) an S corporation distributes money and property with basis in excess of its fair market value, (2) the S corporation has earnings and profits, and (3) the overall distribution of money and property exceeds the amount of AAA otherwise allocable to the distribution, the AAA must be allocated further between the money and the property distributed. The additional allocation is based on the proportion of the money or the fair market value of the property to the amount of the total distribution. Treas. Reg. § 1.1368-2(c).

d. Ordering rules for the AAA

(i) For taxable years beginning before January 1, 1997, under Treas. Reg. § 1.1368-2(a)(4), the adjustments to the AAA are made in the following order:

(a) the AAA is increased under Treas. Reg. § 1.1368-2(a)(2) before it is decreased under Treas. Reg. § 1.1368-2(a)(3) for the taxable year;

(b) the AAA is decreased under Treas. Reg. § 1.1368-2(a)(3)(i) before it is decreased under Treas. Reg. § 1.1368-2(a)(3)(iii);

(c) the AAA is decreased (but not below zero) by any portion of an ordinary distribution to which Section 1368(b) or (c)(1) applies; and

(d) the AAA is adjusted (whether positive or negative) for redemption distributions under Treas. Reg. § 1.1368-2(d)(1).

(ii) For any taxable year beginning on or after August 18, 1998, under Treas. Reg. § 1.1368-2(a)(5), the adjustments to the AAA are made in the following order:

(a) the AAA is increased under Treas. Reg. § 1.1368-2(a)(2) before it is decreased under Treas. Reg. § 1.1368-2(a)(3) for the taxable year;

(b) the AAA is decreased under Treas. Reg. § 1.1368-2(a)(3)(i) (without taking into account any negative net adjustment (as defined in Section 1368(a)(1)(C)(ii))) before it is decreased under Treas. Reg. § 1.1368-2(a)(3)(iii);

(c) the AAA is decreased (but not below zero) by any portion of an ordinary distribution to which Section 1368(b) or (c)(1) applies;

(d) the AAA is decreased by any net negative adjustment (as defined in Section 1368(e)(1)(C)(ii)); and

(e) the AAA is adjusted (whether positive or negative) for redemption distributions under Treas. Reg. § 1.1368-2(d)(1).

(iii) Taxable years beginning on or after January 1, 1997, and before August 18, 1998

The transition rule in the recently finalized regulations provides that, for taxable years beginning on or after January 1, 1997, and before August 18, 1998, the treatment of distributions by an S corporation to its shareholders must be determined in a reasonable manner, taking into account the statute and legislative history. Treas. Reg. § 1.1368-4. The AAA adjustment order applicable for taxable years beginning after August 18, 1998 will be considered reasonable. Id.

e. Elections relating to AAA distribution rules

An S corporation can elect to modify the general AAA distribution rules as follows:

(i) Election to distribute earnings and profits first

(a) Under Section 1368(e)(3), an S corporation with earnings and profits can elect to treat all distributions made during the taxable year as made first from earnings and profits.

(b) Distributions in excess of the amount of earnings and profits are treated as coming from the AAA, with any remainder being treated in accordance with Section 1368(b). Treas. Reg. § 1.1368-1(f)(2)(i). The election applies to all distributions made during the year for which the election is made.

(c) S corporations usually make this election in order to avoid the Section 1375 tax on excess passive investment income. Section 1375 applies only if an S corporation has earning and profits at the end of the taxable year. Section 1375(a).

(ii) Election to make a deemed dividend

(a) An S corporation that elects to distribute earnings and profits may also elect to distribute such earnings and profits through a deemed dividend. Treas. Reg. § 1.1368-1(f)(3).

(b) The deemed distribution is treated as having been made to all shareholders holding stock on the last day of the taxable year, in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders, all on that day. Id.

(c) The amount of the deemed dividend may not exceed the subchapter C earnings and profits of the corporation on the last day of the taxable year, reduced by any actual distributions of subchapter C earnings and profits made during the taxable year. Id.

(d) An election to make a deemed dividend automatically triggers an election to distribute earnings and profits first. Id.

(iii) Election to forego PTI

(a) As previously discussed, if an S corporation with earnings and profits also has PTI, any distribution made in excess of the AAA is treated as made out of PTI before it is treated as made out of earnings and profits.

(b) The regulations permit an S corporation to elect to forego distributions of PTI. Treas. Reg. § 1.1368-1(f)(4).

f. Special termination elections

(i) Shareholder's termination of interest

(a) If an election is made under Section 1377(a)(2) (to terminate the taxable year when a shareholder terminates his or her interest in the S corporation), Section 1368 applies as if there are two taxable years, the first of which ends on the day the shareholder terminates his or her interest in the S corporation. Treas. Reg. §§ 1.1368-1(g)(2)(iv), 1.1377-1(b).

(b) As discussed above, the 1996 Small Business Act amended Section 1377(a)(2) of the Code to provide that, under regulations to be issued by the Secretary, the election under Section 1377(a)(2) to close the books of the S corporation upon the termination of a shareholder's interest is to be made by "all affected shareholders and the corporation." The closing of the books applies only to the affected shareholders. "Affected shareholders" is defined as any shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year. If a shareholder transferred shares to the corporation, "affected shareholders" includes all persons who were shareholders during the year. Treas. Reg. § 1.1377-1(b)(2).

(ii) Disposition of substantial amounts of stock

(a) In the case of a "qualifying disposition," a corporation may elect to treat the year as if there are two separate years, the first of which ends on the date of disposition. A qualifying disposition includes:

i) a disposition by a shareholder of 20 percent or more of the stock of the corporation during any 30-day period during the taxable year;

ii) a redemption (which is treated as an exchange under Sections 302(a) or 303(a)) of 20 percent or more of the outstanding stock of the corporation from a shareholder in one or more transactions during any 30-day period during the taxable year; or

iii) an issuance of an amount of stock equal to or greater than 25 percent of the previously outstanding stock to one or more new shareholders during any 30-day period during the taxable year. Treas. Reg. §1.1368-1(g)(2)(i).

(b) A corporation making this election treats the taxable year as separate taxable years for purposes of

i) allocating income and loss;

ii) making adjustments to the AAA, earnings and profits, and basis; and

iii) determining the tax effect of distributions under Section 1368(b) and (c). Treas. Reg. § 1.1368-1(g)(2)(ii).

g. <u>Adjustments to AAA for redemptions, reorganizations, divisions and year terminations</u>

(i) <u>Redemptions</u>

(a) In the case of a distribution that is treated as a redemption under Sections 302(a) or 303(a), the AAA of the corporation is adjusted in an amount equal to the ratable share of the corporation's AAA (negative or positive) attributable to the redeemed stock as of the redemption date. Treas. Reg. § 1.1368-2(d)(1)(i).

(b) If the redemption occurs in a year in which the S corporation makes ordinary distributions, the AAA is adjusted first for any ordinary distributions and then for any redemption distributions. Treas. Reg.

§ 1.1368-2(d)(1)(ii). This rule simplifies the rule that was set out in the proposed regulations, which required the S corporation to determine the ratable share of the AAA attributable to the redeemed stock in the manner used to determine the pro rata portion of current earnings and profits of a C corporation. See Rev. Rul. 74-338, 1974-2 C.B. 101; Rev. Rul. 74-339, 1974-2 C.B. 103.

(ii) Reorganizations

An S corporation that acquires the assets of another S corporation in a transaction to which Section 381(a)(2) applies succeeds to the AAA of the transferor S corporation as of the effective date of the reorganization. Thus, the AAA of the acquiring corporation after the transaction is the sum of the AAAs of the two corporations prior to the transaction. Treas. Reg. § 1.1368-2(d)(2).

(iii) Corporate divisions under Section 368(a)(1)(D)

In the case of a corporate separation under Section 368(a)(1)(D), the AAA of the distributing corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation in a manner similar to the manner in which earnings and profits of the distributing corporation are allocated under Section 312(h). Treas. Reg. § 1.1368-2(d)(3).

(iv) Year terminations

Prior to the 1996 Small Business Act, if an election was made under Section 1377(a)(2) (to terminate the year in the case of a termination of a shareholder's interest) or under Treas. Reg. § 1.1368-1(g)(2) (to terminate the year in the case of a disposition of substantial amounts of stock), the AAA rules applied as if the taxable year consisted of two separate taxable years. Treas. Reg. § 1.1368-2(e). Under section 1306 of the 1996 Small Business Act (amending Section 1377(a) of the Code), however, if an election is made under Section 1377(a)(2), the closing of the books applies only to the "affected shareholders" (as defined above). Treas. Reg. § 1.1377-1(a)(3)(i).

h. Only S corporations with earnings and profits are required to maintain an AAA. However, every S corporation should maintain

an AAA, even though it will generate no earnings and profits of its own accord during S corporation years.

(i) This is the case because the S corporation may inherit earnings and profits from a C corporation or a pre-1982 S corporation in a subsequent Section 381 transaction.

(ii) Also, once S status terminates, distributions of cash in the post-termination transition period from the allocable AAA may be tax-free to the extent of stock basis. See Section 1371(e).

4. Earnings and Profits

a. An S corporation will not generate current earnings and profits during the time it is an S corporation (assuming post-1982 years). Section 1371(c)(1). However, an S corporation may have earnings and profits either from former C corporation years, pre-1982 S corporation years (i.e., PTI) by operation of Section 381, or through Section 312(h).

b. Section 1371(c)(2) provides that "proper adjustment" is to be made to the earnings and profits in the case of any transaction involving the application of subchapter C to the S corporation.

c. In addition, distributions that are treated as dividends pursuant to Section 1368(c)(2) will reduce earnings and profits. Section 1371(c)(3).

D. Post-Termination Distributions

Section 1371(e)(1) accords special treatment to certain distributions made after the S election is terminated.

1. Section 1371(e)(1) states that distributions of money by a corporation during the post-termination transition period are to be applied against and reduce the basis of the recipient shareholder's stock to the extent of the allocable AAA. In effect, the shareholder may receive cash in a tax-free distribution to the extent of his adjusted stock basis, or the allocable AAA, whichever is less.

a. Section 1371(e)(1) only applies to distributions of money, not property.

b. The distribution must be made during the "post-termination transition period."

(i) Prior to the 1996 Small Business Act, the post-termination transition period generally was the period beginning on the day after the S election terminates and ending on the later of (1) the day which is one year after the beginning date or (2) the due date for filing the last S corporation return (including extensions). A second 120-day period could also apply. See Section 1377(b).

(ii) Section 1307 of the 1996 Small Business Act expanded that definition so that the "post-termination transition period" includes the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a subchapter S item of income, loss, or deduction of the S corporation during the S period. The 1996 Small Business Act also expanded the definition of "determination" to include a final disposition by the Secretary of a claim for refund and, under regulations, certain agreements between the Secretary and any person relating to the person's tax liability. See Section 1377(b). These changes were effective for tax years beginning after December 31, 1996.

(iii) In a technical correction, however, section 1601(d) of TRA '97 clarifies that the effective date for these 1996 Small Business Act provisions is for determinations after December 31, 1996, not for determinations with respect to taxable years beginning after that date. TRA '97 further specifies that in no event will the expanded post-termination transition period end before the end of the 120-day period beginning after August 5, 1997.

c. Section 1371(e) applies to distributions "With respect to the stock" of a corporation. Accordingly, distributions under both Sections 301 and 302 may be covered.

d. Section 1371(e) applies only to the extent of AAA. Section 1371(e)(1) does not specify what happens if the distribution exceeds the shareholder's basis, but does not exceed the AAA. Presumably capital gain treatment would be available.

e. If the distribution exceeds the AAA, presumably the usual subchapter C rules would apply to the excess distribution.

2. An election may be made to forego Section 1377(e)(1) treatment for all distributions made during the post-termination transition period. Section 1371(e)(2). In such a case, the usual subchapter C rules would apply.

V. TRANSACTIONAL PLANNING

A. In General

1. Coordination with Subchapter C

a. One widely recognized benefit of using the S corporation format is that an S corporation and its shareholders generally may take advantage of the reorganization provisions of the Code.

(i) Section 1371(a) states that "[e]xcept as otherwise provided in this title, and except to the extent inconsistent with [subchapter S], subchapter C shall apply to an S corporation and its shareholders."

(ii) The legislative history of Section 1371(a)(1) (redesignated Section 1371(a) by the 1996 Small Business Act) provides that, as to transactions with respect to its own stock, an S corporation is to be treated as a regular corporation, unless the result would be inconsistent with the purposes of the subchapter S rules which treat the corporation as a pass-through entity. S. Rep. No. 97-640, at 15.

