Tax Planning for S Corporations: Mergers and Acquisitions Involving S Corporations (Part 1)

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§ 1.01 INTRODUCTION

The tax considerations relating to the sale and purchase of assets by an S corporation or the sale or purchase of the stock of an S corporation are similar to the tax consequences of asset sales and purchases by C corporations and sales and purchases of C corporation stock, with a number of twists and turns thrown in that are unique to S corporations and their shareholders.

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Some of the issues unique to the sale of assets by S corporations include the potential application of the built-in gain tax, the timing of the liquidation of the S corporation following the sale of all or substantially all of the assets of the S corporation, the receipt (and subsequent distribution) of installment sales obligations received in consideration for the sale of assets and issues related to contingent earn-outs contained in asset purchase agreements.

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

This outline will discuss the basic rules applicable to asset sales and purchases by S corporations, as well as the unique issues that must be considered in the S corporation context, and will also address the basic rules applicable to the sale and purchase of stock of an S corporation, as well as special considerations applicable to sales of S corporation stock, particularly with respect to deemed asset sales under Sections 338(h)(10) and 336(e). Additionally, this outline will address tax-free reorganizations involving S corporations.

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

There is also the much wider world of Subchapter C and the rules governing tax-free and taxable acquisitions, redemptions, distributions, carryover of tax attributes, etc. In certain types of acquisitive transactions, the overriding concern will be to preserve the S corporation's election in order to avoid double taxation currently or in the future under Subchapter C or the built-in gain tax under Subchapter S. There are also inside (asset) basis and outside (stock) basis dichotomies in assessing the potential tax impacts. Associated with this issue are gain or loss characterization rules as well as timing issues, such as the availability or non-availability of the installment method. There are also change of control issues that may trigger certain tax consequences in a particular acquisition, particularly in structuring bonus compensation payments to key executives of the target (so called "golden parachutes").[1] In direct or deemed asset acquisitions, the potential application of the anti-churning rules for purchased intangibles under Section 197(f) must also be considered. Given the limitless amount of material and complexity present in the law, this outline is limited

[1] *See* Sections 280G, 83(a), 421-423, 162(m), 409A and 457.

to highlighting the general considerations and special problems faced by S corporations and their shareholders engaging in mergers and acquisitions.

§ 1.02 CHOICE OF ENTITY STATISTICS

Although LLCs have gained tremendous popularity over the last 15 to 20 years, the number of entities taxed as S corporations still exceeds the number of entities taxed as partnerships for federal tax purposes, and it is projected to stay that way for the foreseeable future, as set forth in the table below published by the IRS (Document 6292, Office of Research, Analysis and Statistics, Fiscal Year Return Projections for the United States: 2015-2022 (Rev. June 2015):

Statistics Regarding Choice of Entity

	2014 (Actual)	**2016 (Projected)**	**2019 (Projected)**	**2022 (Projected)**
Form 1065	3,799,428	3,862,600	4,011,500	4,160,500
Form 1120S	4,642,817	4,748,000	4,917,500	5,038,900
Form 1120	1,843,336	1,761,500	1,652,800	1,544,100

[1] Double Tax on Earnings of C Corporation Distributed as Dividends to Shareholders.

[a] Professional Service Corporations.

Although many existing "C" corporations have converted to S corporation status (or other form of pass-through entity) and most new entities have been formed as some type of pass-through entity (S corporation, LLC or partnership), many professional and other personal service corporations have remained C corporations based on the assumption that they can successfully avoid the double tax on earnings to which C corporations are generally subject by utilizing the strategy of zeroing out their taxable income by payment of all or substantially all of their earnings as deductible compensation to their shareholder-employees. It has been widely accepted in the past by practitioners and taxpayers that the IRS cannot successfully assert unreasonable compensation arguments against a personal service corporation to recharacterize a portion of the compensation paid to its shareholder-employees as dividend distributions. However, in light of the application of the "independent investor test" by the Tax Court and the Seventh Circuit Court of Appeals in *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*,[2] the Tax Court's prior decision in *Pediatric Surgical Associates, P.C. v. Commissioner*,[3] and the Tax Court's recent decision in *Midwest Eye Center, S.C. v. Commissioner*,[4]

[2] *See Mulcahy v. Commissioner,* 680 F.3d 867 (7th Cir. 2012).

[3] *See Pediatric Surgical Assocs. v. Commissioner,* T.C. Memo 2001-8.

[4] *See Midwest Eye Ctr. v. Commissioner*, T.C. Memo 2015-53.

tax practitioners must recognize that the IRS can make a successful argument to recharacterize the wages paid to the shareholders-employees of a personal service corporation as dividends subject to double taxation.

[b] Corporate Versus Individual Tax Rates.

As a result of the maximum marginal tax rate for individuals (39.6%) exceeding the maximum marginal tax rate for corporations (35%), some commentators believe this could result in a resurgence of C corporations. However, if such C corporations desire to distribute their earnings out to their shareholders, the maximum marginal combined tax rate applicable to corporations and shareholders of 48% should be enough of an incentive for such corporations to be formed as, or to remain, a pass-through entity, not to mention the potential state corporate tax on the income of C corporations, as well as the potential application of the 3.8% net investment income tax on dividend distributions of C corporations. The increase in the maximum marginal combined tax rate on a C corporation's earnings distributed as dividends to its shareholders may also provide added incentive for the IRS to make unreasonable compensation attacks on C corporations.

[2] Double Tax on Sale of Assets of C Corporation.

Likewise, most entities have either converted from "C" status to "S" status or to some other form of pass-through entity or been formed as a pass-through entity to avoid the double tax on the sale of assets to which "C" corporations are subject. However, in order to avoid double taxation on the sale of a professional or other service corporation's assets to a third party, tax practitioners have often sought to avoid the double tax imposed upon C corporation's selling their assets by allocation of a large portion of the purchase price to the "personal goodwill" of the shareholders of the professional corporation. Although this strategy has worked under certain circumstances, several recent cases have suggested that the IRS can and will recharacterize so-called personal goodwill as corporate goodwill subject to double taxation (or at the least to ordinary income tax rates rather than capital gain tax rates) on the sale of the assets of a professional corporation.[5]

§ 1.03 APPLICATION OF SUBCHAPTER C TO SUBCHAPTER S

Section 1371(a)(1) provides that "(e)xcept as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders." As a corollary to the general principle, Section 1371(b) generally prohibits carryovers and carrybacks between S corporation and C corporation years, Section 1371(c)(2) requires proper adjustment to an S corporation's accumulated earnings account in certain acquisitive or divisive transactions, which by necessary implication would involve Sections 381-384. Thus, Subchapter C applies to an S corporation except to the extent that application of a rule or principle under Subchapter C would be inconsistent with the pass-through

[5] *See Howard v. United States,* 448 F. App'x 752 (9th Cir. 2011); *Muskat v. Commissioner*, 554 F.3d 183 (1st Cir. 2009); *Kennedy v. Commissioner*, T.C. Memo 2010-206.

rules under Subchapter S. This rule therefore acknowledges that an S corporation can generally participate in a tax-free reorganization under Section 368, acquire the assets or stock of another C or S corporation, including a consolidated group of corporations, engage in a tax-free split-up, split-off or spin-off under Section 355, or engage in a complete liquidation under Part II of Subchapter C.

[1] Background of Section 1371(a)(1): Subchapter S Revision Act of 1982.[6]

Section 1371(a)(1), which was enacted with the Subchapter S Revision Act of 1982, ("SSRA") (prior to SSRA this topic was covered by regulation), provides that except as otherwise provided in the Code and except to the extent inconsistent with the treatment of an S corporation as a flow-through entity for federal income tax purposes, the provisions of Subchapter C will apply to an S corporation and its shareholders. Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge with an S corporation tax-free if all other statutory and non-statutory requirements are satisfied. Furthermore, the IRS had recognized both prior and after SSRA that an S corporation may be part of a divisive or non-divisive corporate division under Section 368(a)(1)(D) or Section 355 despite the presence of a subsidiary relationship, at least a momentary one. See former Treas. Reg. Section 1.1372-1(c). For example, a distribution of AAA under Section 1368(c)(1) effectively overrides Section 301(c)(1). A third and more controversial rule, which serves as a corollary to the "unless otherwise inconsistent" integration principle of Section 1371(a)(1), is contained in Section 1371(a)(2). This subparagraph provides that where an S corporation owns stock in another corporation, then, with respect to its capacity as a shareholder of such corporation, it is treated as an "individual" for purposes of Subchapter C. The purpose of this rule, at least from the scant attention it received in the legislative history to SSRA, was to prevent an S corporation from qualifying as a corporation for the dividends received deduction. Thus, for purposes of Section 301, an S corporation shareholder is an "individual." The legislative history unfortunately was silent as to all other applications of Subchapter C where an S corporation is an actor in its shareholder capacity. It wasn't until 1988, that the Internal Revenue Service announced its position that Section 1371(a)(2) is to be applied literally as to liquidations. Thus, the IRS took the position that a C corporation may not be liquidated under Sections 337/332 upstream into an S corporation. See Ltr. Rul. 8818049 (2/10/88). For purposes of determining whether a corporation remained a small business corporation, transitory ownership of stock in a subsidiary (i.e., stock meeting the Section 1504(a) tests) could be disregarded. In Rev. Rul. 72-320, 1972-1 C.B. 270, the IRS ruled that momentary ownership of all of the stock in another corporation acquired in connection with a divisive reorganization under Section 368(a)(1)(D) did not terminate the S election of the transferor corporation. The ruling specifically notes that the S corporation never contemplated more than "momentary" control of the newly formed spun-off corporation. In Rev. Rul. 73-496, 1973-2 C.B. 313, the IRS disregarded a 30-day period during which an S corporation controlled a subsidiary prior to the liquidation of the subsidiary under former Section 334(b)(2). In *Haley Bros. Construction Corp. v. Commissioner*, 87 T.C. 498 (1986), the Tax Court strongly stated in dictum that the IRS's 30-day rule was inconsistent with the statute. The Court expressly reserved its opinion on whether "momentary" ownership would terminate an S election. Despite *Haley Bros.*, the IRS, relying on both Rev.

[6] P.L. 97-354.

Rul. 72-320 and Rev. Rul. 73-496, continued to issue rulings that ignored transitory stock ownership.[7] In 1992, the IRS reversed its position, stating that the prior ruling was incorrect.[8]

[2] Small Business Jobs Protection Act of 1996.[9]

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

§ 1.04 SALE OF ASSETS BY S CORPORATIONS

[1] Tax Treatment to Selling S Corporation and its Shareholders.

In general, the tax consequences of an asset sale by an S corporation are relatively straight forward because the S corporation itself is generally a non-taxable entity.

[7] *See,* e.g., TAM 9245004; Ltr. Ruls. 9414016; 9321006; 9320009; 9319041; 9319018; 9319016; 9319002; 9318024; 9312025; 9312019; 9311022; 9306017; and 9303021.