(iii) Regulations promulgated under the predecessor of Section 1371 (Section 1372) set forth a list of subchapter C Sections that applied to S corporations. Treas. Reg. § 1.1372-1(c).

(a) Section 301 was applicable as if no election had been made.

(b) Sections 302, 303, 304 and 331 were applicable in determining whether a distribution was in exchange for stock.

(c) Section 305 applied to distributions of the S corporation's own stock.

(d) Section 311 was applicable.

(e) Section 341 also was applicable.

b. Prior to the 1996 Small Business Act, Section 1371(a)(2) provided that for purposes of subchapter C, an S corporation in its capacity as a shareholder was to be treated as an individual.

(i) The legislative history explicitly noted that this provision applied only where an S corporation received a distribution

from a C corporation. As a result, the S corporation could not utilize the dividends received deduction under Section 243. See S. Rep. No. 97-640, at 15. See also Naprano v. United States, 834 F. Supp. 694 (D.N.J. 1993); PLR 9245004.

(ii) Beyond this context, the intended scope of Section 1371(a)(2) was unclear. It was unclear whether this Section was intended to apply literally to reorganization and divisive transactions.

(a) For example, since a B reorganization requires an acquisition by a corporation of control of another corporation, Section 1371(a)(2) literally would have prevented an S corporation from acquiring stock of a target corporation under Section 368(a)(1)(B).

(b) Also, in a divisive D reorganization, Section 355 contemplates the distribution by one corporation of control of another corporation. If the distributing S corporation was treated as an individual under Section 1371(a)(2), Section 355 would not have applied.

(c) A liquidation under Section 332 also would not have been available because that Section is premised on the existence of a corporate shareholder.

(iii) However, in G.C.M. 39768 (Dec. 1, 1988), the Service expressed the view that Section 1371(a)(2) should not prevent a transferor S corporation that momentarily holds the stock of a controlled corporation from engaging in a divisive "D" reorganization. See e.g., PLR 9321006; PLR 9320009; PLR 9319041; PLR 9319018; PLR 9319016; PLR 9319002; PLR 9318024; PLR 9312025. Similarly, Section 1371(a)(2) should not prevent a transferor S corporation that momentarily holds the stock of an acquiring corporation from engaging in an "A", "C", acquisitive "D" or "F" reorganization.

(iv) ABA Task Force Report

(a) The ABA Task Force recommended that Section 1371(a)(2) should be amended to clarify that Sections 332 and 338 were available to S corporations. Task Force Report at 452.

(b) The ABA Task Force further recommended that G.C.M. 39768 be published as a revenue ruling, since the outstanding revenue rulings that are cited with approval in G.C.M. 39768 all predate the Subchapter S Revision Act of 1982, and thus, Section 1371(a). Id. at 468.

(v) Repeal of Section 1371(a)(2)

Section 1310 of the 1996 Small Business Act repealed Section 1377(a)(2) of the Code.

(a) Thus, the 1996 Small Business Act clarified 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 Code Sections 332 and 337 allowing a tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may be subject to tax under Section 1374 upon a subsequent disposition. An S corporation also will be able to make a Section 338 election (assuming all other applicable requirements are met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and any resulting tax liability).

(b) However, the repeal of Code Section 1377(a)(2) was not intended to change the general rule governing the computation of income of an S corporation. For example, it does not allow an S corporation, or its shareholders, to claim a dividends received deduction 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.

2. Special Concerns with S Corporations

Where S corporations are involved in an acquisition or disposition, special planning concerns and issues must be addressed.

a. Where the S corporation is the acquiring entity, a primary concern is whether the acquisition will terminate the S election.

(i) Prior to the 1996 Small Business Act, this could occur, for example, where the transaction caused the S corporation to become disqualified as a small business corporation (e.g., affiliation with the target). See old Section 1361(b).

(a) In G.C.M. 39768, the Service cited with approval Rev. Rul. 72-320, 1972-1 C.B. 270 and G.C.M. 33336 (Sept. 23, 1966). The foregoing authorities held that an S corporation's momentary ownership of stock in another corporation in connection with a divisive "D" reorganization did not terminate its S election under the predecessor to Section 1361(b)(2)(A).

(b) The Service also expressed the view in G.C.M. 39768 that an S corporation that momentarily has a corporate shareholder in the course of a reorganization is not disqualified from being an S corporation under Section 1361(b)(1)(B).

(c) In TAM 9245004, the Service relied on G.C.M. 39768 and Rev. Rul. 72-320 in holding that an S corporation's momentary ownership of stock in a subsidiary immediately prior to the subsidiary's liquidation under Section 332 did not cause the corporation to be an ineligible corporation under Section 1361(b)(2)(A).

(d) As discussed above, the ABA Task Force Report recommended that the Service issue a revenue ruling addressing situations in which an S corporation can engage in tax-free asset acquisitions as the acquiring corporation and situations in which an S corporation is the target.

(e) Also as discussed above, the 1996 Small Business Act now allows an S corporation to be affiliated (as a shareholder) with a C corporation.

(ii) If new shareholders receive more than 50 percent of the shares of the S corporation, they can elect to revoke the election. See Section 1362(d)(1)(B).

b. In addition, the allocation of income and loss items in the year of acquisition between former and current shareholders must be considered along with whether the corporation must pay recapture taxes.

c. The effect of corporate carryovers, such as earnings and profits, also must be considered.

VI. USING S CORPORATIONS AS ACQUISITION VEHICLES

A. Newly Formed S Corporation

Unique subchapter S issues arise if a newly formed S corporation is to be used as the acquisition vehicle.

1. When to File an S Election

a. In general

Where a newly formed corporation is created to complete the acquisition, the S election should be filed: (1) after the corporation comes into existence and (2) within two and one-half months of the first day of its first taxable year. Determining when these two points in time occur may be difficult.

b. Elections prior to corporate existence

An election will be invalid if it is filed before the corporation comes into existence. Under Section 1362, only a small business corporation may make an S election. Under Section 1361(b)(1), a small business corporation, in turn, must be a domestic corporation. In general, a domestic corporation is one organized under domestic law. If the entity is not in existence (i.e., not organized under domestic law) it cannot make an election.

(i) The Service has ruled that an election was invalid because it was made prior to the issuance of the certificate of incorporation. See PLR 8807070; PLR 8530100.

(ii) If the initial election is invalid for this reason, it is unclear whether the election can be considered to be made for the following year.

(iii) The 1996 Small Business Act amended Section 1362(f) to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation (or to obtain the necessary shareholder consents). In order to qualify for such treatment, steps must be taken within a reasonable time after discovering the election was invalid to qualify the corporation as a small business corporation (or acquire the necessary shareholder consents). In addition, the corporation, and each person who was a shareholder therein at any time

during the period of invalidity, must agree to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary.

c. Two and one-half month period

A new corporation must file its election during the first two and one-half months of its initial taxable year if the election is to be effective for that year.

(i) The taxable year of a new corporation begins on the date that the corporation has shareholders, acquires assets, or begins doing business, whichever occurs first. Treas. Reg. § 1.1362-6(a)(2)(ii)(C).

(a) Apparently, the first year will begin with the acquisition of any asset, even if the asset acquired is a non-operating asset. See Artukovich v. Commissioner, 61 T.C. No. 13 (1973) (corporation acquired cash).

(b) A corporation may have shareholders well before it acquires assets or begins business. See, e.g., Lyle v. Commissioner, 30 T.C.M. 1412 (1971).

(c) For a case in which the corporation began business but had no shareholders, see Bone v. Commissioner, 52 T.C. 913 (1969) (existence began when corporation acquired assets and began business, even though stock was not issued).

(ii) Temporary regulations do provide that incorporators treated as shareholders for purposes of state law will not be treated as shareholders for purposes of the S election. Treas. Reg. § 18.1379-2(b), overruling in effect Rev. Rul. 72-257, 1972-1 C.B. 270.

(iii) The two and one-half month period closes two months and 15 days from the date on which the taxable year begins. Treas. Reg. § 1.1362-6(a)(2)(ii).

(iv) The 1996 Small Business Act amended Section 1362(b) of the Code by adding a new provision allowing the Secretary to treat an election filed after the expiration of this two and one-half month period as timely made for such year if the Secretary determines that there was reasonable cause for the failure to timely make such election. The new

provision even allows the Secretary to treat an election as timely filed for a taxable year if no election is made during the year, if the Secretary determines that there was reasonable cause for the failure to timely make an election for such year.

(v) As noted above, the Service recently issued Rev. Proc. 98-55, 1998-2 C.B. 645 (superseding Rev. Proc. 97-40, 1997-2 C.B. 488), to provide procedures by which taxpayers can request relief for a late S election. Under Rev. Proc. 98-55, a valid S election must be filed within twelve months of the original due date for the election and the corporation must have had reasonable cause for failing to make a timely election.

2. Structuring Financing – Impact on Basis

a. In general

Planning to provide shareholders with the maximum basis in both stock and debt instruments of the S corporation should begin at the early stages of the acquisition. Such planning should be done at the same time that financing is being arranged.

(i) Basis is important since it serves as a limitation (along with Sections 465 and 469) on the use of losses generated by the S corporation. Section 1366(d). This is true not only while the election is in effect, but also at the close of the post-termination transition period as well.

(a) Both stock and debt basis may be applied to absorb losses while the election is in effect.

(b) However, only stock basis may be used to absorb unused losses at the close of the post-termination transition period. Section 1366(d)(3)(B).

(ii) In addition, basis determines how much cash can be currently withdrawn tax-free. Also, post-termination transition period distributions of cash can be received tax free (up to the AAA) if the shareholder has sufficient basis in his S corporation stock. See Section 1371(e).

(iii) If possible, financing should be channeled through the shareholders of the S corporation in order to obtain maximum basis. Discussed below are methods of achieving this goal.

b. Contributions from shareholders

(i) The most obvious method of obtaining basis is through a transfer of cash by the shareholder in exchange for stock of the S corporation (i.e., a Section 351 exchange or purchase of stock).

(ii) A subsequent capital contribution of cash to the S corporation may also be made. A non pro rata contribution is not likely, however, as the benefits of such a contribution redound, in part, to the benefit of other shareholders.

(iii) A shareholder may also contribute property (other than cash) to the S corporation. In this case, although not entirely clear, the shareholder's basis in the stock probably will reflect the adjusted basis of the contributed property, if no gain is recognized by the shareholder.

(iv) The contribution of a shareholder's personal note will not create basis. Rev. Rul. 81-187, 1981-2 C.B. 167 (demand note did not result in any new investment by the shareholder).

(v) A shareholder's purchase of long-term debt from the corporation in exchange for the shareholder's personal note may not create basis if the purchase is done on a pro rata basis. See Perry v. Commissioner, 54 T.C. 1293 (1970). A cost basis may result if the purchase is non pro rata and a valid purpose exists for the purchase.

c. Loans from the shareholders

A shareholder may lend the needed financing to the corporation and obtain basis in the receivable created. See Perry v. Commissioner, 49 T.C. 508 (1968), acq., 1968-2 C.B. 2.

(i) However, the shareholder should keep in mind that allocations of income (loss) will not be made with respect to a shareholder's debt instrument. Thus, if initial losses are expected, a stock investment by the shareholder – as opposed to a lending arrangement – will generate a greater allocation of losses than would a loan.

(ii) Loans from a related entity ordinarily will not generate basis for the shareholder. The loan must be made directly from the shareholder to the corporation. See Bergman v. United States, 474 F.3d 928 (8th Cir. 1999); Hitchins v. Commissioner, 103 T.C. 711, 715 (1994); Burnstein v.

Commissioner, 47 T.C.M. 1100 (1984); Frankel v. Commissioner, 61 T.C. 343 (1973); Prashker v. Commissioner, 59 T.C. 172 (1972); Rev. Rul. 69-125, 1969-1 C.B. 207.