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

[9] P.L. 104-188.

[a] Taxation of S Corporations.

Under Section 1363(a), an S corporation is generally treated as a pass-through entity and not as a taxable entity for federal income tax purposes, and as such, its shareholders are generally subject to only one level of tax on its earnings.

Section 1363(b) provides that the taxable income of an S corporation that is allocable to its shareholders is to be computed in the same manner as that of an individual, with the following exceptions:

[i] Items of income (including tax-exempt income), loss, deduction and credit, the separate treatment of which could affect the tax liability of any shareholder, are to be stated separately.

[ii] The corporation is not allowed deductions for personal exemptions under Section 151, foreign and possessions taxes under Sections 164(a) and 901, charitable contributions under Section 170, net operating losses under Section 172, certain expenses of individuals under Section 211 through 219, and depletion with respect to oil and gas wells under Section 611.

[iii] The corporation is permitted to amortize organizational expenses pursuant to Section 248.

[iv] If the corporation was not an S corporation for any of the three immediately preceding taxable years, the limitations on certain corporation preference items contained in Section 291 will apply.

[b]Built-In Gain Tax.

Where the corporation has converted to S corporation status within the built-in gain tax period, or has acquired assets from a C corporation (or an S corporation subject to the built-in gain tax) within the built-in gain tax period, the built-in gain tax imposed under Section 1374 may apply. Thus, an asset sale by an S corporation, with a prior C history, could result in a forced double tax to the extent of its recognized built-in gain.

[i] Section 1374 imposes a corporate-level tax on the built-in gains of S corporations that were previously C corporations. Section 1374 as originally enacted applies to built-in gains recognized by a corporation during the 10-year period following such corporation's conversion to S status. Section 1374(d)(7). Treas. Reg. Section 11374-1(d) provides that the recognition period is the ten-calendar year period, and not the ten-tax year period, beginning on the first day the corporation is an S corporation or the day an S corporation acquires assets under Section 1374(d)(8) in a carryover basis transaction. The tax rate is presently 35% (the highest rate of tax imposed under Section 11(b)) of the S corporation's "net recognized built-in gain." Section 1374(b)(1).

[ii] On September 27, 2010, President Obama signed into law the Small Business Jobs Act of 2010, H.R. 5297. Section 2014 of the Act amends Section 1374 to provide for the reduction of the recognition period during which corporations that converted from C corporation status to S corporation status

are subject to the built-in gain tax from 10 years to 5 years for taxable years beginning in 2011. Specifically, the text of the amendment is very similar to the temporary reduction from 10 years to 7 years made by the American Recovery and Reinvestment Act of 2009. Pub. L. No. 111-5, 123 Stat. 115 (2/17/2009) The text of the amendment reads as follows:

> "(b) Special Rules for 2009, 2010 and 2011. - No tax shall be imposed on the net recognized built-in gain of an S corporation - (i) in the case of any taxable year beginning in 2009 or 2010, if the 7th taxable year in the recognition period preceded such taxable year, or (ii) in the case of any taxable year beginning in 2011, if the 5th year in the recognition period preceded such taxable year."

[iii] The amendment is applicable to taxable years beginning after December 31, 2010, and generally raises the same questions as were raised in connection with the reduction from 10 years to 7 years for taxable years beginning in 2009 and 2010. For a discussion of these issues, see Looney and Levitt, "Reasonable Compensation and The Built-In Gains Tax," 68 NYU Fed. Tax. Inst., ¶15.05[1][a], [b]. [c] and [d] (2010). However, it should be noted that the proposed amendment specifically uses the term "taxable year" in connection with the recognition period for taxable years beginning in 2009 and 2010, but only uses the term "5th year" (not taxable year) in connection with the recognition period for a taxable year beginning in 2011. This appears to resolve any ambiguity created by the previous amendment and clarifies that for dispositions in 2009 and 2010, 7 tax years (including short tax years) need to have transpired prior to the year of disposition for the built-in gain tax ***not*** to apply to such dispositions, and that for dispositions in 2011, 2012 and 2013, 5 ***calendar*** years need to have transpired prior to the year of disposition for the built-in gain tax ***not*** to apply to such dispositions.[10]

[iv] The American Taxpayer Relief Act of 2012 similarly reduced the recognition period for dispositions made in 2012 and 2013 to 5 (calendar) years. Additionally, the American Taxpayer Relief Act of 2012 clarified that if the 5-year recognition period is satisfied for a disposition occurring in 2012 or 2013, such sale will not be subject to the built-in gain tax even if the purchase price will be received over a period of years under the installment sales method.

[v] The Camp Proposal reduces (permanently) the 10-year recognition period for the imposition of built-in gain tax imposed under Section 1374 to five years, effective for tax years beginning after 2013.

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[10] The differences between the express statutory language and the Committee Reports accompanying the 2009 Act raised the issue of whether Congress actually intended to use tax years rather than calendar years in measuring the 7-year recognition period. In fact, Section 2(h) of the Tax Technical Corrections Act of 2009, H.R. 4169, 111 Congress, 1st Session, which was introduced on December 2, 2009, but which did not pass, would have changed the phrase "7th taxable year" to "7th year" in Section 1374(d)(7)(B) retroactively for tax years beginning after 2008. With the passage of the Small Business Jobs Act of 2010, it appears that Congress has conceded that tax years will apply to the special 7-year rule applicable to dispositions in 2009 and 2010 but that calendar years will be used for the special 5-year rule applicable to dispositions made in 2011.

[c] Amount of Gain or Loss.

The gain or loss recognized on a sale of assets by the S corporation will be determined under the general rules of Section 1001, and as such, will be equal to the difference between the consideration received on the sale and the S corporation's adjusted tax basis in the assets that are sold.

[d] Pass-Through of Income; Basis.

Because an S corporation is a pass-through entity, the gain or loss recognized on the sale of assets will be passed through to the shareholders of the S corporation in accordance with their stock ownership in the S corporation. Specifically, Section 1366(a)(1) requires that an S corporation shareholder take into account such shareholder's pro rata share of the S corporation's items of income, loss, deduction and credit for the taxable year. In general, each shareholder's pro rata share of any S corporation item described in Section 1366(a) for any taxable year is the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day of the S corporation's taxable year, and then by dividing that portion pro rata among the shares outstanding on that day. In turn, shareholder's basis is increased by the amount of gain passed through to such shareholder under the provisions of Section 1367. As will be discussed below, this basis increase is critical in connection with the distribution of the consideration received in the sale of assets to the shareholders so that the shareholders are subject to only a single level of tax on the asset sale.

[e] Character of Gain or Loss.

Under Section 1366(b), the character of any item included in a shareholder's pro rata share under Section 1366(a)(1) is determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation. Consequently, any gain attributable to ordinary income items, such as inventory, accounts receivable of a cash basis taxpayer or depreciation recapture will be treated as ordinary income rather than as capital gain.

[f] Allocation of Purchase Price.

Where the S corporation has been a qualifying electing small business corporation for its entire history and has not acquired the assets of a C corporation (or an S corporation subject to the built-in gain tax) within the past ten years in an exchanged basis transaction, then the corporate-level tax from the asset sale is, for federal (and most state) income tax purposes, passed through to the shareholders and results in a single level of tax. The amount realized is allocated among the basis of the individual assets in accordance with the residual method of valuation in accordance with Section 1060 and the Section 338 regulations, to the extent applicable. Allocated gain or loss is characterized by reference to the nature of the corporation's purpose in holding the particular assets sold, *e.g.*, depreciable real property used in a trade or business or Section 1231 property, inventory, depreciation subject to recapture, or property held for investment, including corporate goodwill. ***A critical component that should be included in any asset purchase agreement is a provision which allocates the purchase price among the various purchased assets***.

[g] Installment Sales Method.

In many sales of S corporations, whether assets or stock, a portion of the purchase price may be paid out over a period of time under a promissory note. Under Section 453(b), an installment sale is defined as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. Under the installment reporting method set forth in Section 453, a portion of each payment must be reported as income as received. The portion to be recognized as income is determined by multiplying the amount of payment by a fraction, the numerator of which is the "gross profit," and the denominator is the "total contract price" (i.e., the "gross profit ratio"). Temp Reg. Section 15A.453-1(b)(2)(i).

"Gross profit" is the selling price less the adjusted basis in the property. Temp Reg. Section 15A.453-1(b)(2)(v). "Total contract price" is the selling price less "qualifying indebtedness" assumed or taken subject to by the buyer to the extent that such qualifying indebtedness does not exceed the basis. Temp Reg. Section 15A.453-1(b)(2)(iii). Qualifying indebtedness generally means debt encumbering the property, subject to certain limitations. See Temp Reg. Section 15A.453-1(b)(2)(iv).

Installment reporting is mandatory unless the seller "elects out" under Section 453(d) by filing IRS Form 6252 with a timely filed return (including extensions) for the taxable year in which the closing takes place. Temp Reg. Section 15A.453-1(d)(3)(i). The election, once made, may not be revoked without the consent of the IRS. Section 453(d).

If there is any Section 1245 recapture, the entire amount of the recapture income must be recognized in the taxable year in which the closing occurs, regardless of the amount of payments received in such year. Section 453(i). Likewise, the installment sales method is not available for gain on the sale of inventory, gain on the sales of depreciable property to related persons, or gain on the sales made by so-called "dealers" (versus investors).

[h] Sale of Assets Versus Sale of Stock.

For a selling corporation that has not previously been a C corporation, the impact of an asset sale is straight forward. The decision of whether it is more advantageous and to what extent the S corporation should sell its assets or its stock will require the consideration of four tax issues:

The comparison of inside (asset) basis versus outside (stock) basis.

[ii] The character of gain differential between an "inside" sale versus and "outside" sale (long-term capital gain).

[iii] Whether a corporate-level of tax will be imposed because of the sale.

[iv] Whether (and to what extent) the installment sales method of reporting gain is available under Section 453.

[2] Tax Treatment on Liquidation of S Corporation.

Following the sale by an S corporation of all or substantially all of its assets, the S corporation will normally liquidate by distributing the sales proceeds to its shareholders. Where the sales proceeds include installment sales obligations or contingent earn-out payments, special attention must be paid to such items.

[a] Overview.

When an S corporation liquidates, it is generally subject to the same income tax rules as applicable to C corporations.[11] Liquidating distributions, whether cash or property, are treated as payments in exchange for the shareholder's stock in the corporation. Section 331; Treas. Reg. Sections 1.331-1(a) and (b). Distributions of property cause gain or loss to be recognized by the S corporation in the same manner as if the property had been sold to the shareholders. Section 336; Treas. Reg. Section 1.336-1. In the case of a sale of all or substantially all of the assets of an S corporation preceding the liquidation, the only assets of the S corporation will generally be cash, installment obligations, holdbacks, escrowed funds and/or contingent earn-out payments. Special considerations apply to the liquidation of an S corporation because of, among other attributes, the pass-through tax treatment, the eligible shareholder limitations, and the built-in gain rules. To constitute a distribution in complete liquidation, the distribution must be:

[1] Made by the liquidating corporation in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation, or

[2] One of a series of distributions in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation. Treas. Reg. Section 1.332-2(c).