(iii) Adjustments to basis of indebtedness to shareholders

(a) Decrease in basis

i) The basis of indebtedness of an S corporation to its shareholder is reduced (but not below zero) to the extent that the corporation's losses, deductions and expenses exceed the basis of the shareholder's stock in the corporation. Any indebtedness that has been satisfied by the corporation, or disposed of or forgiven by the shareholder, during the taxable year, is not subject to the basis reduction. Treas. Reg. § 1.1367-2(b)(1).

ii) If a shareholder terminates his or her interest in the corporation during the taxable year, the basis reduction rules are applied to any indebtedness held by the shareholder immediately prior to the termination of the shareholder's interest. Treas. Reg. § 1.1367-2(b)(2).

iii) If the shareholder holds more than one debt instrument at the close of the corporation's taxable year, the basis reduction rule is applied to each instrument based on their relative percentage of basis. Treas. Reg. § 1.1367-2(b)(3).

(b) Increase in basis

i) The basis of indebtedness of an S corporation to its shareholders is increased in a subsequent taxable year to the extent that the corporation's income items and excess depletion deductions exceed the corporation's losses, deductions and expenses for that taxable year. Treas. Reg. § 1.1367-2(c)(1).

ii) The restoration rules apply only to indebtedness held by the shareholder on the first day of the taxable year in which the net increase arises. Id.

iii) The restoration rules apply before any net increase is applied to restore the basis of a shareholder's stock in an S corporation, but in no event is the shareholder's basis of indebtedness restored above the outstanding balance of the indebtedness determined as of the beginning of the taxable year in which the net increase arises. Id.

d. Back-to-back loans

If third party financing is to be obtained (e.g., banks), the loan should be made to the shareholder if possible, and not to the corporation. The shareholder can then reloan the proceeds to the corporation and obtain basis in the debt instrument. See PLR 8747013; Cf. Prop. Treas. Reg. § 1.465-10 (regarding the application of the at-risk rules in a back-to-back loan scenario).

(i) Loans directly to the S corporation from third party lenders do not increase the basis of a shareholder's stock in the S corporation. In this regard, the S corporation mode compares unfavorably with the partnership mode inasmuch as a partner generally may obtain basis in his partnership interest for partnership debt.

(ii) If the outside lender will not accept a mere pledge of the S corporation stock as security for the loan, the shareholder should first obtain security from the corporation on the shareholder's loan to the corporation. The shareholder can then reassign this security interest to the lender or otherwise use it as collateral to satisfy the lender. Cf. TAM 8443002.

(iii) A direct pledge of corporate assets to secure a shareholder loan should not be made since, in such a case, the loan may be treated as being made directly to the corporation. See Harrington v. United States, 605 F. Supp. 53 (D. Del. 1985). Cf. PLR 8546110; PLR 8542020; PLR 8539056.

(iv) Alternatively, the shareholder could use unrelated property as collateral.

e. Shareholder guarantees

Guarantees by shareholders of debt owed by the corporation to third parties generally will not create basis. See e.g., Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983).

(i) However, where the evidence indicates that the lender was looking to the shareholder for payment, guaranteed debt may be treated as if the money was lent directly to the shareholder who then made a capital contribution to the corporation. See Selfe v. United States, 778 F.2d 769 (llth Cir. 1985); Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972).

(a) According to Selfe, the issue generally is a factual one: whether the lender was looking primarily to the shareholder/guarantor for payment.

(b) However, most courts require an actual "economic outlay" by the shareholder to obtain basis. Thus, a guaranty by the shareholder generally has not been a successful basis generating technique in the subchapter S area. See, e.g., Underwood v. Commissioner, 535 F.2d 309 (5th Cir. 1976), Estate of Leavitt v. Commissioner, 90 T.C. 206 (1988), aff'd 875 F.2d 420 (4th Cir. 1989); PLR 9403003 (lack of actual economic outlay prevents taxpayer from increasing its basis under Section 1366(d)). See Keyes, "Shareholder Debt Guarantees Do Not Create Basis," Journal of Small Business Taxation (Sept./Oct. 1988) at p. 40.

(ii) Actual payment by the shareholders of guaranteed corporate debt should give rise to basis in the year of payment (and not sooner). See Rev. Rul. 70-50, 1970-1 C.B. 178; Rev. Rul. 71-288, 1971-2 C.B. 319. In this case, the corporation becomes directly indebted to the shareholder through subrogation.

(iii) The substitution of the shareholder's note in satisfaction of the corporation's obligation may generate basis for the shareholder. See Gilday v. Commissioner, 43 T.C.M. 1295 (1982); Rev. Rul. 75-144, 1975-1 C.B. 277; but see Underwood v. Commissioner, supra.

f. Seller financing

(i) Seller financing should be treated as other third party debt to the corporation. Thus, the shareholders will not receive an increased basis where the S corporation acquires property in exchange for its own notes.

(ii) As an alternative, the shareholder may consider purchasing the property directly from the seller and then contributing such property to the S corporation.

3. Priority Concerns of Investors

Because a small business corporation may have only one class of stock outstanding, creative planning is required to provide investors with desired priority.

a. Investors may obtain priority over shareholders by loaning money to the S corporation.

(i) If the debt satisfies the "straight debt" safe harbor in Section 1361(c)(5), it will not be recharacterized as a second class of stock.

(ii) The loans may be non pro rata.

b. Priority between creditors may also be created.

(i) Interest rates may vary. Thus, priority may be reached by setting a higher interest rate than that carried on other debt instruments or by giving fixed interest rates to some creditors and variable rates to others.

(ii) Subordinated debt may also be used to create priority without such debt being treated as a second class of stock. See Treas. Reg. § 1.1361-1(1)(5)(ii).

c. The equivalent of priority may be obtained if two or more S corporations form a partnership to acquire assets.

(i) For example, investor A and investor B wish to acquire the assets of a target corporation. However, A will not participate unless she can be assured of obtaining priority with respect to distributions. Accordingly, A and B form corporations S-1 and S-2, respectively. Both corporations elect S status.

(ii) S-1 and S-2 form a partnership to acquire and operate the assets of a target business. The partnership agreement

provides that S-1 is to receive priority on partnership distributions and liquidations.

(iii) S-l's partnership interest is functionally equivalent to a preferred stock interest.

(iv) With the issuance of Rev. Rul. 94-43, 1994-2 C.B. 198, which, as discussed in II.A.3.e. of this Part, revoked Rev. Rul. 77-220, there is significantly less risk that the Service will treat the two corporations as one for purposes of determining eligibility for an S election. However, if the Service were to treat the two entities as a single corporation, the combined entity would not be eligible for S treatment because the different distribution rights between A and B amount to two classes of stock. The Service may view this structure as an attempt to circumvent the single class of stock restriction.

4. Special Allocations

Compared to partnerships, a major disadvantage of an S corporation is that special allocations of income (loss) items are not possible. Compare Sections 1362(e)(2) and 1377 with Section 704.

a. However, it may be possible to organize the capital structure of the S corporation to produce results similar to special allocations.

b. For example, assume that, with respect to investors A and B, initial losses (or initial income where the shareholder is in an NOL position) of the S corporation are to be allocated in favor of investor A.

(i) Investor A contributes cash to the S corporation in exchange for stock. Investor B contributes cash in exchange for convertible debt, options and a lesser amount of stock.

(ii) Until the options are exercised and/or debt converted, A will receive a greater share of the income (loss) items generated by the S corporation.

(iii) The terms of the convertible debt and the options must be structured so that they would not be considered a second class of stock under Section 1361 or the regulations thereunder.

B. Asset Acquisitions by S Corporations

1. Taxable Asset Acquisitions

An S corporation may acquire target assets directly in exchange for cash or promissory notes. Alternatively, the S corporation may acquire the target assets in a taxable merger. See Rev. Rul. 69-6, 1969-1 C.B. 104.

a. Effect on S election

In general, a purchase of assets by an S corporation should not result in the termination of the S election.

(i) Prior to the 1996 Small Business Act, the election would be terminated if the acquired assets included stock of a subsidiary, and such subsidiary could not be disregarded as an inactive subsidiary under Section 1361(c)(6). The 1996 Small Business Act amended Section 1361(b)(2) to allow an S corporation to hold stock of a subsidiary C corporation.

(ii) Where part of the consideration package includes S corporation stock, the election will be terminated if such stock is received by, or transferred to, ineligible shareholders.

(iii) In addition, if the S corporation uses notes to acquire the assets, the S election will be terminated if the notes constitute a second class stock.

b. Allocation of income in year of acquisition

The income or loss generated by the acquired assets apparently will be blended in with other income of the S corporation and allocated to the S corporation's shareholders under the usual per-share per-day rule of Section 1377(a)(1).

c. Corporate level taxes

Because the acquired assets generally will have a cost basis, Section 1374 should not apply even if the assets are acquired from a C corporation.

2. Tax-Free Asset Acquisitions

An S corporation may make a tax-free asset acquisition using several formats, including a statutory merger or consolidation under Section 368(a)(1)(A), a conveyance of assets under Section 368(a)(1)(C) (a "C"

reorganization) or Section 368(a)(1)(D) (acquisitive "D" reorganization). In addition, Section 351 may be used to acquire the assets of a target enterprise, including a sole proprietorship.

a. Effect on election

(i) Merger

Where the S corporation acquires assets in a statutory merger, its status as an S corporation should not be affected solely because of the merger itself. Rev. Rul. 69-566, 1969-2 C.B. 165; Rev. Rul. 79-52, 1979-1 C.B. 283; PLR 9410022; PLR 9206011; PLR 9115059; PLR 9115029; PLR 9040066.

(a) However, the S election will be terminated if S corporation stock is received by an ineligible shareholder (such as a corporation or a partnership) or the number of shareholders exceeds the maximum permitted. In addition, if the target shareholders receive more than 50 percent of the shares of the S corporation stock outstanding, they may revoke the S election under Section 1362(d)(1). Further, the S corporation must make sure that if S corporation securities are issued in the transaction, they do not constitute a second class of stock.

(b) To date, the Service apparently has not attempted to recharacterize a merger into an S corporation as a constructive receipt of stock by the target followed by the target's liquidation. Cf. West Shore Fuel, Inc. v. United States, 598 F.2d 1236 (2d Cir. 1979).

(c) Where the target is also an S corporation, the Service has ruled that the target's S election does not terminate solely because of the merger, although the target's final taxable year ends on the date of the merger. Rev. Rul. 64-94, 1964-1 C.B. 317; PLR 9350003. Therefore, Section 1362(g) should not apply to the acquiring S corporation. See Rev. Rul. 70-232, 1970-1 C.B. 177.

(d) If the acquiring S corporation loses its S status because of the merger, Section 1362(g) will apply to prevent a new election until the five-year waiting period expires. This result may be avoided if the transaction is structured so that the target survives

(e.g., a reverse acquisition). The target could then elect S status without the restriction of Section 1362(g) (i.e., for the next taxable year instead of the fifth succeeding taxable year as under Section 1362(g)).

(e) Query how Section 1362(g) applies if the target is a former S corporation subject to Section 1362(g) and the acquiring S corporation loses its S status as a result of the reorganization? It would seem that a new 5-year waiting period would begin.

(ii) Consolidation

Where an S corporation and its target are merged into a new entity (i.e., a consolidation) the existence of the S corporation will terminate. Although the S status will also simultaneously terminate, the new entity should be able to make a new S election without restriction under Section 1362(g). Rev. Rul. 70-232, 1970-1 C.B. 178; PLR 9040066; PLR 8007089.

(iii) C reorganization

Where an S corporation acquires assets in a C reorganization, there is greater risk that the election will be terminated.

(a) A C reorganization contemplates the issuance of stock to the corporate transferor. The result is that the S corporation would have an ineligible shareholder (the corporate transferor).

(b) Even if the corporate transferor is immediately liquidated pursuant to Section 368(a)(2)(G), ownership of stock by an ineligible shareholder technically occurred. However, the Service has ruled privately that transitory ownership of S corporation stock by a corporation will not result in the termination of the S election. See, e.g., PLR 8736014; PLR 8518034; PLR 8515043; PLR 8439013.

(c) Importantly, in G.C.M. 39768 (December 1, 1988), the Service stated that an S corporation will not lose its S status merely because it has a momentary

corporate shareholder in the course of a reorganization, including a C reorganization.

(d) In addition, the Service has issued a number of private rulings in the context of other reorganization transactions which indicate that the presence of a transitory corporate shareholder will not result in the termination of the election. See PLR 8830025; PLR 8849015; PLR 8736014; Cf. Rev. Rul. 69-566, 1969-2 C.B. 165.

(e) The ABA Task Force recommended that an S corporation be able to acquire the assets of a target company in a C reorganization without losing its S status. Task Force Report at 468-69.

(iv) Acquisitive D reorganization

An acquisitive D reorganization generally requires that the S corporation acquire "substantially all" of the assets of the target, and that the target be liquidated. Sections 368(a)(1)(D) and 354(b)(1). The assets may be transferred by direct conveyance or by a merger into the S corporation. If the acquisition is completed using the merger format, the effects on the S election should be similar to those of a Section 368(a)(1)(A) merger.

(a) If the acquisition is completed by a direct conveyance of assets, the effects on the S election should be similar to those of a Section 368(a)(1)(C) transaction.

(b) Because of the continuity of interest requirement in a D reorganization (i.e., 50 percent common control), the acquiring corporation may be treated as a successor corporation to the target. See Treas. Reg. § 1.1362-5(b). If the acquiring corporation has not yet filed its election, and if the target was a former S corporation, Section 1362(g) may apply to the acquiring corporation.

(v) As previously discussed, the ABA Task Force recommended that the Service reissue G.C.M. 39768 in the form of a revenue ruling.

b. Allocation of income or loss in the acquisition year

(i) Where the S election is not terminated, income items are allocated under the per-share per-day rule of Section 1377(a)(1). If any shareholder terminates his interest as a result of the reorganization, an election to close the books under Section 1377(a)(2) should be considered.

(a) Absent an election to close the books, the allocation rules will shift income (loss) items among the shareholders. Pre-acquisition income (loss) of the acquiring corporation may be shifted to the former target shareholders; post-acquisition income (loss) attributable to the target's assets may be shifted to the acquiring S corporation's shareholders.

(b) The target's pre-acquisition income (loss) should not be included in the S corporation's income. See Section 381(b)(1).

(ii) Where the S election is terminated, items of income (loss) would be allocated under Section 1362(e)(2), unless all relevant shareholders elect to close the books under Section 1362(e)(3) or such closing is required under Section 1362(e)(6)(D).

c. Carryover of corporate attributes

In general, the S corporation will succeed to the tax attributes of the acquired corporation under Section 381.

(i) The basis of the acquired assets is generally a carryover basis. This may subject the S corporation to Section 1374.

(a) If the S election was made after December 31, 1986, the assets received by the S corporation may be subject to new Section 1374. See Section 1374(d)(8), as added by TAMRA. See also Ann. 86-128, supra; Treas. Reg. § 1.1374-8.

(b) Similarly, if the acquired assets were housed in an S corporation subject to new Section 1374, the S corporation also may be subject to new Section 1374. See Ann. 86-128, supra.

(ii) Section 1371(b)(1) states that no carryover from a C year to an S year may be used. However, it is unclear whether Section 1371(b)(1) applies only to attributes generated by the corporation itself or those inherited from the target corporation via Section 381.

(a) Resolution of this issue will be important if the S corporation is subject to Section 1374.

(b) Section 1374(b)(2) allows the S corporation to offset built-in gain with NOL carryovers arising in years "for which the corporation was a C corporation."

(c) This language implies that the target's NOL carryovers under Section 381 could not offset built-in gain. However, one can also argue that predecessor and successor corporations should be treated as the same corporation. Moreover, the NOL carryovers should be available to offset any net recognized built-in gain attributable to the target's assets.

(iii) Earnings and profits of the target also can carry over to the S corporation. If so, the corporation may be subject to restrictions on passive investment income. See Sections 1375 (annual tax) and 1362(d)(3) (termination of election). In addition, future S corporation distributions may be subject to Section 1368(c) instead of Section 1368(b).

d. Pre-reorganization distribution

Pre-reorganization distributions generally should be governed by Section 1368. Cf. Rev. Rul. 71-266, 1971-1 C.B. 262.

e. Post-reorganization distributions

Post-reorganization distributions should be governed by the usual Section 1368 rules. However, the reorganization may cause Section 1368(c) to apply if the S corporation succeeds to the target's earnings and profits.

(i) In cases where the acquiring S corporation does not have earnings and profits, distributions to the former target shareholders apparently may be treated as tax-free distributions under Section 1368(b)(1) to the extent of basis. This is true even though such shareholders hold the S corporation stock with a substituted basis and such basis does not reflect allocations of S corporation income. See S. Rep. No. 97-640, supra, at 20.

(ii) Where the acquiring S corporation does have earnings and profits of its own, the corporation should be maintaining an

AAA. Because the AAA is a corporate-level account, all the shareholders of the S corporation (including the former target shareholders) apparently may benefit from distributions out of the AAA. Treas. Reg. § 1.1368-2(a)(1).

(iii) Where the S corporation succeeds to the target's earnings and profits, distributions to historic S corporation shareholders may be transformed from tax-free distributions to taxable dividends. In addition, if the number of shareholders increases because of the transaction, future distributions may deplete the AAA at a faster rate than subsequent earnings can replenish the account.

(iv) For example, individual (A) forms an S corporation to acquire the assets of a target C corporation in a tax-free reorganization. A contributes $1 million to be used as boot in the reorganization. The S corporation succeeds to the target's earnings and profits under Section 381. Distributions to A after the reorganization may be taxable as dividends even though they actually represent a return of capital.

(v) If the acquiring S corporation's election terminates as a result of the reorganization, cash distributions may be made during the post-termination transition period to the extent of the shareholder's basis or the AAA, whichever is less. Section 1371(e)(1). However, it is questionable whether the benefits of Section 1371(e)(1) should be extended to corporate or other ineligible S corporation shareholders.

(vi) Where two S corporations are merged, the AAA of the survivor will equal the sum of the AAA's of each party to the reorganization immediately before the merger. Treas. Reg. § 1.1368-2(d)(2); see also PLR 9008041; PLR 9002051; PLR 8946052.

f. Distributions pursuant to the merger

Where distributions are made pursuant to the plan of reorganization (or contemporaneously therewith) it is unclear whether such distributions are governed by Section 356 or Section 1368.

(i) Under Section 356(a)(1), boot distributions would be taxed to the extent of gain realized; whereas, under Section 1368,

boot distributions may be treated as tax-free distributions. Sections 1368(b)(1), (c)(1) or (c)(3).

(a) For example, individual A has a basis in target stock of $100 and receives in a merger $20 in cash and stock of the acquiring S corporation worth $130.

(b) If Section 356(a)(1) controls, A would be taxed on the $20. If Section 1368 controls, A would treat the $20 as a tax-free distribution (assuming the AAA is sufficient if earnings and profits are present).

(ii) Section 1371(a) implies that subchapter S takes precedence over subchapter C. This is supported by old Section 1363(e) which, prior to TAMRA, stated that Section 356 applies only to the extent that permitted property is distributed. Thus, old Section 1363(e) suggested that subchapter S will apply to boot distributions. However, TAMRA repealed old Section 1363(e).

(iii) If Section 356 does control, it would seem that Section 356(a)(2) should not treat distributions as dividends where such distributions would be tax-free under Section 1368.

(iv) The ABA Task Force Report recommended that the Service issue a ruling addressing the handling of the corporate-level AAA under various situations involving acquiring and target C corporations and S corporations, as well as the treatment of boot. Task Force Report at 468.

g. LIFO recapture

(i) As previously discussed, the regulations under Section 1363(d) extend the application of the LIFO recapture rules to an S corporation that succeeds to LIFO inventory in a tax-free asset acquisition with a C corporation. See Treas. Reg. § 1.1363-2(a)(2).

(ii) If the tax-free asset acquisition takes the form of a merger, the acquiring S corporation in all likelihood would be liable for the tax under state law. It is less clear in a situation involving a C reorganization or an acquisitive D reorganization.

C. Stock Acquisitions by S Corporations

In many cases, the target shareholders will insist on selling their stock rather than

the target's assets. A stock acquisition by an S corporation creates additional risks not present in an asset acquisition.

1. Taxable Stock Acquisitions

a. Effect on election prior to the 1996 Small Business Act

(i) An acquisition of stock by an S corporation generally terminated the S election if the corporation acquired sufficient stock of the target to satisfy the Section 1504(a)(2) tests.

(ii) If the target was immediately liquidated or spun-off, the S status of the acquiring corporation may have been preserved.

(a) The ABA Task Force Report concluded that an S corporation should be permitted to purchase the stock of a target S or C corporation and then liquidate the target into itself without either terminating the purchaser's S status or causing the recognition of gain or loss by the target. This required both the continuation of a momentary affiliation rule similar to the ruling in Rev. Rul. 73-496 and an interpretation of Section 1371(a)(2) that recognized the "corporation" status of the S corporation purchaser for purposes of Sections 332 and 337. The Task Force Report concluded that a ruling or other administrative pronouncement should establish the scope of the momentary affiliation rule. Task Force Report at 451.

(b) The Service has ruled that transitory ownership of a subsidiary may be disregarded for purposes of qualifying as a small business corporation. See Rev. Rul. 73-496, 1973-2 C.B. 313.

(c) The parent-subsidiary relationship should last no longer than 30 days. See PLR 8504028; PLR 8439013. Cf. PLR 8338080.

(d) The Tax Court has expressed its view, in dictum, that the Service's 30 day rule may be invalid. See Haley Bros. Construction Corp. v. Commissioner, 87 T.C. 498 (1986).

(e) The Service has continued to cite Rev. Rul. 73-496 in post-Haley Bros. private rulings. See, e.g., PLR

9108059; PLR 8810045; PLR 8739010; PLR 8736014; see also, TAM 9245004 (discussed in Section VI.C.l.a.(v), below). Moreover, in G.C.M. 39768, the Service explicitly reaffirmed the momentary ownership rule of Rev. Rul. 72-320.

(f) G.C.M. 39768 does not consider the continuing validity of the 30-day liquidation rule of Rev. Rul. 73-496. Indeed, in reaffirming the holding in Rev. Rul. 72-320, the G.C.M. notes that the court in Haley Bros. did not address the validity of Rev. Rul. 72-320 – arguably signaling capitulation to the Haley Bros. criticism of Rev. Rul. 73-496.

(iii) If the target corporation is immediately liquidated into the acquiring S corporation, the transaction could be viewed as a purchase of assets. See Snively v. Commissioner, 19 T.C. 650 (1953); Cullen v. Commissioner, 14 T.C. 368 (1950); Rev. Rul. 76-123, 1976-1 C.B. 94. Cf. Rev. Rul. 67-274, 1967-2 C.B. 141.

(a) In this case, the acquisition of stock and the liquidation of the target apparently would be ignored.

(b) However, in Revenue Ruling 90-95, 1990-2 C.B. 67, the Service held that an acquiring corporation that purchases the stock of the target corporation and immediately liquidates the target corporation 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 light of the Service's ruling in TAM 9245004, discussed below, it would appear that the Service would interpret Rev. Rul. 90-95 so as to apply to S corporations.

(iv) Alternatively, if the target corporation is liquidated immediately, the Service could also have argued prior to the 1996 Small Business Act that the liquidation of the target was fully taxable both to the S corporation under Section 331 and to the target under Section 336.

(a) Sections 332 and 337 would not have applied because of Section 1371(a)(2) (repealed by the 1996 Small Business Act).

(b) However, since the acquiring S corporation generally would have a cost basis in its target stock, the S corporation should not have recognized Section 331 gain on the target's liquidation. Moreover, this interpretation is unlikely given the Service's recent holding in TAM 9245004, discussed below.

(c) Finally, as discussed above, the 1996 Small Business Act repealed Section 1371(a)(2). As a result, a liquidation of a target subsidiary could be tax-free under Sections 332 and 337.

(v) In TAM 9245004, the S corporation in question was a seven percent shareholder of T, a C corporation. Two other shareholders owned the remaining 93 percent of the T stock. In the transaction in question, S acquired the remaining 93 percent of the T stock, and immediately thereafter caused T to dissolve and distribute all of its assets to S. The Service focused on the following issues:

(a) Does Section 1371(a)(2) prevent (i) S's acquisition of the T stock from being treated as a qualifying stock purchase under Section 338(d)(3) and (ii) the subsequent dissolution of T into S from being treated as a Section 332 liquidation, because Sections 338 and 332 only apply to acquisitions by corporations?

The Service analyzed the legislative history of Section 1371(a)(2), and concluded that it was "devoid of any suggestion that Congress intended to prevent S corporations from making qualified stock purchases under Section 338 or receiving property in Section 332 liquidations." Moreover, permitting S corporations to engage in Section 338 purchases or Section 332 liquidations does not conflict with any policy underlying subchapter S, nor does it create an abuse under the tax system. In addition, Congress intends for S corporations to have the same business and tax flexibility in making corporate acquisitions as C corporations.