The liquidation of a corporation for federal income tax purposes may be completed before the actual dissolution of the corporation under state law. See Rev Rul 54-518, 1954-2 CB 142. For example, the retention of the corporation's charter does not prevent the liquidating distributions from being taxed as a sale or exchange of the corporate stock.[12] Similarly, the failure to file Form 966 generally will not cause any additional tax liability for the shareholders or the corporation.[13]

[b] Tax Consequences to the Shareholders.

[11] To the extent that it is not inconsistent with the rules of Subchapter S, these subchapter C rules apply to S corporations and S shareholders. See Section 1371(a)(1).

[12] *Id.*

[13] Section 6043(a); Reg. Section 1.6043-1(a); Rev Rul 65-80, 1965-1 CB 154 (the failure to file Form 966 does not prevent a complete liquidation for tax purposes). Furthermore, Reg. Section 1.6043-1 and Reg. Section 1.6043-2(a) require the filing of Forms 1096 and 1099L to report liquidating distributions.

[i] Computation of Gain or Loss.

Amounts received by an S corporation shareholder in complete liquidation of an S corporation are treated as payments in exchange for the shareholder's stock. Section 331. See Ltr. Rul. 9218019. Gain or loss is determined under Section 1001 by comparing the amount realized with the shareholder's stock basis. See Treas. Reg. Section 1.331-1(b).[14] The amount realized is the sum of cash and the fair market value of any property distributed in the liquidation. See Treas. Reg. Section 1.331-1(e). Stock basis increases by any items of income or gain that pass through to the shareholder during the year of liquidation immediately prior to determining the shareholder's gain or loss from the distribution. See Sections 1366 and 1367. The shareholder has the burden of proving stock basis.[15]

[ii] Character of Shareholder Gain or Loss.

The liquidation of an S corporation generally results in capital gain treatment for the shareholders.[16] The gain or loss will be long term or short term depending on the shareholder's holding period for the stock. See Section 1221, 1222. A shareholder's gain or loss must be computed on a share-by-share basis. Treas. Reg. Section 1.331-1(e), Ex. Different blocks of stock may have different holding periods and different tax bases.[17]

Ordinary income or loss may arise if the stock is held as an integral part of the business of the shareholder,[18] if the corporation is a collapsible corporation under Section 341,[19] or if the stock in the corporation is Section 1244 stock.[20]

[iii] Timing of the Recognition of Gain or Loss.

Section 331 provides that amounts received by a shareholder in complete liquidation of an S corporation will be treated as full payment in exchange for the stock. The question of when a distribu-

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[14] Gain or loss is calculated on a share-by-share basis. See Reg. Section 1.331-(e).

[15] See *D'Errico v Commissioner*, T.C. Memo 2012-149.

[16] Section 331 treats liquidation distributions from an S corporation to its shareholders as payments in exchange for the stock. Section 1221 generally treats S corporation stock as a capital asset.

[17] *Id.* Reg. Section 1.1367-1(b)(2), (c)(3) and Reg. Section 1.1368-3, Ex 1.

[18] *Corn Products Refining Co v Commissioner*, 350 US 46 (1955). Subsequent decisions have not expanded the Corn Products doctrine to allow ordinary loss on liquidation. See *W W Windle Co v Commissioner*, 65 T.C. 694 (1975), *appeal dismissed*, 550 F2d 43 (1st Cir 1977), and *Hollingsworth v Commissioner*, 71 T.C. 580 (1979). See also Rev Rul 78-94, 1978-1 CB 58. *Arkansas Best Corp v Commissioner*, 485 US 212 (1988) has narrowed the Corn Products doctrine to hedging transactions that are an integral part of a business' inventory and thus within the Section 1221(1) exclusion from the definition of a capital asset.

[19] Section 341 was suspended as part of the ETGGRA through the end of 2010. This suspension is scheduled to expire on December 31, 2010 upon which date Section 341 will again be applicable for certain S corporations.

[20] Section 1244 allows ordinary loss treatment up to $100,000 on a joint return and $50,000 on an individual return. See also Section 124(e).

tion is received is one of fact, and depends on the shareholder's method of accounting.[21] A shareholder is entitled to use the cost recovery method in reporting a series of liquidating distributions paid in installments. Rev Rul 68-348, 1968-2 CB 141. If the property received by the shareholder has no ascertainable value, the transaction may result in open transaction treatment. In that case, no current tax is imposed, and the transaction is held open, until the shareholder's tax basis for the stock has been fully recovered.[22] Open transaction treatment will apply in only rare and unusual circumstances in which the fair market value of the property cannot be reasonably ascertained.[23]

[iv] Basis to Distributee.

The shareholder tax basis for property received in a complete liquidation is the fair market value of the property at the time of the distribution. Section 334. If the shareholder assumes or takes property subject to any liabilities secured by the property, the tax basis is the unencumbered fair market value of the property.[24] If the fair market value of a property is less than the amount of a liability to which it is subject, the difference is treated as a contingent liability and the shareholder is not entitled to a basis for the liability until it is paid.[25]

[c] Taxation of the Liquidating S Corporation

[i] Gain or Loss Recognized to Liquidating S Corporation.

When an S corporation distributes property to its shareholders in a complete liquidation, gain or loss is recognized by the corporation as if the property was sold to the distributee shareholders at fair market value. Section 336. Any gain or loss recognized passes through to the shareholders and is reported on schedule K-1. If the S corporation is subject to the built-in gain tax,[26] the gain may also be subject to tax at the corporate level, as well as the shareholder level. Section 1366 and 1367.[27] No loss is recognized by a liquidating corporation on the distribution of any property to a related person (within the meaning of Section 267) if: (1) such distribution is not pro rata; or (2) such distribution consists of disqualified property. Disqualified property means any property which is acquired by the liquidating corporation in an Section 351 transaction or as a capital contribution during the five-year period ending on the date of the distribution. Section 336(d). Again, keep in mind that where the S corporation has sold its assets, the gain from the

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[21] See Rev Rul 80-177, 1980-2 CB 109. See also Reg. Section 1.301-1(b) and *Avery v Commissioner*, 292 US 210.

[22] See *Burnett v Logan*, 283 US 404 (1931). See *Arrowsmith v Commissioner*, 344 US 6 (1952), and *Kessler v Commissioner*, T.C. Memo 1982-432.

[23] See S. Rept. No. 96-100, 24 (1980); *McCormac v US*, 424 F2d 607 (Ct Cl 1970).

[24] See Section 16.02[4]. The installment note must be a qualifying installment obligation, and it must be distributed to a qualifying shareholder. See *Ford v US*, 311 F2d 951 (Ct Cl 1963), and *Crane v Commissioner*, 331 US 1 (1947).

[25] *Inter-City Television Film Corp v Commissioner*, 43 T.C. 270 (1964); *Rees Blow Pipe Manufacturing Co v Commissioner*, 41 T.C. 598 (1964), *affd per curiam*, 342 F2d 990 (9th Cir 1965). See also *Columbus and Greenville Railway Co v Commissioner*, 42 T.C. 834 (1964), *affd per curiam*, 358 F2d 294 (5th Cir 1966).

[26] Section 1374; See Ch 3.

[27] The basis increase is taken into account prior to computing the shareholder gain under Section 331.

sale of the assets will already have passed through to the shareholders under Section 1366 and increased their basis under Section 1367. At this point, the S corporation will generally have no appreciated assets to distribute in the liquidation.

While liabilities associated with distributed assets are taken into account as part of the amount realized for purposes of computing the S corporation's gain or loss under Section 336, CCA 201237017 confirms that there is no adjustment to the shareholder's stock basis associated with the assumption of liabilities on liquidation.

[ii] Character of Liquidating Gain Recognized by S Corporation.

Section 336 provides that gain or loss is recognized upon the distribution from an S corporation as if the distributed property had been sold to the shareholders. Therefore, the treatment of any gain or loss recognized by the liquidating S corporation, as capital or ordinary, will depend on the character of the distributed property.[28] For example, the distribution of capital assets produces capital gain or loss, the distribution of ordinary assets results in ordinary gain or loss, and the distribution of Section 1231 assets results in Section 1231 gain or loss. The recapture provisions such as Sections 1245 and 1250 must also be taken into account. Sections 1221, 1231, 1245, 1250. Gain for previously claimed Section 197 amortization or depreciation is treated as Section 1245 ordinary income recapture, not as long-term capital gains. Treas. Reg. Section 1.1245-3(b)(2).

If depreciable or amortizable property is distributed to a shareholder, the gain may be treated as ordinary income under Section 1239. Section 1239 converts the gain from certain sales of depreciable property between "related parties" from Section 1231 gain into ordinary income.[29] For purposes of an S corporation liquidation, the term "related party" means an S corporation and a shareholder who owns more than 50% of the stock, directly or through attribution.[30] When determining whether an S corporation is distributing depreciable property, amortizable Section 197 intangibles such as goodwill, customer lists, and going concern values are treated as property, subject to the allowance for depreciation under Section 167. See Section 197(f)(7).

In order for Section 1239 to apply to liquidating distributions by an S corporation, the shareholder receiving the distribution must own (directly or indirectly) more than 50% of the value of the outstanding stock. Sections 1239 (a), (b) and (c). For these purposes, the constructive ownership rules under Section 267(c) apply.[31]

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[28] Section 336 provides that the corporation is treated as if the property had been sold to the shareholders receiving the liquidating distribution.

[29] Section 1239 applies because Section 336 treats a liquidating distribution of property as a sale to the shareholders. Section 336 doesn't contain any exception to the normal rules for determining the character of the gain to the liquidating corporation. *See, for example, Tax Management Portfolio, Corporate* Liquidations, No 784-2nd, A-57, and Bittker and Eustice, "Federal Taxation of Corporations and Shareholders" (7th Ed.), p 10–28, ftn 97.

[30] A controlled entity means a more than 50% corporation or partnership, taking into account the Section 267(c) attribution rules, or any related entity under Section 267(b), (10), (11), or (12).

[31] Attribution from corporations, partnerships, estates and trusts to shareholders, partners and beneficiaries and among siblings, spouses, ancestors and lineal descendants; attribution among partners is not taken into account. See Sections 267(c)(1), (2), (3) and (4).

As discussed above, in the case of an S corporation selling all or substantially all of its assets, generally there will be no appreciated property distributed in the liquidation, and as such, Section 1239 will not be applicable. However, Section 1239 could be applicable in cases, for example, where the corporation is selling all of the assets of its on-going business, but is retaining the real property on which the business is operated and will be leasing that property to the purchaser.