For these reasons, the Service concluded that Section 1371(a)(2) does not prevent an S corporation from being treated as a corporation for purposes of Sections 338 and 332.

(b) Will an S corporation's purchase of the T stock, followed by the immediate liquidation of T, terminate S's election under Section 1362(d)(2)?

The Service, relying on the exception provided in Rev. Rul. 72-320, concluded that the momentary ownership of the T stock would not cause the S election to terminate.

(c) See also PLR 9325006 (TAM 9245004 would apply retroactively).

(vi) Consistent with its position in TAM 9245004, in PLR 9323024, the Service revoked an earlier private letter ruling (PLR 8818049) in which it had reached a contrary result.

(a) In PLR 8818049, this issue was presented in the context of one S corporation acquiring all of the stock of a second S corporation, followed by the planned liquidation of the target.

(b) In PLR 8818049, the Service was asked to rule that the acquiring S corporation could make a Section 338 election with respect to the acquisition of the target S corporation. The Service ruled that an S corporation cannot make a Section 338 election, citing Sections 338(d), 1371(a)(2) and Treas. Reg. § 1.338-4T(d) (Ans. 4). The Service treated the transaction as a purchase of assets by the acquiring S corporation. However, on the seller's side, the transaction was treated as a sale of stock.

(c) In PLR 9323024, the Service noted that the revocation of PLR 8818049 would not have retroactive effect for the specific taxpayer involved.

(vii) In light of these conflicting positions, prior to the enactment of the 1996 Small Business Act, the tax consequences of a stock purchase followed by an immediate liquidation of the target was very uncertain. As one commentator noted, "The result at this point, therefore, is that the Service's informal position is that an S corporation may use I.R.C. §§ 332 and 338 when acquiring the stock of another corporation. No taxpayer may rely, however, on TAM 9245004 or 9325006. Thus, the Service has no official position, and taxpayers may take either

position on tax returns. Caution is in order." Eustice & Kuntz, supra, ¶ 13.08[2], note 345 at S13-8 (1996 Cumm. Supp. No. 1).

(viii) An alternative to liquidating the target might be to merge the acquiring S corporation into the target, with the target surviving. See PLR 8648037 and PLR 8643022.

(a) If the downstream merger is made immediately after the stock acquisition, the target conceivably would not be prevented from making an immediate election due to the existence of a transitory corporate shareholder (assuming all other requirements under Section 1362 are met). Cf. PLR 8810045. Also, the acquiring S corporation's election conceivably would not be terminated by the transitory affiliation with the target. The target could then elect S status without Section 1362(g) applying. (No termination of S status). Rev. Rul. 64-94, 1964-1 C.B. 317.

(b) Similar results should obtain where the target is immediately spun-off by the S corporation, with the S corporation then being merged into the target. See PLR 8739010.

(ix) If the S corporation's election terminates, Section 1362(g) will prevent a subsequent election until the close of the prescribed waiting period. Obtaining the Service's consent to an earlier effective date is unlikely. See Rev. Rul. 78-364, 1978-2 C.B. 225.

b. Effect on election pursuant to the 1996 Small Business Act

(i) The 1996 Small Business Act repealed Section 1371(a)(2). Thus, an acquisition of stock by an S corporation will not terminate the S election even if the corporation acquires sufficient stock of the target to satisfy the Section 1504(a)(2) tests.

(ii) As a result, the target need not be immediately terminated or spun-off.

(iii) If the target corporation is a C corporation that has affiliated C corporation subsidiaries, the target corporation and its subsidiaries may elect to file consolidated Federal income tax returns. If the target and its subsidiaries already file consolidated returns, they are required to continue

filing consolidated returns. See Treas. Reg. § 1.1502-75(a)(2).

(iv) If the target corporation would be eligible to be an S corporation if its stock were held directly by the shareholders of its acquiring parent S corporation, and if 100 percent of its stock is owned by such parent S corporation, the parent S corporation may elect to treat the target corporation as a QSub. If such an election is made, the QSub is not treated as a separate corporation; instead, all of its assets, liabilities, and items of income, deduction and credit are treated as assets, liabilities, and items of income, deduction and credit of the parent S corporation.

c. Allocation of income or loss in the acquisition year

(i) Where the S election is not terminated, income items are allocated under the per-share per-day rule of Section 1377(a)(1).

(a) Such allocation rules will shift income (loss) items among the shareholders. Pre-acquisition income (loss) of the acquiring corporation may be shifted to the former target shareholders; post-acquisition income (loss) attributable to the target's assets may be shifted to the acquiring S corporation's shareholders.

(b) The target's pre-acquisition income (loss) should not be included in the S corporation's income.

(ii) Where the S election was terminated as a result of the purchase of stock prior to the 1996 Small Business Act, items of income (loss) would be allocated under Section 1362(e)(2), unless all relevant shareholders elected to close the books under Section 1362(e)(3).

2. Tax-Free Stock Acquisitions

In general, a tax-free stock acquisition may take the form of a B reorganization (Section 368(a)(1)(B)) or as a reverse subsidiary merger (Section 368(a)(2)(E)). Because the subchapter S issues under both formats are similar, only B reorganizations will be discussed.

a. Availability of tax-free treatment

To qualify as a B reorganization, one corporation essentially must

acquire control of another corporation solely in exchange for its voting stock. See Section 368(a)(1)(B).

(i) Prior to the 1996 Small Business Act, where an S corporation was the acquiring entity, there was some question as to whether an acquisition would qualify under Section 368(a)(1)(B).

(a) Under old Section 1371(a)(2) (repealed by the 1996 Small Business Act), an S corporation was treated as an individual in its capacity as a shareholder. Thus, the target stock could be treated as being acquired by an individual. But see TAM 9245004 (Section 1371(a)(2) (prior to repeal) does not prevent an S corporation from being treated as a corporation for purposes of Sections 338 and 332); G.C.M. 39678 (Section 1371(a)(2) (prior to repeal) does not bar an S corporation from engaging in a divisive D reorganization).

(b) However, the acquisition by the S corporation of control within the meaning of Section 368(c) was also likely to satisfy the Section 1504(a)(2) requirements.

(c) If so, the S election would terminate and Section 1371(a)(2) (prior to repeal) no longer should have applied. Therefore, the transaction should have qualified as a B reorganization, but at the cost of termination of the S election.

(ii) As noted above, the 1996 Small Business Act repealed Section 1371(a)(2). Accordingly, an S corporation will be treated in its capacity as a shareholder of another corporation as a corporation rather than as an individual (except for purposes of computing the S corporation's income).

(a) Thus, the target corporation's stock will be treated as acquired by a corporation in exchange for such corporation's stock. Moreover, as discussed above, under current law, an S corporation may acquire control within the meaning of Section 368(c), since an S corporation may own an amount of stock that satisfies the Section 1504(a)(2) requirements.

(b) However, after the reorganization, the acquiring S corporation must have no more than 75 eligible shareholders.

b. Effect on election

(i) As with a taxable stock acquisition, a tax-free acquisition was likely to terminate the S election prior to the enactment of the 1996 Small Business Act. Sections 1361(b)(2)(A) (prior to repeal) and 1362(d)(2).

(a) If the acquired corporation was liquidated immediately after acquisition, the transitory ownership of stock may have been ignored.

(b) Such a liquidation may have caused the transaction to be viewed as a C reorganization. Rev. Rul. 67-274, 1967-1 C.B. 141.

(ii) With the enactment of the 1996 Small Business Act, many of these concerns seem to be alleviated, and S corporations are increasingly able to acquire corporations through tax-free reorganizations. Again, however, care must be taken to ensure continued compliance with the shareholder limitations applicable to the acquiring S corporation. If the S corporation's election terminates, Section 1362(g) will prevent a subsequent election until the close of the prescribed waiting period. Obtaining the Service's consent to an earlier effective date is unlikely. See Rev. Rul. 78-364, 1978-2 C.B. 225.

c. Pre-reorganization distributions

Distributions prior to the B reorganization should be governed by Section 1368, even if the S election is terminated because of the reorganization. Such a termination would be effective as of the date of reorganization (i.e., the date the S corporation becomes affiliated with the target).

d. Post-reorganization distributions

If the S election terminates, post reorganization distributions of cash (not property) may be distributed tax-free during the post-termination transition period. Section 1371(e). Apparently, such cash distributions may be made to new shareholders who acquired their stock in the reorganization; however, it is questionable

whether Section 1371(e) treatment should extend to corporate and other types of ineligible shareholders.

e. Distributions contemporaneously with the reorganization

Since boot is not permissible in a B reorganization, any contemporaneous distributions should emanate from the target itself and not from the acquiring S corporation. See Rev. Rul. 75-360, 1975-2 C.B. 110. Accordingly, it would seem that neither Section 1368 (unless the target is also an S corporation) nor Section 356 should apply.

3. Stock Acquisition Alternative

One alternative to a direct stock acquisition by an S corporation is the acquisition of target stock by the S corporation's shareholders (for cash or notes) followed by a merger of the target into the S corporation.

a. Subchapter C issues

(i) If the merger qualifies for tax-free treatment under Section 368(a)(1)(A), the acquiring S corporation would take the target's assets with a carryover basis.

(ii) However, there is a risk that the merger would not qualify as a reorganization because historic shareholder continuity of interest is lacking. See Yoc Heating Corporation v. Commissioner, 61 T.C. 168 (1973).

(a) If the merger is taxable, the target would be treated as having sold its assets to the S corporation in exchange for S corporation stock. See Rev. Rul. 69-6, 1969-1 C.B. 104.

(b) The Service's position, ascertained through informal discussions, is that gain would be reportable on the buyer's side, not the seller's side. Under this scenario, Sections 267 and 1239 may apply to the deemed sale.

(c) The target would be liable (and possibly the acquiring shareholders as well under Section 6901) for tax on the deemed sale of assets.

(d) The shareholders would also be liable for any tax on the deemed liquidation. However, since the shareholders would have a cost basis in the target stock, any Section 331 gain should be minimal.

(iii) According to the Service, the Yoc Heating risk may be reduced if Section 338 is elected. See PLR 8645041.

(a) Such an election would produce gain at the target level but the receipt of stock generally would then be tax-free. The result is that a Section 338 election guarantees one level of immediate tax instead of two potential levels of tax.

(b) Prior to the 1996 Small Business Act, S corporation shareholders could not elect Section 338. See Old Treas. Reg. § 1.338-2(b)(1).

(c) However, the 1996 Small Business Act repealed Section 1371(a)(2), thereby enabling S corporations to make a Section 338 election (assuming all the requirements are otherwise met).

(iv) Historic continuity issues can be avoided if the acquiring S corporation is merged into the target (in which case the assets of both corporations may be subject to new Section 1374). Historic continuity also may not be a problem if the subsequent merger constitutes an F reorganization. See PLR 8849017; PLR 8807071; PLR 8807044.

(v) The transaction could also be viewed as a stock purchase by the S corporation followed by the immediate liquidation of the target.

b. Subchapter S issues

(i) The merger of the target into the S corporation itself should not affect the acquiring corporation's election. If the merger is taxable, it apparently would be treated as a taxable asset acquisition by the S corporation.

(ii) If the merger is tax-free, the acquired assets will have a carryover basis. Any built-in gain would be subject to new Section 1374 if that Section is otherwise applicable. See Section 1374(d)(8), as added by TAMRA; Ann. 86-128, supra; Treas. Reg. § 1.1374-8. If the S corporation is subject to old Section 1374, the assets received would also be subject to old Section 1374. See Ann. 86-128, supra.

(iii) The income items for the entire year would be allocated under Section 1377(a)(1).

c. Other alternative

If the shareholders deem the risk associated in a stock acquisition to be too great, the investors may consider acquiring the stock directly and electing S status. See Section VII, below.

VII. S CORPORATION AS A TARGET

Where an S corporation is the target, its shareholders may sell their stock in the corporation or cause the corporation to sell its assets directly to the purchaser. The decision will turn on such tax issues as: whether an asset sale would produce less gain or more loss (due to higher inside basis versus outside basis); whether the character of the gain or loss on an asset sale differs from a stock sale; whether a corporate level of tax will be imposed because of the sale; and whether (and to what extent) the installment method of reporting is available.

A. Asset Dispositions

The assets of an S corporation may be acquired directly in exchange for cash, notes or other property. Alternatively, the assets of the S corporation may be acquired in a taxable merger. See Rev. Rul. 69-6, 1969-1 C.B. 104. In addition, in PLR 9032031, an S corporation dropped its assets down to a newly formed subsidiary and immediately exchanged the subsidiary stock for stock in an acquiring corporation. The Service ruled that the transaction would be treated as a taxable sale of the S corporation's assets for the acquiring corporation's stock.

1. Taxable Asset Dispositions – Direct Sale of Assets

a. Effect on election

(i) The sale of assets by the S corporation to the purchaser alone should not cause the termination of the S election.

(ii) However, if the S corporation has accumulated earnings and profits, interest income on any installment note received or investment income derived from cash proceeds may cause a termination of the election under Section 1362(d)(3) (excess passive income).

b. Allocation of income in year of sale

(i) The usual Section 1377(a)(1) rules should apply. The character and amount of the gain is determined at the corporate level. Section 1366.

(ii) Such gain or loss is passed-through to the shareholders and increases (decreases) their basis in the S stock (or debt if Section 1367(b) applies).

(iii) Income or loss is allocated to the shareholder as the corporation recognizes income under its normal method of accounting. Where an installment obligation is received, gain may be deferred until payment is received; however, a taxable asset sale may trigger more immediate gain recognition than a stock sale would.

(a) Under Section 453(b)(2), installment method reporting is not available on the sale of inventory or dealer dispositions.

(b) Also, under Section 453(i), recapture income is recognized in the year of sale.

(c) 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, where the sales price exceeds $150,000, and the face amount of all such obligations held by the taxpayer for the taxable year exceeds $5 million. In addition, a pledge of an installment obligation arising from such a sale may be treated as a payment. See Section 453A(d).

c. Corporate level taxes

(i) A sale of assets by the S corporation may generate corporate level tax under new Section 1374 if the S election was made after December 31, 1986. Old Section 1374 may

apply if an election was made before 1987, but the election was not in effect for the three preceding years or, if less, the life of the corporation. See PLR 8809083.

(ii) Corporate level tax under Section 1374 may not be avoided where the S corporation sells its assets for a note maturing after the close of the ten-year recognition period. See discussion of Treas. Reg. § 1.1374-4(h) and Notice 90-27, supra.

2. Taxable Asset Dispositions – Taxable Merger

Where the asset sale takes place via a taxable merger, the same general tax consequences should ensue as a direct sale of assets. This Section discusses some special issues arising from this format.

a. Special tax consequences

Where notes are issued in exchange for the S corporation's assets, a taxable merger format may produce harsh results.

(i) If a taxable merger is utilized, the target S corporation is deemed to sell its assets and then liquidate. Rev. Rul. 69-6, 1969-1 C.B. 104. See PLR 9008068.

(ii) However, the deemed liquidation will accelerate any gain in the installment notes. Section 453B.

(a) This gain will pass through to the shareholder pursuant to Section 1366.

(b) However, the shareholder will not have received the cash until the notes are actually paid.

(c) Section 453(h) generally does not provide relief in this case. The shareholder's basis is increased by any gain passed through; subsequent cash payments will be treated as a return of capital (i.e., the gross profit ratio will be reduced – possibly to zero).

(iii) In contrast, if the S corporation sells assets and remains in existence, and the installment method is available, the gain should be deferred until the S corporation receives payment.

(a) Care must be taken if the S corporation has earnings and profits.

(b) Under Section 1362(d)(3), the S election could terminate if passive investment income exceeds prescribed levels for three consecutive years.

(c) If the S election terminates, the installment gain will be subject to double tax.

(d) Sections 1366(d)(3) and 1375 can be avoided by structuring the installment payments to fail the 25 percent gross receipts test.

(iv) Section 1006(e)(22) of TAMRA corrected this problem by adding Section 453B(h). Section 453B(h) allows an S corporation to distribute Section 453B(h) installment obligations without accelerating gain, subject to Section 1374.

b. Effect on election

In a taxable merger, the last year of the S corporation would not be treated as an S termination year. See Rev. Rul. 64-94, 1964-1 C.B. 317. However, the election would cease with the corporation's existence.

c. Allocation of income (loss) in year of disposition

(i) In the case of a taxable merger, S corporation status generally terminates with the existence of the corporation. The final taxable year of the S corporation should not constitute an S termination year. See Rev. Rul. 64-94, 1964-1 C.B. 317; Rev. Rul. 70-232, 1970-1 C.B. 178.

(ii) Thus, the S corporation will retain S status throughout the close of the final year. Income (loss) items recognized until the deemed liquidation should be allocable under Section 1377(a)(1).

(a) Section 1362(e) should not apply.

(b) Were Section 1362(e) to apply, a short C year for the day of the merger would be created. See Section 1362(e). This would produce double tax.

(iii) If the reorganization occurs mid-year, the pass-through of income (loss) items to the shareholders will be accelerated because the year closes early. However, the deemed liquidation itself will not cause a shifting of income (loss) items among the shareholders.

3. Deemed Asset Dispositions – Section 338(h)(10)

On January 12, 1994 (T.D. 8515), the Treasury Department promulgated regulations relating to Section 338(h)(10) elections. These regulations were replaced by temporary regulations issued January 5, 2000 (T.D. 8858). The temporary regulations are generally effective for stock purchases occurring after January 5, 2000. These temporary regulations were replaced by final regulations issued February 12, 2001 (T.D. 8940). The final regulations are generally effective for stock purchases occurring after March 15, 2001. For purposes of S corporations and their shareholders, the temporary and final regulations contain the same rules. If a section 338(h)(10) election is made, the target corporation is deemed to sell all of its assets and distribute the proceeds to the S corporation shareholders and then cease to exist. The sale of target stock included in the qualified stock purchase is ignored.

a. In general

(i) The regulations provide that a Section 338(h)(10) election can be made for an S corporation if the purchasing corporation acquires the stock of the S corporation from the shareholders in a qualified stock purchase. Treas. Reg. § 1.338(h)(10)-1(c)(1).

(ii) The election is made jointly by the purchasing corporation and the S corporation shareholders on Form 8023 not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. Treas. Reg. § 1.338(h)(10)-1(c)(2). All S corporation shareholders, selling or not, must consent to the making of the Section 338(h)(10) election. Id. Once made, the election is irrevocable. Treas. Reg. § 1.338(h)(10) -1(c)(3).

b. Consequences of the election

(i) The S corporation recognizes gain or loss as if it had sold all of its assets in a single transaction at the close of the acquisition date. Treas. Reg. § 1.338(h)(10)-1(d)(3).

(ii) The S corporation is then deemed to have transferred all of its assets to the S corporation shareholders and ceased to exist (the "deemed liquidation"). Treas. Reg. § 1.338(h)(10)-1(d)(4).

(iii) The S corporation's S election continues in effect through the acquisition date (including the time of the deemed asset

sale and the deemed liquidation) notwithstanding Section 1362(d)(2)(B). Treas. Reg. § 1.338(h)(10)-1(d)(3).

(iv) If the S corporation has subsidiaries that it has elected to treat as QSubs, those QSubs remain QSubs through the close of the acquisition date. Id.

(v) The S corporation's final tax return is the return for the taxable year ending at the close of the acquisition date, and it includes the deemed sale of assets under Section 338. Id.

(vi) The new regulations use a different computation to determine the sale price in the deemed sale than the old regulations. Under the new regulations, the sales price of the assets equals the "aggregate deemed sales price" or "ADSP." The deemed sales price for each asset is calculated by determining the ADSP and then allocating the ADSP among the assets in accordance with Treas. Reg. § 1.338-6 and -7. ADSP is the sum of:

(a) the grossed-up amount realized on the sale to the purchaser of the purchaser's recently purchased S corporation stock; and

(b) the S corporation's liabilities.

(vii) Under the old regulations, the sales price of the assets was equal to the "modified aggregate deemed sales price" of the assets, which is the sum of:

(a) the grossed-up basis of the purchaser's recently purchased S corporation stock;

(b) the S corporation's liabilities after the acquisition; and

(c) other relevant items, including reductions for (i) acquisition costs incurred by the purchaser and (ii) selling costs of the S corporation shareholders that reduce the amount realized on the sale of the S corporation stock. Old Treas. Reg. § 1.338(h)(10) -1(f)(2), -(f)(3) and (4).

(viii) The S corporation shareholders (whether or not they sell their stock) take their pro rata share of the deemed sale gain into account under Section 1366 and increase or decease their basis in the S corporation stock under Section 1367. Treas. Reg. § 1.338(h)(10)-1(d)(5).

(ix) The S corporation shareholders are treated as if, after the deemed asset sale and before the close of the acquisition date, they received the S corporation's assets. Id.

(x) No gain or loss is recognized on the sale or exchange by the S corporation shareholders of the S corporation stock included in the qualified stock purchase. Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii).

(a) In the preamble to the final regulations under Section 338(h)(10), Treasury provides that the payment of differing amounts of consideration to selling shareholders (as the result of varying Federal and state tax liabilities of the selling shareholders) does not cause the S corporation to violate the second class of stock requirement of Section 1361(b)(1)(D). See T.D. 8940, 2001-15 I.R.B. 101 (Feb. 12, 2001); Treas. Reg. § 1.1361-1(l)(2)(v).

(xi) S corporation shareholders that retain stock in the former S corporation are treated as acquiring the stock so retained on the day after the acquisition date for its fair market value. Treas. Reg. § 1.338(h)(10)-1(d)(5)(ii). The holding period for the retained stock starts on the day after the acquisition date. Id.

(xii) The adjusted grossed-up basis for the S corporation's assets is determined in accordance with Treas. Reg. § 1.338-5 and is allocated among the assets under the residual method set out in Treas. Reg. § 1.338-6 and -7. Treas. Reg. § 1.338(h)(10)-1(d)(2).

c. Effective date

The old regulations under Section 338(h)(10) are generally effective for S corporations with acquisition dates on or after January 20, 1994 but before or on January 5, 2000. Old Treas. Reg. § 1.338(i)-1(a). The new temporary regulations are generally effective for S corporations with acquisition dates after January 5, 2000 but on or before March 15, 2001. Treas. Reg. § 1.338(i)-1(a). The final regulations are generally effective for S corporations with acquisition dates after March 15, 2001. Id.

d. Deemed ownership of stock held by a QSST

The Service has determined that gain from the deemed sale of assets resulting from a Section 338(h)(10) election that is allocable to the stock held by qualified subchapter S trusts, must be reported as gain of the trusts, not their income beneficiaries. PLR 9828006.

(i) In PLR 9828006, two trusts (T1 and T2) acquired the stock of an S corporation (X). The respective income beneficiaries of T1 and T2 then elected under Section 1361(d)(2) to treat these trusts as QSSTs. The income beneficiaries of T1 and T2 reported all pass-through items of income, deduction, and credit allocable to the X stock held by the trusts.

(ii) All of X's shareholders, including T1 and T2, agreed to sell all of their X stock to Y, a publicly traded corporation. As part of the agreement, the shareholders of X and Y filed an election under Section 338(h)(10). Gain resulted from the deemed sale of X's assets resulting from the Section 338(h)(10) election.

(iii) The Service relied on Treas. Reg. § 1.1361-1(j)(8) to determine that any corporate gain or loss resulting from the deemed sale of X's assets that is allocable to the X stock held by T1 and T2 is reportable for tax purposes by T1 and T2, not by their income beneficiaries. Accord, PLR 199920007.

4. Tax-Free Asset Dispositions

a. Availability of reorganization provisions

If the S corporation disposes of its assets in an A, C or D reorganization, a threshold issue is whether the reorganization provisions of the Code apply to any of such transactions.

(i) In G.C.M. 39768 (December 1, 1988), the Service concluded that Section 1371(a)(2) did not bar an S corporation from transferring its assets in an A, C, acquisitive D, divisive D, or F reorganization. The Service rejected the technical interpretation of Section 1371(a)(2) which would prevent an S corporation from qualifying for reorganization treatment (i.e., that an S corporation as a shareholder is treated as an individual and therefore cannot participate in a reorganization).

(ii) First, it reasoned that the enactment of Section 1363(e) (which allowed the tax-free distribution of stock received in a reorganization) explicitly recognized that an S corporation could transfer its assets pursuant to a reorganization, and the subsequent repeal of Section 1363(e) as deadwood did not alter this conclusion.

(iii) Second, prior to enactment of Section 1371(a)(2), the Service had ruled on several occasions that an S corporation could be a transferor in a reorganization. Therefore, the Service reasoned that if Congress had intended to overturn this ruling position, it would have done so explicitly.