[d] Liquidating Distributions of Qualified Installment Obligations.

An S corporation may sell all or a portion of its assets in exchange for one or more installment notes in connection with the liquidation of the corporation. If the notes are qualified installment obligations and the S corporation distributes them to qualifying shareholders, then special rules apply to both the S corporation and the shareholders when reporting the sale and the liquidation. A qualified installment obligation is an installment note that is eligible for installment reporting under Section 453 and that is acquired from the sale of property by an S corporation during the 12-month period beginning on the date that a plan of complete liquidation was adopted. Treas. Reg. Section 1.453-11(c)(1). The liquidation must be completed during the 12-month period. See Sections 453(h) and 453B(h). A qualifying shareholder means a shareholder entitled to treat the liquidating distributions as made in exchange for the stock under Section 331. Treas. Reg. Section 1.453-11(b).

The distribution of a qualified installment obligation by an S corporation to a qualifying shareholder is not treated as a disposition under the Section 453B installment reporting rules, except to the extent of any corporate level taxes, such as the built-in gain tax. Sections 453B(a) and (h). Therefore, any gain from a sale of assets by the S corporation that results in a qualifying installment obligation can escape recognition at the corporate level by making a qualifying liquidating distribution of the note to the shareholders. In effect, the gain is converted into gain recognized by the shareholders in connection with the exchange of their stock.

The sale must otherwise qualify for installment reporting by the S corporation to be eligible for the no disposition rule under Section 453B(h). If the installment obligation is acquired from the sale of inventory, depreciation, recapture, or the sale of depreciable property by the S corporation to a greater-than-50-percent shareholder,[32] the portion of the note attributable to the sale of those assets is not eligible for installment reporting even if the sale and liquidation take place within the 12-month period.

The qualifying shareholder who receives a qualified installment obligation as part of a liquidating distribution treats the receipt of the installment obligation as payment for the stock in the S corporation. Therefore, any cash, property, and qualifying installment obligations received as liquidating distributions by the shareholder will all be reported using the installment method. Sections 453(h)(1) and (2); Treas. Reg. Section 1.453-11(a)(1). Under the installment method, the gross profit ratio is applied to each payment received by the shareholder in connection with the liquidating distribution, whether pursuant to the installment note or any cash or property received by the shareholder. Sections 453(h)(1) and (2); Treas. Reg. Sec-

[32] Sections 453(g), (h)(1)(C).

tion 1.453-11(a)(1). The shareholder's gross profit ratio will be the gross profit realized, or to be realized, by the shareholder from the liquidating distributions and the note payments divided by the total contract price. Section 453(c). The shareholder's gross profit is the excess of the total value of the liquidating distributions over the stock basis. Section 453(c). The contract price is the total value of the liquidating distributions reduced by any qualified indebtedness assumed or taken subject to by the buyer, but not in excess of the shareholder's adjusted basis for the stock. Temp Reg. Section 15A.453-1(b)(2)(iii).

Example (1): Raiders, Inc. is a calendar year S corporation, all of the stock of which is owned by Davis. On January 1, 2015, Raiders sold all of its assets to Eagles, an unrelated purchaser, for $2 million. All of the assets were eligible for installment reporting. A $1 million down payment was paid at closing and the balance was in the form of Eagles' promissory note payable in five equal annual installments of $200,000, plus interest at the applicable federal rate. Assume no portion of Raiders' gain will be subject to the built-in gain tax. Raiders' basis in its assets (all of which qualify for installment reporting) is $500,000 and Davis had a $100,000 stock basis. Raiders completely liquidated on July 1, 2015 distributing the $1 million down payment and the $1 million installment note received from Eagles to Davis. As illustrated below, Raiders' gross profit percentage was 75% ($1.5 million gross profit divided by the $2 million contract price). Therefore, Raiders must report a $750,000 gain (75% times the $1 million down payment). This gain passed through to Davis and increased his tax basis from $100,000 to $850,000. The distribution of the $1 million installment note to Davis was not a disposition under Section 453B(h) and Raiders did not recognize any additional gain. Davis was treated as making an installment sale of his stock in Raiders in exchange for a $1 million down payment and a $1 million dollar installment note. The note was a qualified installment obligation and Davis was a qualifying shareholder. Davis' gross profit percentage was 57.5% [the $1,150,000 gross profit ($2 million less his $850,000 stock basis) divided by the $2 million contract price.] Therefore, Davis recognized $575,000 gain on the $1 million cash distribution and deferred $575,000 gain until the payments are received on the $1 million installment note distributed in the liquidation of Raiders.

The results to Raiders and Davis are illustrated below:

Cash payment (amount realized)		$1,000,000
Gross profit percentage		
Contract price	$2,000,000	
Less: asset basis	<500,000>	
Gross profit	$1,500,000	
Gross profit percentage		x75%
Schedule K-1 passes through to shareholders		$750,000
Shareholder-Level Gain		
Pass-through gain	$750,000	
Liquidation gain		

Cash payment		$1,000,000
Gross profit percentage		
Contract price	$2,000,000	
Less: stock basis		
Pre-sale basis	<100,000>	
Pass-through gain	<750,000>	
Gross profit	$1,150,000	
Gross profit percentage ($1,150,000/$2,000,000)		x57.5%
Liquidation gain		$ 575,000
Total current gain ($75,000 + $575,000)		$1,325,000
Deferred gain		$575,000
Total gain		$1,900,000

In example (1), the total gain recognized by Davis will total $1.9 million ($2 million value of the Raiders' stock less Davis' $100,000 stock basis) when all of the payments on the installment note are paid. However, since the $1 million cash down payment created year of sale gain when the Section 453 installment reporting was applied at both the corporate level and again at the shareholder level, the year of sale gain was $1,325,000 and the deferred gain was only $575,000. ***Under these circumstances, it would have been more favorable for Davis to have received a smaller down payment and then require a larger payment under the installment note after it had been distributed to him as set forth in Example (2), below***.

Example (2): Raiders, Inc. is a calendar year S corporation, all of the stock of which is owned by Davis. On July 1, 2015, Raiders sold all of its assets to Eagles, an unrelated purchaser, for $2 million. $100,000 is paid at closing, $900,000 is due July 15, 2015, and the balance is payable in five equal annual installments of $200,000. Raiders' basis in its assets (all of which qualify for installment reporting) is $500,000 and Davis had a $100,000 stock basis. Raiders completely liquidated on July 10, 2015, distributing the $100,000 cash down payment and the $1,900,000 installment note received from Eagles to Davis. As illustrated below, Raiders' gross profit percentage was 75% ($1.5 million gross profit divided by the $2 million contract price). Therefore, Raiders must report a $75,000 gain (75% times the $100,000 down payment). This gain passed through to Davis and increased his tax basis from $100,000 to $175,000. The distribution of the $1.9 million installment note to Davis was not a disposition under Section 453B(h), and Raiders did not recognize any additional gain. Davis was treated as making an installment sale of his stock in Raiders in exchange for a $100,000 down payment and a $1.9 million installment note. The note was a qualified installment obligation and Davis was a qualifying shareholder. Davis' gross profit percentage was 91.25% [the $1,825,000 gross profit ($2 million less his $175,000 stock basis) divided by the $2 million contract price.]. Therefore, Davis recognized $91,250 gain on the $100,000 cash distribution and deferred $1,725,000 gain until the payments are received on the $1.9 million installment note distributed to him in liquidation of Raiders. Davis will recognize an $821,250 gain on receipt of the $900,000 payment on July 15, 2015.

Cash payment (amount realized)		$100,000
Gross profit percentage		
Contract price	$2,000,000	
Less: asset basis	<500,000>	
Gross profit	$1,500,000	
Gross profit percentage		x75%
Schedule K-1 passes through to shareholders		$75,000
Shareholder-Level Gain		
Pass-through gain	$75,000	
Liquidation gain		
Cash payment		$100,000
Gross profit percentage		
Contract price	$2,000,000	
Less: stock basis		
Pre-sale basis	<100,000>	
Pass-through gain	<75,000>	
Gross profit	$1,825,000	
Gross profit percentage ($1,825,000/$2,000,000)		x91.25%
Liquidation gain		$91,250
Total current gain ($75,000 + $91,250)		$166,250
Deferred gain		$1,733.750
Total gain		$1,900,000

Another strategy for solving Davis' problem is not to liquidate Raiders and to retain the installment note in the corporation. Using this strategy, the year of share gain would be $750,000 and the same 75% gross profit ratio will be applied to each payment under the installment note.

[e] Special Problems When a QSST is a Shareholder of the Liquidating Corporation.

A qualified subchapter S trust ("QSST") is treated as a grantor trust for income tax purposes. Section 678 and 1361(d)(1)(B). The trust's share of S corporation income and loss are taxable to the QSST beneficiary, rather than to the trust itself. Section 671. However, when the QSST disposes of the stock, Treas. Reg. Section 1.1361-1(j)(8) requires that any gain recognized must be reported and the tax paid by the trust, rather than the trust beneficiary. If the disposition is a sale, the rationale for the regulation is that the QSST election has terminated as to the stock sold. Any gain or loss recognized on the sale is taxed to the trust, not the beneficiary.

The rule found in Treas. Reg. Section 1.1361-1(j)(8) could cause mismatching of income and deductions if assets are sold by the S corporation and the proceeds of the sale are then distributed to the QSST in liquidation of its stock. Gain from a sale of the S corporation's assets is reported on the QSST's Schedule K-1. The QSST beneficiary is subject to tax on the gain. The QSST's stock basis is increased by the gain. If the QSST's stock basis ("outside basis") is higher than its pro rata share of the corporation's basis for its assets ("inside basis") prior to the sale, a loss will occur when the consideration received in the sale is distributed in liquidation in exchange for the stock. For the beneficiary to match the Schedule K-1 against the loss on the sale, it would appear that the trustee must liquidate the trust and pass the loss to the beneficiary under Treas. Reg. Section 1.642(h)-1, or distribute the stock from the trust to the beneficiary prior to the sale.

Fortunately, the IRS has ruled that if the S corporation recognizes gain on a distribution of property in connection with a liquidating distribution to a QSST,[33] or if the S corporation recognized gain resulting from a stock sale treated as an asset sale as a result of a deemed asset sale under Section 338(h)(10),[34] ***the IRS will treat both the gain or loss recognized by the corporation and the gain or loss recognized by the trust on the liquidation as occurring at the trust level***.

The rationale of these private letter rulings should also apply to a sale of assets to a third party in connection with the liquidation of the corporation. ***In one private letter ruling, the IRS ruled that where the sale of assets was made pursuant to a plan of liquidation, both the gain on the sale of the assets and the loss on the liquidating distribution would be recognized by the trust***. Ltr. Rul. 199905011. Other alternatives in the event of an asset sale include distributing the stock to the QSST beneficiaries prior to the sale or terminating the trust in the same taxable year as the sale so any capital loss will pass out to the QSST beneficiaries.