(iv) Finally, the policy of corporation reorganizations – to allow tax-free movement of assets between corporations as dictated by business exigencies – would be seriously hindered if Section 1371(a)(2) were interpreted as preventing reorganization treatment.

(v) In TAM 9245004, the Service similarly rejected the Section 1371(a)(2) argument in connection with a qualified stock purchase under Section 338 and a complete liquidation under Section 332.

(vi) The ABA Task Force Report recommended that the Service issue a revenue ruling addressing the situations in which an S corporation can be involved in tax-free asset transactions. Task Force Report at 468.

(vii) The 1996 Small Business Act repealed Section 1371(a)(2). The House Committee Report to the 1996 Small Business Act indicates that the repeal of Section 1371(a)(2) was intended to clarify that (i) the liquidation of a corporation into an S corporation will be governed by generally applicable subchapter C rules, including the provisions of section 332 and 337 and (ii) an S corporation is eligible to make a section 338 election (assuming all other requirements are otherwise met). See H. Rep. No. 104-586, 104th Cong., 2d Sess. 92 (1996).

b. Effect on election

(i) Merger or consolidation

Where an S corporation is acquired in a merger or consolidation, the S corporation's existence will terminate

as a result of the transaction. Although the election will also terminate, the Service has ruled that the target S corporation's election does not terminate with respect to the final taxable year. Rev. Rul. 64-94, 1964-1 C.B. 317; Rev. Rul. 70-232, 1970-1 C.B. 178; PLR 8307119. If the acquiring corporation is a C corporation, it should be able to elect S status, even if it is a "successor corporation" (unless Section 1362(g) already applies to the acquiring corporation). See Section 1362(g); Treas. Reg. § 1.1362-5(b).

(ii) C reorganization

Where an S corporation transfers substantially all of its assets to another corporation in a C reorganization, the S election should not terminate unless the S corporation becomes affiliated with the acquiring corporation. See Rev. Rul. 71-266, 1971-1 C.D. 262. However, the S election will terminate when the S corporation is liquidated pursuant to Section 368(a)(2)(G).

(iii) Acquisitive D reorganization

In an acquisitive D reorganization, the S corporation generally transfers substantially all of its assets in exchange for stock/securities and then distributes such stock/securities and any remaining properties to its shareholders in complete liquidation. See Sections 368(a)(1)(D) and 354(b)(1). The assets may be transferred by the S corporation to the acquiring corporation by direct conveyance or merger.

c. Allocation of income (loss) in year of disposition

(i) In the case of a merger or consolidation, S corporation status generally terminates with the existence of the corporation. The final taxable year of the S corporation should not constitute an S termination year. See Rev. Rul. 64-94, 1964-1 C.B. 317; Rev. Rul. 70-232, 1970-1 C.B. 178.

(ii) Thus, the S corporation will retain S status throughout the close of the final year. Income (loss) items recognized until the reorganization should be allocable under Section 1377(a)(1).

(a) Section 1362(e) should not apply.

(b) Were Section 1362(e) to apply, a short C year for the day of the merger would be created. See Section 1362(e).

(iii) If the reorganization occurs mid-year, the pass-through of income (loss) items to the shareholders will be accelerated because the year closes early. However, the reorganization itself will not cause a shifting of income (loss) items among the shareholders.

d. Carryovers

(i) Typically, in an A, C or acquisitive D reorganization, the target's attributes are inherited by the acquiring corporation. However, where the target is an S corporation, no carryovers from S corporation years may exist. See Section 1371(b)(2). Such items as loss and credit carryovers should have passed through to the S corporation's shareholders.

(ii) It is unclear whether the AAA carries over to the acquiring corporation. Section 381(c) does not expressly allow such a carryover. In the past, however, the Service has allowed nonspecified items to carry over to the acquiring corporation.

e. Suspended losses

As mentioned above, an S corporation generally would have no NOL carryovers because losses pass through to the shareholders. However, where losses have been suspended under Section 1366(d)(2), numerous issues must be resolved.

(i) It is unclear whether losses suspended under Section 1366(d)(2) carry over with respect to the stock of the acquiring corporation.

(a) Query whether such carryover should be available only if the acquiring corporation is an S corporation.

(b) Query whether a target shareholder can make a capital contribution to the acquiring corporation to get a basis step-up for Section 1366(d)(2) purposes.

(ii) If no carryover under Section 1366(d)(2) survives, query whether Section 1366(d)(3) would provide relief. Section 1366(d)(3) would allow loss recognition to the extent of the

shareholder's stock basis as of the close of the post-termination transition period.

(a) As with Section 1366(d)(2), would Section 1366(d)(3) relief be available only if the acquiring corporation is an S corporation?

(b) If Section 1366(d)(3) relief is available, it would seem that the former S shareholder could make contributions to the acquiring corporation in order to create stock basis.

f. Pre-reorganization distributions

(i) Distributions by an S corporation prior to the reorganization should be governed by Section 1368. See Rev. Rul. 71-266, 1971-1 C.B. 262.

(ii) However, if such distributions ultimately are funded by the acquiring corporation (e.g. repayment of debt used to make a distribution), the distribution may be treated as a boot distribution. It is unclear how boot distributions are taxed where an S corporation is involved. See Section VI.B.2.f., above.

g. Post-reorganization distributions

The treatment of post-reorganization distributions by the acquiring corporation is uncertain. This uncertainty stems from the fact that the statute does not provide for the treatment of S corporation attributes in a reorganization transaction.

(i) It appears that the AAA carries over to the acquiring corporation. No statutory authority exists for such a result. However, the Service has ruled that the AAA will carry over where the acquiring entity was also an S corporation. See PLR 8751013. The regulations confirm this result where both entities are S corporations. Treas. Reg. § 1.1368-2(d)(2). Compare PLR 8810045 (no ruling possible on whether the AAA is allocated in a D reorganization between the transferee and transferor corporations).

(ii) If the AAA does carry over, it is unclear whether cash distributions out of the AAA would be treated as tax-free distributions to the extent of the shareholder's adjusted basis under Section 1371(e)(1).

(a) Section 1371(e) on its face does not require a distribution by the former S corporation.

(b) Thus, a successor corporation potentially could make distributions from the AAA to its shareholders.

(c) Query whether Section 1371(e) would apply to distributions to the former target shareholders only, or to distributions to all of the acquiring corporation's shareholders.

(iii) If the acquiring corporation were a C corporation, post-reorganization distributions could not qualify for tax-free treatment under Section 1368 even if the AAA does carry over. This is because Section 1368 only applies to distributions by S corporations.

(iv) The ABA Task Force Report recommended that the ability of the target shareholders to increase basis in acquiring corporation stock in order to utilize losses, or to receive distributions from the acquiring corporation from AAA of the target corporation under the post-termination transition period rules, should be clarified. In addition, with respect to post-termination transition period distributions, when an acquired corporation's S election terminates as a result of an acquisition, the inability to distribute AAA tax-free from the acquiring corporation should be clarified. Task Force Report at 468-69.

h. Distributions pursuant to the reorganization

If the target S corporation distributes money or property during the reorganization, it is unclear whether Section 1368 or Section 356 controls. See Section VI.B.2.f., above.

B. Taxable Stock Dispositions

1. Sales of Stock

The shareholders of a target S corporation may decide to sell the stock of their corporation instead of the assets. This Section analyzes such a stock sale.

a. Effect on the election

(i) A sale of stock generally will affect the S election only if the stock is sold to an ineligible shareholder, or the sale

causes the total shareholders to exceed the limit of 75 shareholders.

(ii) Where an ineligible shareholder acquires the stock, such ownership may be disregarded as being transitory if the ineligible shareholder immediately disposes of its stock. See PLR 8739010.

b. Allocation of income (loss) items in the year

(i) If the election is not terminated, income (loss) items will be allocated under Section 1377(a)(1), unless the shareholders make a Section 1377(a)(2) election to close the books.

(a) Such an election may prove invaluable. For example, where losses are incurred by the S corporation prior to the sale, post-sale income could eliminate such loss.

(b) In addition, after the sale, the buyer may cause the S corporation to change its method of accounting to the detriment of the selling shareholder.

(c) An election to close the books would help prevent such surprises to the selling shareholders.

(ii) If the election is terminated, the allocation may be made under Section 1362(e)(2).

(a) Under Section 1362(e)(2), income or loss will be allocated between the C and S short years on a daily pro rata basis.

(b) However, if the sale encompasses more than 50 percent of the shares of stock outstanding, the shareholders are required to close the books. Section 1362(e)(6)(D).

c. Amount and character of gain or loss on the sale

(i) The shareholders' basis should reflect the income (loss) items allocated for the year of sale. The exact procedure for adjusting the shareholders' basis must be provided in regulations. Section 1367 is silent on this issue.

(ii) Generally, the character of gain will be capital in nature. But see, e.g., Sections 304, 306 and 341.

d. Post-sale distributions

(i) If the S election is not terminated, post-sale distributions to the acquiring shareholders may be treated as nondividend distributions under Section 1368. As discussed above, the AAA is a corporate level account; its benefits are not limited to specific shareholders (as the PTI account was under prior law).

(ii) Where the buyer purchases the stock for notes, withdrawals from the AAA would allow the buyer to satisfy the acquisition indebtedness with tax-free cash (to the extent of basis). This is not possible where a C corporation is purchased, since the withdrawal of target earnings would be taxable to the buyer as a dividend. If the S corporation's AAA is not sufficient to cover the acquisition debt, a bootstrap redemption should be considered by the parties.

(iii) If the S election is terminated, it is unclear whether the acquiring shareholders could take advantage of Section 1371(e) (tax-free distributions to the extent of basis or the AAA, whichever is less).

e. Pre-sale distributions

A pre-sale distribution by the S corporation may result in a tax-free distribution to the selling shareholder.

(i) Under Section 1368, the selling shareholder could cause the S corporation to distribute excess cash to the extent of basis.

(ii) The stock could then be sold on the installment basis for a reduced price. Each installment would carry a higher percentage of gain, but such gain would be deferred.

(iii) The shareholder could receive immediate cash without gain recognition.

f. Section 338 election

Although an S corporation is a pass-through entity, a Section 338 election by the buyer of S corporation stock will produce a double tax. This occurs because of the interaction of Sections 1362(e) and 338(a)(2).

(i) The purchase of S corporation stock terminates the S election. The termination produces a short S year which

ends on the day before the acquisition date. The short C year begins on the acquisition date. See Section 1362(e)(1).

(ii) The Section 338 election causes the target to be treated as a new corporation beginning on the day after the acquisition date. Section 338(a)(2).

(iii) Thus, the deemed sale will take place in a one-day taxable year consisting of the acquisition date. As to this one-day period, the corporation will be a C corporation subject to double-levels of tax on the stock sale and on the asset sale.

2. Redemptions

A redemption occurs where the corporation acquires all or some of a shareholder's stock in exchange for property. See Section 317(b). A redemption often occurs in connection with a shareholder's sale of target stock where the target has excess cash or unwanted assets, or where the transactions must be tailored to the buyer's ability to pay the purchase price. See Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954). In addition, the Service treats the acquisition of target stock with borrowed funds as a redemption by the target (and not a purchase of stock) to the extent that the debt is secured by target assets or the target assumes the debt. See Rev. Rul. 78-250, 1978-1 C.B. 83; PLR 8546110; PLR 8542020; PLR 8539056.

a. Effect on election

A redemption alone should not affect the S election.

b. Allocation of income or loss in the year

(i) Unless the shareholders make an election under Section 1377(a)(2), the general allocation rules will apply.

(ii) Under Section 1377(a)(2) the stockholders can elect to close the books of the S corporation.

(iii) The distribution of appreciated property will trigger gain at the corporate level which will be allocated to all shareholders under Section 1377(a).

c. Distributions

The redemption will qualify for sale or exchange treatment under Section 302(a) if any one of the Section 302(b) tests is satisfied. If

Section 302(b) is not met, the redemption will be treated as a Section 301 distribution. See Section 302(d).

(i) Section 302(a) redemptions

(a) The usual Section 302 rules will apply to the shareholder. Thus, gain will be recognized in an amount equal to cash plus fair market value of property received less the basis of the shares redeemed.

(b) A Section 302(a) redemption decreases the AAA by an amount equal to the ratable share of the corporation's AAA attributable to the redeemed stock as of the redemption date. Treas. Reg. § 1.1368-2(d)(1)(i); PLR 9412032. For example, if 60 percent of the shares are redeemed, the AAA will be reduced by 60 percent.