[3] Tax Treatment to Purchaser of Assets.

The tax consequences to the purchaser of assets of an S corporation are very straight forward. The purchaser will receive a stepped-up basis in the acquired assets equal to the consideration

[33] Ltr. Rul. 9721020; Ltr. Rul. 9828006.

[34] Ltr. Rul. 199920007; and Ltr. Rul. 201232003.

paid for the acquired assets. The consideration will include the cash paid, the fair market value of any property transferred in connection with the acquisition of the assets, the face value of any promissory notes given in connection with the acquisition of assets, as well as any contingent purchase price ultimately paid for the assets.

[a] Allocation of Purchase Price.

Just like the S corporation seller, the consideration paid by the purchaser for the acquired assets must be allocated among the assets in accordance with the residual method of valuation in accordance with Section 1060 and the Section 338 regulations, to the extent applicable. ***Again, it is critical that the selling S corporation and the purchaser expressly set forth in the asset purchase agreement the amount to be allocated to each of the various assets acquired in the asset purchase.***

[b] Assumption of Liabilities.

Consideration paid for the acquired assets will also include any liabilities expressly assumed by the purchaser in connection with the acquisition of the assets. With respect to non-tax issues, special attention must be paid to whether the purchaser of the assets may be subject to successor tax liability, such as for state sales taxes.

§ 1.05 REPRESENTATIONS, WARRANTIES AND INDEMNIFICATION PROVISIONS

[1] Representations and Warranties.

With respect to a number of issues discussed in this outline, clearly the purchaser will want the S corporation seller and/or its shareholders to make representations and warranties in the stock purchase, or to a lesser degree, asset purchase agreement regarding such matters (such as representations concerning the validity of the corporation's S election, the qualifications of the corporation's shareholders as eligible S corporation shareholders, whether the corporation is subject to the built-in gain tax, the amount of the corporation's AAA and earnings and profits, etc.). In connection with such representations and warranties, strong indemnification provisions should provide the purchaser with the right of recovery in the event the purchaser sustains any losses as a result of the breach of any such representations and warranties. However, the inclusion of representations and warranties and indemnification clauses are no substitute for thorough due diligence, as an indemnification provision is only as good as the seller making such indemnification and assumes that the seller will still have adequate resources from which to recover in the event of a breach of a representation or warranty under the indemnification provisions of the stock acquisition agreement.

[2] Other Considerations for Acquisition Agreement.

In any case where the purchaser of S corporation stock is to pay the purchase price over a period of time under a promissory note, a right of offset should be included both in the acquisition agreement and in the body of the promissory note itself in order to enable the purchaser to offset any losses suffered by the purchaser as a result of the seller's breach of any representations or warranties made in the stock acquisition agreement against any payments due under the promissory note. Additionally, even if the purchase price is to be paid in cash at closing, consideration should be given to holding back a portion of the purchase price in escrow for some period of time in order to provide security in the event of a breach of the representations and warranties. Sample representations and warranties, indemnification provisions and rights of offset are set forth in Appendix I to this outline.

§ 1.06 HOLDBACKS, ESCROWS AND CONTINGENT PURCHASE PRICE

As discussed above, in a typical purchase and sale agreement (whether an asset purchase agreement or a stock purchase agreement), the seller will:

- Make certain representations and warranties regarding the business being sold;
- Make covenants, including those regarding operation of the business between signing the agreement and closing the transaction;
- Indemnify the buyer for losses caused by any breaches of the representations, warranties or covenants; and
- May agree for the buyer to hold back a portion of the purchase price or to place a portion of the purchase price in an escrow account for a period of time to secure the payment on the indemnification. If there are no claims against the holdback or the escrow during the term of the holdback or escrow, the full amount is ultimately paid to the seller. However, if claims are made by the buyer, all or a portion of the holdback or escrow will be paid to the buyer and any balance paid to the seller.

Additionally, in many transactions, contingent purchase price, or an "earn-out" is an increasingly popular technique. Typically, a portion of the purchase price is contingent on the future financial performance of the target business so that the buyer pays the agreed earn-out amount, if at all, in years subsequent to the sale upon satisfaction of the specified contingencies. Options for measuring the earn-out include, among others, EBITDA (earnings before interest, taxes, depreciation and amortization), income or revenue growth, gross profit or some other specific event. In connection with the business issues relating to holdbacks, escrows and contingent purchase price provisions, tax practitioners should be familiar with the tax treatment related to such provisions.

[1] Holdbacks and Escrow Accounts.

More often than not, asset purchase and stock purchase agreements provide for some portion of the sales proceeds to be placed in escrow, or otherwise held back from the sales proceeds due to the seller at closing. Some or all of these proceeds will normally be released to the seller in a future tax year after satisfaction of certain conditions, or when the buyer is assured that it has received the benefit of the bargain.

[a] While holdback and escrow arrangements often qualify for use of the installment sales method under Section 453 discussed above, under certain circumstances, the installment sales method may not be available. Transactions involving escrow arrangements or holdback agreements will require the tax practitioner to consider Treas. Reg. Section 15A.453-1(b)(3)(i), which states that payments include amounts actually or constructively received by the taxpayer.

[b] Treas. Reg. Section 1.451-2(a) provides that income is constructively received by a taxpayer when, without substantial limits or restrictions on his control of the receipt, the income is either (a) credited to his account, (b) set apart for him, or (c) made available so he may draw on it at any time. Conversely, there will not be constructive receipt when: (i) the taxpayer enters into an agreement to defer income before it is earned, (ii) the taxpayer's right to the income has not yet matured or vested, and (iii) the taxpayer's right to the income is contingent on the occurrence (or nonoccurrence) of an event or condition (and is therefore subject to a restriction).

[c] If an escrow arrangement imposes a substantial restriction on the seller's right to receive the sales proceeds, such amount can be reported on the installment sales method, provided the transaction otherwise qualifies. For an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of a buyer, that is a real and definite restriction placed on the seller, or a specific economic benefit conferred on the buyer. See IRS Publication 547 (2008). Escrows that secure a seller's representations and warranties have been held to be a substantial restriction. See *Stiles v Commissioner*, 69 T.C. 558 (1978); Ltr. Rul. 8629038 and Ltr. Rul. 8645029. The IRS has maintained this position as recently as 2005 in Ltr. Rul. 200521007, and in 2007 in Ltr. Rul. 200746004. It is worth noting that both in *Stiles* and in *Murray v Commissioner*, 28 B.T.A. 624 (1933), 75% of the sales proceeds were held in escrow and in both cases installment accounting was available. In *Stiles*, the restriction was that the funds could be used to satisfy breaches of representations and warranties. In *Murray*, the restriction was that the funds were held in escrow as security for the taxpayer to honor their covenant not to compete.

[d]It is equally clear that a seller's restriction on escrowed funds based solely on the passage of time is ***not*** a substantial restriction. See Rev. Rul. 79-91, 1979-1 C.B. 179.

[e]Moreover, Treas. Reg. Section 15A.453-1(b)(3)(i) states that receipt of an installment obligation secured "directly or indirectly by cash or cash equivalent" will be treated as a "payment" in the year of sale. The regulations define "cash" and "cash equivalents" as bank certificates of deposit and treasury notes.

[f] Finally, if an escrow arrangement is established by a seller ***after*** a buyer has made available the full amount of the purchase price, regardless of the terms of the escrow, the constructive receipt doctrine would apply so that the entire amount would be taxable currently and not eligible for the installment sales method.

[2] Contingent Purchase Price.

As stated above, contingent purchase price or so-called earn-out provisions are very common both in asset purchase and stock purchase agreements. Clearly, sellers will want more cash up front and less on an earn-out, and buyers will want to pay less up front and more on the earn-out. The practical implementation of earn-outs can be quite difficult.

[a.] Any earn-out provision should be specific and address:

[i] Control of the entity post-closing;

[ii] Method of operation of the business post-closing; and

[iii] Method of accounting for profits, losses and expenses.

[b] Earn-out provisions should include the following:

[i] The performance metric or milestone;

[ii] The timeframe or achievement of the earn-out metrics and milestones;

[iii] Methods to be used to determine whether the performance metrics have been attained; and

[iv] Control issues relating to the earn-out business against which the performance is being measured.

[c] The parties should expressly agree in the asset purchase agreement or stock purchase agreement on the calculation methodology, involve the accountants in such calculation and attach a schedule and sample calculation. It is also important that a dispute resolution mechanism be included in the stock purchase agreement or asset purchase agreement to minimize disputes, cost and time, which will usually involve the appointment of an independent accounting firm.

[3] Taxation of Contingent Purchase Price to the Seller.

As discussed above, any disposition of property in which at least one payment is to be received after the close of the taxable year in which the disposition occurs qualifies for installment sales treatment and the statute does not distinguish between a payment whose amount is fixed and a payment whose amount is contingent on future events. It is fair to say that the contingent payment provisions contained in the installment sales regulations make some very unfriendly assumptions on the behalf of sellers. The installment sales regulations basically set forth three categories into which contingent payment sales may fall.

[a] Sales With a Stated Maximum Selling Price.

If there is a stated maximum price, the gross profit ratio will be computed on the assumption that the maximum amount will be paid. If less than the maximum price is ultimately paid, the seller is allowed a loss (undoubtedly a capital loss) in the final year equal to the excess gain previously included in income, unless one of the specific rules permitting the seller to recompute the maximum selling price applies.

[b] Sales with a Fixed Period.

If the price is open-ended, but payments are due only for a specified period, basis is generally recovered ratably over the period for which payments are received. If in any particular year, the payment received is less than the basis allocated to that year, no loss is allowed; the unrecovered basis allocated to that year is carried forwarded to the next succeeding year, and if it is not recovered in that year likewise to the subsequent succeeding years until it has been recovered or until the obligation becomes worthless and a bad debt or loss deduction is allowable.

[c] Sales with Neither a Stated Maximum Selling Price nor a Fixed Period.

If both the purchase price and payment periods are indefinite, basis is recovered ratably over 15 years, unless the seller can demonstrate that recovery over 15 years would substantially and inappropriately defer the recovery of basis. In this case, if payments received in a particular year are less than the ratable share of basis allocated to the year, no loss is allowed. Rather, the unrecovered basis originally allocated to that year is reallocated over the remaining years of the original 15-year period. If any basis remains unrecovered at the end of the 15 years it is carried forward until it is recovered (on a dollar-for-dollar basis) or until the obligation becomes worthless and a bad-debt or loss deduction is allowable.

[d] Electing Out of Installment Sales Method.

As an alternative, the seller could decide to elect out of the installment method. If the seller elects out of the installment method, the seller will need to demonstrate that it has used a reasonable method for determining the fair market value of the contingent purchase price, and will be subject to immediate taxation on that amount at the time of closing.

[e] Open Transaction Doctrine.