(c) The AAA is adjusted for (i) the effect of income (loss) items for the year, (ii) ordinary distributions, and then (iii) for redemption distributions. Treas. Reg. § 1.1368-2(d)(1)(ii). Note, however, that the 1996 Small Business Act amended Section 1368(e)(1) to provide that, for purposes of determining the tax treatment of distributions that (i) would be subject to Section 301(c) but for Section 1368 and (ii) are made during a taxable year by an S corporation having earnings and profits, net negative adjustments to the AAA (i.e., the excess of the decreases in AAA other than for distributions over the increases in AAA) for that taxable year are disregarded.

(d) The S corporation's earnings and profits will also be reduced. Treas. Reg. § 1.1368-2(d)(1)(iii).

(ii) Section 302(d) redemptions

If the redemption is covered by Section 302(d) (because Section 302(a) is inapplicable), the redemption will be treated as a Section 301 distribution. The result is that Section 1368 will apply.

(a) Where the shareholder's interest is completely terminated and the corporation does not have earnings and profits, a Section 302(a) redemption

and a Section 1368 distribution will produce similar results. Both are tax-free to the extent of basis with capital gain thereafter.

(b) However, if a shareholder's holdings are only partially redeemed, a redemption distribution may be wholly tax-free under Sections 1368(b)(1) or (c)(1); whereas, under Section 302(a) gain may result. Thus, in this case, Section 1368 would produce more favorable results.

(c) Where the corporation has earnings and profits, and the distribution exceeds the AAA, the excess will be taxed as dividend income to the extent of accumulated earnings and profits. Distributions taxed as dividends do not receive any basis offset. Thus, in such cases, Section 302(a) treatment would be preferable to Section 1368.

C. Complete Liquidation

1. General Tax Consequences

a. Under Section 331, distributions in complete liquidation are treated as payment in exchange for the stock of the S corporation. In general, the shareholders recognize gain or loss to the extent that the fair market value of property received (less liabilities assumed) exceeds their basis.

b. The shareholders take a fair market value basis in the property received. Section 334(a).

2. Effect on Election

The election terminates upon the final liquidating distribution; however, until that time, the election remains valid. Rev. Rul. 70-232, 1970-1 C.B. 178; Rev. Rul. 64-94, 1969-1 C.B. 317.

3. Distributions

Old Section 1363(d) seemed to apply to complete liquidations. However, section 1006(f)(7) of TAMRA deleted old Section 1363(d), so that Section 336 now applies to the complete liquidation of an S corporation. See Section III.B.1. and 2., above.

4. Allocation of Income and Loss in Year of Liquidation

a. Allocation of gains and losses arising in the S corporation's final year should not be affected by the liquidation.

b. Since a complete liquidation terminates the taxable year, a bunching of income may result if the S corporation is a fiscal year taxpayer. However, following TRA '86, fiscal year S corporations will be fewer in number. See Section II.A.6., above.

5. Character and Amount of Gain to Shareholders

a. The allocation of income (loss) items for the final year will increase (reduce) the shareholder's basis before the liquidation is taken into account. Accordingly, the amount of gain or loss on the liquidation will be affected.

b. Gain or loss on the liquidation is determined separately from any gain or loss items passed through to the shareholders.

c. The character generally will be capital gain or loss, unless Section 1244 applies.

VIII. ACQUIRING AND CONVERTING C CORPORATIONS TO S STATUS

A. Making a C Corporation Eligible

If an existing C corporation already satisfies the small business corporation definition, it can convert to S status by filing Form 2553. An existing C corporation that is not currently a small business corporation may be structured to qualify as a small business corporation. Importantly, the size of the corporation is not a factor. Compare Section 1244.

1. Purchase of Stock

Where the C corporation does not currently qualify as a small business corporation, it may become qualified as a result of stock purchases by other shareholders.

a. Ineligible shareholders may be bought out directly or squeezed out through a merger. This may occur where management or an investor group (comprised of qualifying shareholders) takes the target C corporation private in a leveraged buy out.

b. However, caution must be exercised so that acquisition indebtedness is not treated as a second class of stock.

2. Recapitalization

If the corporation has more than one class of stock outstanding, a

recapitalization may be necessary so that the corporation's capital structure satisfies the Section 1361 test. In addition, if existing debt does not meet the straight debt safe harbor rules under Section 1361(c)(5), the old debt may be exchanged for new debt pursuant to Section 368(a)(1)(E).

3. Divisive D Reorganization

In a divisive D reorganization, the transferor corporation transfers some of its assets to a newly-formed corporation in exchange for control of the new corporation. The stock of this corporation is then distributed in a transaction fulfilling the requirements of Section 355. See Section 368(a)(1)(D).

a. The spun-off corporation may make an S election, unless the transferor corporation was barred under Section 1362(g) and the spun-off corporation is treated as a successor corporation.

b. However, the spun-off corporation may be forced to wait one year before it can elect S status.

(i) This is because it will have had a corporate shareholder during its first taxable year. In this case, Rev. Rul. 72-320, 1972-1 C.B. 270 (momentary ownership by transferor ignored) may not apply to the spun-off transferee.

(ii) However, the Service has ruled privately on numerous occasions that transitory ownership of S corporation stock by a corporation will not prevent an immediate election by the spun-off corporation. See PLR 9414016; PLR 9405014; PLR 9404014; PLR 9402029 (same regarding a split-off); PLR 9403031; PLR 9350039; PLR 9344034; PLR 9344022; PLR 9338038; PLR 9321006; PLR 9319018 (same regarding a split-off).

(iii) The ABA Task Force Report recommended that the Service issue a ruling that approves an S corporation's use of a divisive D reorganization. Task Force Report at 469.

c. If the transferor corporation is a member of a consolidated group, the subsidiary will have a new taxable year. Treas. Reg. § 1.1502-75(d)(2)(ii). In this setting, an S election may be made even though the period for election with respect to the consolidated return year has expired. See PLR 8424042.

d. Importantly, if the transaction is to qualify as a tax-free reorganization, it must satisfy the business purpose test. Eligibility for an S election alone will not qualify as a sufficient business

purpose. See Treas. Reg. § 1.355-2(b)(2) (reducing Federal taxes is not a valid business purpose).

(i) If the S election is respected for state tax purposes, the state and local tax savings will not provide a business purpose for the transaction if the reduction in Federal taxes is "greater than or substantially coextensive with the reduction of non Federal taxes." Treas. Reg. § 1.355-2(b)(2) and (5) (Ex. 7).

(ii) A distribution solely to make an S election at the state level may be valid. See PLR 8825085.

(iii) Also, a subsequent S election may be made if the transaction is supported by another business purpose. However, the presence of Federal tax savings will invite scrutiny by the Service. See Treas. Reg. § 1.355-2(b)(1); Rev. Proc. 96-30, 1996-1 C.B. 696 (Appendix C).

B. Changing Taxable Years to Obtain Maximum Benefit

As indicated above at Section VI.A.1., an S election for a taxable year generally may only be made during the preceding year or the first two and one-half months of the current year. Where this time period has expired for the current taxable year (and the expiration was not inadvertent), a taxpayer might consider changing the taxable year in order to obtain the S benefits without waiting until the beginning of the following year.

1. New Corporations

a. A new corporation that fails to elect within the first two and one-half months may terminate its first taxable year early. The corporation may then make an S election for its next taxable year. See Brown v. United States, 68-2 USTC ¶ 9657 (M.D. Fla. 1968).

b. For example, individual A forms corporation (X) on January 1, 1994, and begins business on that date. In April 1994, A decides that an S election is appropriate. A can close the books on January 31, 1994, and make an S election for X by April 15, 1994 for the year beginning February 1, 1994.

2. Existing Corporations

For existing corporations, it is more difficult to accelerate the benefits of an S election where the election period for the current year has expired.

a. Under Treas. Reg. § 1.442-1(c)(2)(v) a corporation cannot change its year in order to elect S status for the year immediately following the short C year.

b. However, there is more flexibility if consolidated returns are being filed. A new separate return year under Treas. Reg. § 1.1502-76(b) will begin a new election period. This technique may be used as follows:

(i) A parent corporation desiring to elect S status immediately can merge its subsidiaries into itself. Subsequently, but within the same year, the parent can form a subsidiary for the sole purpose of preserving a corporate name. The parent and its newly created subsidiary then file a consolidated return for the balance of the year.

(ii) A new election can be made with respect to this new consolidated return year (i.e., it is treated as a separate taxable year).

(iii) Alternatively, the surviving corporation can spin-off assets in a D reorganization, and the newly-formed corporation can elect S status. See PLR 8736014.

c. Also, where a subsidiary leaves an affiliated group, a separate taxable year is created under Treas. Reg. § 1.1502-75(d). An S election may be made for this short period and subsequent periods. See PLR 8443039.

3. Acquisition of Existing C Corporation

Where an existing C corporation is to be acquired and converted into an S corporation, the benefits of an S election may be accelerated as follows.

a. The investors form a holding company ("HC") on April 1, 1994. HC purchases the stock of the target C corporation, a calendar year taxpayer, on April 15, 1994.

b. HC then merges the target C corporation into itself.

c. Since HC is a newly formed corporation, it may terminate its year prematurely by closing its books as of April 30, 1994 (the end of the acquisition month). See Treas. Reg. § 1.441-1T(b)(2) and (e)(2).

d. An election may be made for the next short taxable period beginning May 1 and ending December 31, 1994. The restrictions recently adopted by Treasury regarding the adoption or change in

accounting periods would not appear to apply. See Treas. Reg. § 1.442-2T(a)(5) and -3T(a)(2).

C. Effect of Conversion on the Corporation

1. Change to a Calendar Year

a. The C corporation currently may be a fiscal year taxpayer. Unless the corporation can establish a business purpose for the fiscal year (other than deferral of income) or an election under Section 444 is made, the S election will force the corporation to adopt a calendar year.

b. Converting to a calendar year may cause a "bunching" of income.

2. LIFO Recapture

a. Where a C corporation using the LIFO method of accounting converts to S status, the C corporation must include in income for its last taxable year the "LIFO recapture amount." See Section 1363(d)(1).

b. The LIFO recapture amount is defined as the amount by which the basis of the inventory of the C corporation under the FIFO method would exceed the basis of the inventory under the LIFO method as of the end of the last taxable year that the corporation is a C corporation. See Section 1363(d)(4).

c. The tax attributable to the recapture amount is payable in four equal installments. See Section 1363(d)(2)(A). The first payment is payable on or before the due date (determined without regard to extensions) of the C corporation's last tax return. See Section 1363(d)(2)(B).

d. The electing corporation is not treated as a member of an affiliated group with respect to the LIFO recapture amount. Thus, where a corporation is acquired from a consolidated group, the LIFO recapture amount is imposed on the electing corporation and is not included in the consolidated group's return. See Section 1363(d)(4)(D).

3. Corporate Level Taxes

Where an S corporation formerly was a C corporation, the S corporation may be subject to corporate level tax, notwithstanding its basic pass-through nature.

a. Built-in gain

(i) If the S election is filed after December 31, 1986, the S corporation will be subject to new Section 1374. See Section III.C., above. Transitional relief for certain small, closely-held corporations is available. See P.L. 99-514, Section 633(d); Rev. Rul. 86-141, 1986-2 C.B. 151.

(ii) If the S election was filed before January 1, 1987, the S corporation will be subject to old Section 1374.

b. Effect of accumulated earnings and profits

Since the newly electing S corporation formerly was a C corporation, it may have accumulated earnings and profits for its C corporation days.

(i) As a result, the S corporation may be subject to tax under Section 1375 on its "excess net passive income." See Section III.D., above. Further, the S election is subject to termination if excess passive investment income exceeds 25 percent of gross receipts for a consecutive three year period. See Section 1362(d)(3).

(ii) In addition, under Section 1368(c) and Section 301(c) distributions in excess of the AAA will be taxable to the shareholders as dividends.

c. Investment tax credit recapture

The S election itself or termination thereof will not cause recapture of investment tax credits claimed during C corporation years. See Section 1371(d)(1). However, the S corporation will be liable for recapture taxes on subsequent dispositions of assets upon which the credit was claimed in prior C corporation years. See Section 1371(d)(2).

d. Foreign losses

For purposes of Section 904(f), an S election is treated as a disposition of a foreign business. See Section 1373(b).