Additionally, the taxpayer could argue that the "open transaction" doctrine should be applied to contingent purchase price. Under the open transaction doctrine, the seller is permitted to recover his or her basis in the asset being sold before reporting any gain. The open transaction doctrine can be traced to the seminal case of *Burnett v Logan*, 283 U.S. 404 (1931). Although the regulations do not completely rule out the possibility that the "open transaction" method may be available to report the sales gain attributable to a contingent payment obligation, the temporary regulations provide that "only in those ***rare and extraordinary cases*** involving sales for a contingent payment obligation in which the fair market value … cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is 'open'. Any such transaction will be carefully scrutinized to determine whether a sale has taken place." Temp. Treas. Reg. Section 15A.453-1(d)(2)(iii).

[1] Buyer's Tax Consequences.

The treatment of contingent purchase price or earn-out to the buyer is such that the buyer cannot generate depreciable basis until the earn-out has been earned and paid to the seller. Frequently, any contingent purchase price will be allocated to goodwill and amortized over the allowable 15-year period.

§ 1.07 QUALIFICATION AS AN S CORPORATION

As discussed above, especially with respect to acquisitions of S corporation stock where the acquirer desires to retain the S corporation status of the seller, the purchaser will need to conduct thorough due diligence of the S corporation, which will include confirming the validity of the selling corporation's S election, determining whether the S corporation is subject to the built-in gain tax imposed under Section 1374, consideration of the allocation of income or loss of the S corporation in the year of sale of the stock, determination of the accumulated adjustments account and earnings and profits of the selling S corporation and if a deemed asset sale is involved, issues relating to the Section 338(h)(10) election or the Section 336(e) election. See Appendix 2 attached to this outline for specific items to be included in conducting due diligence in connection with acquisitions of S corporation stock.

[1] In General.

An S corporation is defined under Section 1361(a)(1) as a "small business corporation" for which an election under Section 1362(a) is in effect for such year. Under Section 1361(b)(1), the term "small business corporation" is defined as a "domestic corporation" which is not an "ineligible corporation" and which does not have: (1) more than 100 shareholders; (2) as a shareholder a person (other than an estate, certain types of trusts or an organization described in Section 1361(c)(6)) who is not an individual; (3) a non-resident alien as a shareholder; and (4) more than one class of stock.

[2] Limits on Types of Corporations.

[a] To be eligible, a corporation must be a "domestic corporation." Sections 7701(a)(3) and 7701(a)(4) define the term "domestic corporation" as a corporation that is created or organized in the United States or under the laws of the United States or of any state or territory thereof.

[b] Section 1361(b)(2) provides that the term "ineligible corporation" means any corporation which is a financial institution that uses the reserve method of accounting for bad debts under Section 585, an insurance company, a possessions corporation, or a DISC or former DISC.

[2] Limits on Number of Shareholders.

[a] Section 1361(b)(1)(A) permits an S corporation to have a maximum of 100 shareholders.

[b] For purposes of the numerical shareholder limitation, all of the members of a family are treated as a single shareholder. Members of a family include the common ancestor and all lineal descendants of the common ancestor not more than six generations removed, plus spouses or former spouses of such individuals. Section 1361(c)(1). The Gulf Opportunity Zone Act of 2005 eliminated the requirement that a family elect to be treated as a single shareholder.

[c] Stock that is substantially non-vested within the meaning of Treas. Reg. Section 1.83-3(b) is not outstanding stock of the corporation and the holder of such stock is not treated as the shareholder solely by reason of holding such stock, unless the holder makes an election under Section 83(b). As such, the non-vested shareholder would not be counted for purposes of determining the number or eligibility of shareholders, as well as reporting of S corporation income.

[4] Limits on Types of Shareholders.

Sections 1361(b)(1)(B) and (C) place limitations upon the types of persons that may own stock in an S corporation. Permissible shareholders of an S corporation include an individual (other than non-resident aliens), a decedent's estate, an individual's estate in bankruptcy, an organization described in Section 1361(c)(6) or one of six types of trusts. A corporation will be ineligible to elect or maintain S corporation status for any year in which an ineligible shareholder owns stock. The IRS, however, may not treat momentary ownership of stock by an ineligible shareholder as violative of this eligibility requirement (e.g., in connection with a reorganization or an incorporation of a partnership).

[a] Estates.

Although a decedent's estate may be a shareholder of an S corporation, if the administration of the decedent's estate is unduly prolonged, the estate may be treated as a testamentary trust for federal income tax purposes, in which case the corporation may lose its S corporation status. An estate will not be deemed an ineligible shareholder, however, if it remains open to hold stock during the deferral period permitted by Section 6166 with respect to estate taxes.

[b] Grantor Trust.

A grantor trust as defined in Section 671 through 678 is a permissible S corporation shareholder, provided the deemed owner is an eligible shareholder. After the death of the grantor or other deemed owner, the trust may continue as a S corporation shareholder for the two-year period beginning on the date of the grantor's or deemed owner's death, as the case may be.

[c] Testamentary Trust.

A testamentary trust, to which stock is transferred pursuant to the terms of a will may qualify as an S corporation shareholder, but only for the two-year period beginning on the date the stock is transferred to the trust. The estate of the testator is treated as the shareholder for purposes of determining the corporation's eligibility as an S corporation.

[d] Voting Trust.

A voting trust, created primarily to exercise the voting power of the stock transferred to it, is a permissible shareholder of an S corporation. A voting trust is defined as a trust represented by a written instrument that:

[i] delegates to one or more trustees the right to vote;

[ii] requires all distributions to be for the benefit of the beneficial owners;

[iii] requires title and possession of the stock to be transferred to the beneficial owners of the trust upon its termination; and

[iv] terminates before a specific date or event under state law or by its own terms.

[e] QSST.

Under Section 1361(d), a "qualified Subchapter S trust" ("QSST") may own the stock of an S corporation if the beneficiary so elects. Under Section 1361(c)(2)(B)(i), the beneficiary is also treated as the shareholder of the corporation for purposes of determining its eligibility as an S corporation. A QSST is a trust meeting all of the following requirements:

[i] All of the trust income under Section 643(b) must be distributed currently, or be required to be distributed currently, to the current income beneficiary of the QSST.

[ii] The current income beneficiary must be an individual who is a U.S. citizen or resident.

[iii] The current income beneficiary must be the only income beneficiary of the trust during such beneficiary's lifetime.

[iv] Any corpus of the QSST distributed during the current income beneficiary's lifetime must be distributed only to the current income beneficiary.

[v] The current income beneficiary's income interest must terminate on the earlier of the beneficiary's death or the termination of the trust.

[vi] If the trust terminates during the current income beneficiary's life, all of the trust assets must be distributed to the current income beneficiary.

[vii] The current income beneficiary must make an election on a timely basis to treat the trust as a QSST as set forth in Treas. Reg. Section 1.1361-1(j)(6)(iii)(C).

[f] ESBT.

Section 1361(c)(2)(A)(v) provides that an electing small business trust ("ESBT") is a permitted S corporation shareholder. An ESBT means any trust meeting the following requirements:

[i] The trust does not have as a beneficiary any person other than an individual, an estate, or an organization described in Section 170(c)(2) through (5).

[ii] No interest in the trust may have been acquired by purchase.

[iii] The trustee of the trust makes a timely ESBT election for the trust.

Effective for tax years beginning after December 31, 2006, the Act provides that a deduction for interest paid or accrued on indebtedness to acquire stock in an S corporation can be taken into account in computing the taxable income of the "S portion" of an electing small business trust. Under the current regulations, interest paid by an ESBT to purchase stock in an S corporation is allocated to the S portion of the ESBT but is not a deductible administrative expense for purposes of determining the taxable income of the S portion. (Treas. Reg. Section 1.641(c)-(d)(4)(ii).)

[g] Tax Exempt Organization.

Section 1361(C)(6) provides that an organization which is: (a) described in Section 401(a) or Section 501(c)(3); and (b) exempt from taxation under Section 501(a), is a permitted S corporation shareholder.

[h] IRAs.

An IRA holding bank S corporation stock (including a Roth IRA) is permitted to hold S corporation stock, but only to the extent of the bank stock held by the IRA on the date of enactment of the 2004 Act. S corporation income allocated to the shares held by an IRA and gain or loss upon disposition of the shares are subject to the unrelated business income tax.

[i] "Tax Nothings".

A question generated from the recent check-the-box provisions is whether a single member LLC can be a shareholder in an S corporation. If its tax status is that of a "tax nothing," then its owner must be evaluated as to whether such owner is permitted to own the S stock much in the same way as a grantor trust is ignored and the settlor is treated as the "owner" of the trust assets for federal income tax purposes.

[j] Nominee Status.

Under Subchapter S, a nominee is not treated as a shareholder for eligibility purposes. Rather, the beneficial owner is treated as the shareholder for S corporation eligibility purposes.[35] The IRS has ruled, for example, that a corporation's S election did not terminate when its stock was held by a non-resident alien under a particular uniform gift to minor's act transfer.[36] Thus, if the tax owner of the LLC "tax nothing" is otherwise an eligible shareholder, and such owner acts accordingly for Subchapter S purposes, e.g., signs Form 2553, is indicated as the owner with the IRS via the K-1, etc., the corporation's S election should be respected notwithstanding the nominee shareholder's state law separate identity.[37]

[i] The CTB regulations permit certain single member controlled entities to be disregarded for federal income tax purposes such as a branch or division.[38] An entity engaged in business operations with two or more members generally will be classified as a corporation or a partnership. Certain entities designated in the regulations will be required to be "per se" corporations. Where there is only one owner, it is treated as either a corporation or a disregarded entity. Where a business entity is unincorporated and has only a single owner, it is a disregarded entity.[39] A business entity with two or more members is classified as either a corporation or a partnership. A business entity with only one owner is classified as either a corporation or a disregarded entity. Thus, a business entity that is not a corporation and that has a single owner is disregarded as an entity separate from its owners-it is a disregarded entity. A business entity that is not a per se corporation and that has at least two members is classified as a partnership absent a reverse default election to be treated as a corporation.[40]

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[35] *Ozier v. Commissioner, T.C. Memo. 1977-53, aff'd, 600 F.2d 594 (6th Cir. 1979). See Ltr. Ruls. 9010042 and 8934020 (momentary ownership of S stock by partnership ignored).*

[36] Rev. Rul. 71-287, 1971-2 C.B. 316.

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

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

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

[40] *See Treas. Reg. Section 301.7701-3(b). Littriello v. United States, 95 AFTR 2d 2005-2581, 2005-1 U.S.T.C. 50, 385 (WD Ky. May 18, 2005) (validity of CTB regulations upheld). See Silverman, Zarlenga and Cain, "Use of Limited Liability Companies in Corporate Transactions," 80 Tax Notes 1469 (9/21/98).*

[ii] Where an entity is owned by disregarded entities, then the upper tier disregarded entity will be disregarded.[41]

[k] Conversion of Partnership to Disregarded Entity.

Where an eligible entity classified as a partnership is converted to a single member, the conversion will be treated as a liquidation of the partnership.[42] In Rev. Rul. 99-6,[43] the IRS analyzed two situations where one person purchased all of the interests in a multi-person LLC, causing the LLC to change from partnership to a disregarded entity. In each situation, the sellers are treated as selling their partnership interests under Sections 741(a) and subject to Section 751(a) ("hot assets" rule). The purchaser in each instance is treated as the purchaser of assets which first are distributed in liquidation.[44] Thus, to the sellers, each may recognize gain to the extent that money treated as distributed exceeds their basis in their partnership interest immediately before the distribution under Section 731(a)(1), and loss is not recognized unless only money and unrealized receivables and inventory items are distributed and the sum of such items exceeds the partners' adjusted basis in his or her partnership interest under Section 731(a)(2). Under Section 732(b), the distributee's basis in the partnership assets will be the same as his basis in his partnership interest, reduced by any money treated as having been distributed to him, and must be allocated in the manner described in Section 732(c).[45]

[l] Conversion of Disregarded Entity to Partnership.

Rev. Rul 99-5[46] provides: (1) where the original member of a single member domestic LLC, holding only capital assets or Section 1231 property, that is disregarded for tax purposes as an entity separate from the owner under Treas. Reg. Section 301.7701-3, converts into a partnership where a new non-related member purchases a 50% interest in the LLC, the original member recognizes gain or loss from the deemed sale of the 50% interest in each asset to the new member under Section 1001; but under Section 721, the partners won't recognize gain or loss as a result of the conversion of the disregarded entity to a partnership; (2) where the new member's cash contribution to the LLC, which converts it from a disregarded entity to a partnership, is treated as a contribution in exchange for an ownership interest, under Section 721(a), neither of the partners recognize gain or loss on the conversion into a partnership.

In both situations, under Section 722, the new member's basis in the partnership interest is equal to the amount paid for the assets which the new member is deemed to contribute to the newly-created partnership. The original member's basis is equal to his basis in his share of the assets in the LLC. In situ-

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

[42] See Treas. Reg. Section 1.708-1(b)(1)(i).

[43] 1999-1 C.B. 432

[44] See *McCauslen v. Commissioner,* 45 T.C. 588 (1966); Rev. Rul. 67-65, 1967-1 C.B. 168.

[45] See Section 735(a)(2) (holding period).

[46] 1999-1 C.B. 434

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

[m] Conversion of Disregarded Entity to Corporation.

A straightforward application of Section 351 will apply to this situation.[47]

[n] Conversion of Corporation to Disregarded Entity.

This type of a conversion poses a potential trap for the unwary inasmuch as the conversion constitutes a complete liquidation under Sections 331 and 336 and is taxable to the corporation and its shareholders. Exception from taxable treatment is provided where the liquidation meets the requirements for the liquidation of a controlled subsidiary under Sections 332 and 337.[48] The conversion of an eligible entity to a disregarded entity can be accomplished by election. An election should be treated as a distribution of the assets in liquidation of a corporation. In general, the tax consequences of the conversion are deemed to occur at the end of the day preceding the election.

[5] Limits on Taxable Years.

Under Section 1378, an S corporation must have a "permitted taxable year" which is either a calendar year, a fiscal year for which the corporation establishes a sufficient business purpose, or a fiscal year permitted pursuant to an election under Section 444. Section 444 permits an S corporation to elect a taxable year different from that required under Section 1378 provided that such taxable year does not result in a deferral of greater than three months and provided that the corporation makes the tax payments required under Section 7519 for each year the election is in effect. Under Section 7519(b), an S corporation electing under Section 444 must make annual payments to the IRS for approximately the same amount of taxes as the shareholders would have paid if the corporation were on a calendar taxable year. The payments are due on or before May 15 following the calendar year in which the election year begins.

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[47] See Treas. Reg. Section 301.7701-3(g)(1)(iv). See Rev. Rul. 80-228, 1980-2 C.B. 115.

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

[6] Qualified Subchapter S Subsidiaries.

Prior to the changes made by the Small Business Job Protection Act of 1996, S corporations could not own 80% or more of the stock of another corporation without causing the termination of the parent corporation's S election. Following the '96 Act, S corporations may own ***any*** percentage of stock in a C corporation subsidiary without causing the termination of the parent corporation's S election and may elect to treat a wholly-owned subsidiary as a qualified subchapter S subsidiary ("QSub").

[a] Repeal of Former Inactive Subsidiary Rule.

As a result of the ability to own a (S or C corporation) subsidiary, the inactive subsidiary exception in Section 1361(c)(6) has been repealed as no longer necessary. Furthermore, the issue of momentary affiliation is substantially reduced in its importance; the only issue being whether momentary affiliations incident to an acquisition or reorganization are to be ignored for federal income tax purposes. Thus, for example, an S corporation may acquire all the stock of a C corporation (and its lower tier subsidiaries) without having to liquidate immediately. Similarly, an S corporation that is purchased by another S corporation no longer will have to be liquidated immediately in order to preserve the application of the flow through rules with respect to its income and losses. Loss of either the purchaser's or the target's S corporation election could have resulted in built-in gains tax, passive investment income, and LIFO recapture tax implications.[49]

[b] Consolidated Reporting Denied.

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

[c] Treatment of Dividends.

Generally, dividends received from a C corporation which are from current or accumulated earnings and profits under applicable rules under Subchapter C, will constitute passive investment income for termination purposes under Section 1362(d)(3) as well as for purposes of the tax on excess passive investment income under Section 1375.[50] Again, a dividends received deduction under Section 243 is unavailable. Final regulations dealing with dividends received from affiliated C corporation subsidiaries by an S corporation parent have been issued.[51]

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

[50] See Sections 1375(b)(3) and 1362(d)(3)(D).

[51] See Treas. Reg. Section 1.1362-8.

[d] Active Business Exception.

Where the S corporation parent owns at least 80% of the stock of a C corporation, subsidiary dividends which are attributable to earnings and profits of the subsidiary will not be treated as passive investment income provided such earnings are derived from the active conduct of a trade or business. The legislative history is silent on how the allocation or tracing of the subsidiary dividend to its active business operations is to be made. This problem will be especially pronounced where dividend distributions are from accumulated earnings and profits over a span of years. Application of the same rule will also be complex where the C subsidiary receives a dividend from a controlled affiliate. Where the distribution from the controlled C corporation constitutes gain (distribution in excess of earnings and profits and basis), presumably such gains will constitute passive investment income even if such distribution is from the conduct of active business operations. Despite the tracing problem, it is important to recognize that the passive income problem for S corporations is only faced where the S corporation parent itself has accumulated subchapter C earnings and profits. Dividends, even passive dividends, do not increase or create C year earnings and profits as provided in Section 1371(c)(1). Final regulations issued by the IRS address the question of tracing active earnings and profits in a C subsidiary or from a C affiliated group.[52] Under the regulations, earnings and profits of a C corporation derived from the active conduct of a trade or business are the earnings and profits of the corporation derived from activities that would not produce passive investment income under Section 1362(d)(3) if the C corporation were an S corporation. A safe harbor is provided by which the corporation may determine the amount of the active earnings and profits by comparing the corporation's gross receipts derived from non-passive investment income-producing activities with the corporation's total gross receipts in the year the earnings and profits are produced. If less than 10% of the C corporation's earnings and profits for a taxable year are derived from activities that would produce passive investment income, all earnings and profits produced by the corporation during the taxable year are considered active earnings and profits. The regulations also provide that a C corporation may treat all earnings and profits accumulated by the corporation prior to the time an S corporation held stock meeting the requirements of Section 1504(a)(2) as active earnings and profits in the same proportion as the C corporation's active earnings and profits for the three taxable years ending prior to the time when the S corporation acquired 80% of the C corporation bears to the C corporation's total earnings and profits for those three taxable years. Provisions also address the allocation of distributions from current or accumulated earnings and profits.[53] The final QSub regulations generally apply to taxable years that begin on or after January 20, 2000, but taxpayers may elect to apply the regulations in whole, but not in part, for taxable years beginning on or after January 1, 2000.

[e] Example: Distributions From Controlled C Subsidiary.

S Corp. owns 85% of the outstanding voting (and value) common stock of a C corporation subsidiary. The subsidiary declares and pays an operating dividend to S Corp. of $1000x of which $700x is from earnings and profits. During the year in which the distribution is made, C corporation derived 90% of its

[52] Treas. Reg. Section 1.1362-8.

[53] See Treas. Reg. Section 1.1362-8.

gross income from active business operations and 10% from its interest as a limited partner in a real estate partnership. Of the dividend of $700x, $70x will constitute passive investment income for purposes of Subchapter S. Of the $300x remaining distribution, assume that S Corp.'s stock basis in the C corporation was $200x, under Section 301(c)(2), $200x would be a return of capital and $100x as gain from the sale or exchange of stock. The gain of $100x will constitute passive investment income regardless of the fact that 90% of the C corporation's gross income was from the conduct of active business operations.

[f] Example: Distributions From Non-Affiliated C Subsidiary.

Same facts as in prior example except that S Corp. owns 75% of the C corporation. Assume further that all of C corporation's gross income was from active business operations. Under these facts, $800x, the $700x dividend and the $100x gain would constitute passive investment income.

[g] Eligibility for QSub Election.

Treas. Reg. Section 1.1361-2(a) provides that a QSub means any domestic corporation that is not an ineligible corporation if the following two conditions are met:

[i] 100% of the stock of such corporation is held by an S corporation.

[ii] The S corporation properly elects to treat the subsidiary as a QSub under Treas. Reg. 1.1361-3.

[h] Ineligible Corporations.

Under Section 1361(b)(2), an "ineligible corporation" is (a) a financial institution that uses the reserve method of accounting for bad debts under Section 585, (b) an insurance company subject to tax under Subchapter L, (c) a corporation to which an election (relating to the Puerto Rico and possession tax credit) under Section 936 applies, or (d) a DISC or former DISC.

[i] Effect of QSub Election.

Treas. Reg. Section 1.1361-4(a)(1) provides that a QSub election generally has the following consequences for federal tax purposes:

[i] A QSub is ***not*** treated as a separate corporation.

[ii] All assets, liabilities, and items of income, deduction, and credit of a QSUB are treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

[j] Deemed Liquidation and the Step Transaction Doctrine.

Consistent with the legislative history accompanying the QSub provisions, the final regulations provide that if an S corporation makes a valid QSub election with respect to a subsidiary, the latter will be deemed to have liquidated into the parent S corporation. The tax treatment of the deemed liquidation is determined under the Code and general principles of federal tax law, including the step transaction doctrine. In general, under Section 332 a parent corporation generally recognizes no gain on the liquidation of its wholly-owned subsidiary, and under Section 337 a wholly-owned subsidiary generally recognizes no gain on liquidating into its parent.

[k] Termination of QSub Election.

Treas. Reg. Section 1.1361-5(a)(1) generally provides that the termination of a QSub election is effective:

[i] On the effective date in the revocation statement, if a QSub election is revoked pursuant to Treas. Reg. Section 1361-3(b).

[ii] At the close of the last day of the parent corporation's last tax year as an S corporation if the parent corporation's S election terminates.

[iii] 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).

[l] Effect of Termination.

If a QSub election terminates, Treas. Reg. Section 1.1361-5(b)(1)(i) treats the former QSub as a new corporation that acquires all of its assets (and assumes all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation.

[m] Deemed Formation and the Step Transaction Doctrine.

Similar to the liquidation deemed to occur on the making of a QSub election, the tax treatment of the deemed formation of the new corporation on the termination of a QSub election is determined under the Code and general principles of federal tax law, including the step transaction doctrine.

[n] Sale of Stock of QSub.

Effective for tax years beginning after December 31, 2006, the rules applicable to the sale of stock of a QSub more like the rules applicable to the sale of interests in a single member limited liability company (SMLLC), the separate existence of which is disregarded for federal tax purposes. Specifically, the Act provides that, where the sale of stock of a QSub results in the termination of the QSub election, the sale will be treated as a sale of an undivided interest in the assets of the subsidiary (based on the percentage of the stock sold), followed by a deemed acquisition by the subsidiary of its assets in a transaction to which

Section 351 applied. Thus, for example, if an S corporation sold 21% of the stock of a QSub, the S corporation will recognize gain as if it had sold a 21% undivided interest in the assets of the QSub. ***Note that where 100% of the stock of a QSub is sold, the entire transaction will be treated as an asset sale and not as a stock sale.***

[7] Limits on Classes of Stock.

Under Section 1361(b)(1)(D), an S corporation may only have one class of stock.

[a] Outstanding Shares of Stock.

[i] General Rule. Under Treas. Reg. Section 1.1361-1(l)(1), a corporation that has more than one class of stock will not qualify as a small business corporation, and as such, cannot be an S corporation. 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.

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

(B) Non-conforming Distributions. The original proposed second class of stock regulations provided that even where all outstanding shares of stock conferred identical rights to distribution and liquidation proceeds, the corporation still would be treated as having more than one class of stock if the corporation made "non-conforming distributions." Non-confirming distributions were defined as distributions which differed with respect to timing or amount as to each outstanding share of stock, with certain limited exceptions. Thus, under the original proposed regulations, excessive or inadequate compensation from an S corporation to a shareholder, shareholder loans, fringe benefits to shareholders, and other constructive distributions such as excessive rental payments between a shareholder and an S corporation could cause the inadvertent termination of an S corporation's election under the non-conforming distribution rule. Under the final second class of stock regulations, however, non-conforming distributions will not cause a corporation to be treated as having more than one class of stock but such distributions (including actual, constructive or deemed distributions) that differ in timing or amount will be given appropriate tax effect in accordance with the facts and circumstances. Thus, the IRS has the power to recharacterize such distributions. Treas. Reg. Section 1.1361-1(l)(2)(i).

[i] Stock Taken into Account. Under Treas. Reg. Section 1.1361-1(l)(3), in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, all outstanding shares of stock of a corporation are taken into account, except for: (i) restricted stock within the meaning of Treas. Reg. Section 1.1361-1(l)(b)(3) with respect to which no Section 83(b) election has been

made; (ii) deferred compensation plans within the meaning of Treas. Reg. Section 1.1361-1(b)(4); and (iii) straight debt under Treas. Reg. Section 1.1361-1(b)(5).

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

(A) Routine Commercial Contractual Arrangements. Treas. Reg. Section 1.1361-1(l)(2) provides that routine commercial contractual arrangements, such as leases, employment agreements and loan agreements, will not be considered binding agreements relating to distribution and liquidation proceeds, and consequently will not be considered Governing Provisions, ***unless such agreements are entered into to circumvent the one class of stock requirement***.

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

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

(D) Buy-Sell, Redemption and Other Stock Restriction Agreements. Treas. Reg. Section 1.1361-1(l)(2)(iii) sets forth rules regarding when buy-sell, redemption and other stock restriction agreements will be disregarded in making the determination as to whether a corporation's shares of stock confer identical rights to distribution and liquidation proceeds.

[1] Agreements Triggered by Death, Divorce, Disability or Termination of Employment. A bona fide agreement to redeem or purchase stock at the time of death, divorce, disability or termination of employment will be disregarded in determining whether a corporation's shares of stock confer identical rights to distribution and liquidation proceeds. Treas. Reg. Section 1.1361-1(l)(2)(iii)(B).

[2] Non-Vested Stock. If stock that is substantially non-vested is treated as outstanding, the forfeiture provisions that cause the stock to be substantially non-vested will be disregarded.

[3] Buy-Sell Agreements, Stock Restriction Agreements and Redemption Agreements. Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements will be disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless:

- A principal purpose of the agreement is to circumvent the one class of stock requirement; and

- 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.

[4] Determination of Value. Treas. Reg. Section 1.1361-l(l)(2)(iii) provides that a price established at book value or at a price between fair market value and book value will not be considered to establish a price significantly in excess of or below the fair market value of the stock.

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

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

[b] Other Instruments, Obligations or Arrangements.

[i] Arrangements Taken Into Account.

Treas. Reg. Section 1.1361-1(l)(4)(i) provides that in no event will instruments, obligations or arrangements described in Treas. Reg. Section 1.1361-1(b)(4) (relating to deferred compensation plans), Treas. Reg. Section 1.1361-1(l)(4)(iii)(B) and (C) (relating to exceptions and safe harbors for options), Treas. Reg. Section 1.1361-1(l)(4)(ii)(B) (relating to safe harbors for certain short-term unwritten advances and proportionally-held debt), or Treas. Reg. Section 1.1361-1(l)(5) (relating to the safe harbor for straight debt) be treated as a second class of stock.

[ii] General Rule.

Treas. Reg. Section 1.1361-1(l)(4)(ii) provides that any instrument, obligation or arrangement issued by a corporation, regardless of whether designated as debt, will be treated as a second class of stock of the corporation if such instrument, obligation or arrangement meets the following two requirements.

(A) Classification as Equity. The instrument, obligation or arrangement must constitute equity or otherwise result in the holder being treated as the owner of stock under general principles of federal tax law; and

(B) Intent. A principal purpose of issuing or entering into the instrument, obligation or 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.

[iii] Safe Harbors.

The regulations set forth two safe harbors to the general rule.

(A) Short-Term Unwritten Advances. Treas. Reg. Section 1.1361-1(l)(4)(ii)(B)(1) provides that unwritten advances from a shareholder that do not exceed $10,000 in the aggregate at any time during the taxable year, which are treated by the parties as debt, and which are expected to be repaid within a "reasonable time" will not be treated as a second class of stock even if such advances would otherwise be considered equity under general principles of federal tax law. Additionally, the regulations provide that the failure of an unwritten advance to meet this safe harbor will not automatically result in a second class of stock unless both conditions of the general rule set forth above are met.

[1] Proportionally-Held Obligations. Treas. Reg. Section 1.1361-1(l)(4)(ii) (B)(2) provides that obligations of the same class which are considered equity under general principles of federal tax law, which are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, will not be treated as a second class of stock. Obligations owned by the sole shareholder of a corporation will always be held proportionally to the corporation's outstanding stock and thus cannot constitute a second class of stock. Obligations which are considered equity but which do not fall within this safe harbor will not automatically result in a second class of stock unless a principal purpose of the obligations is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders.

[2] Call Options, Warrants and Similar Instruments. Under Treas. Reg. Section 1.1361-1(l)(4)(iii)(A), a call option issued by a corporation is treated as a second class of stock if, taking into account all the facts and circumstances, the call option is substantially certain to be exercised (by the holder

or a potential transferee) ***and*** has a strike price substantially below the fair market value of the underlying stock.

(B) Test Dates. The regulations apply the test to determine whether a call option constitutes a second class of stock at three points in time:

[1] Issuance. When the call option is issued;

[2] Transfer to Ineligible Person. When the call option is transferred to a person who is not an eligible S corporation shareholder; and

[3] Material Modification. When the call option is materially modified. Where, however, 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 (and consistent with) a modification of the terms of the loan, such extension of time with respect to the option will not be considered a material modification.

(C) Price at Time of Exercise. Under the regulations, a call option will not be considered to have a strike price substantially below the fair market value of the stock 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.

(D) Lender Exception. Under Treas. Reg. Section 1.1361-1(l)(4)(iii)(B)(1), a call option will not be treated as a second class of stock if it is issued by a corporation 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.

(E) Options Issued to Employees or Independent Contractors. Treas. Reg. Section 1.1361-1(l)(4)(iii)(B)(2) provides that a call option issued to an individual who is either an employee or an independent contractor in connection with the performance of services (and that is not excessive by reference to the services performed) will not be treated as a second class of stock if two requirements are met.

[1] Nontransferable Option. The call option must be non-transferable within the meaning of Treas. Reg. Section 1.83-3(d). If, however, the call option later becomes transferable, this safe harbor will no longer apply.

[2] No Readily Ascertainable Fair Market Value. The call option must not have a readily ascertainable fair market value within the meaning of Treas. Reg. Section 1.83-7(b) at the time the option is issued.

(F) Safe Harbor for Certain Options. Under Treas. Reg. Section 1.1361-1(l)(4)(iii)(C), where the strike price of a call option is at least 90% of the value of the underlying stock on the date the call option is issued, transferred to a person who is not an eligible shareholder or is materially modified, as the case may be, the option will not be treated as a second class of stock.

[1] Good Faith Determination of Value. The regulations provide that a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of value was not performed with reasonable diligence to obtain a fair value. Treas. Reg. Section 1.1361-1(l)(4)(iii)(C).

[2] Failure to Meet Safe Harbor. The failure to meet this safe harbor will not automatically result in such option being treated as a second class of stock. Treas. Reg. Section 1.1361-1(l)(4)(iii)(C).

(G) Convertible Debt. Treas. Reg. Section 1.1361-1(l)(4)(iv) provides that a convertible debt instrument will be considered a second class of stock if either of the following requirements are met.

[1] Recharacterization as Equity. A convertible debt instrument will be considered a second class of stock if it is treated as equity under general principles of federal tax law governing the distinction between debt and equity ***and*** a principal purpose of issuing or entering into the instrument, obligation or 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. This is the same test set forth above for determining whether other instruments, obligations or arrangements are considered a second class of stock.

[2] Equivalence to Call Options. A convertible debt instrument will additionally be considered a second class of stock if it embodies rights equivalent to those of a call option that is substantially certain to be exercised and has a conversion price that is substantially below the fair market value of the underlying stock on the date of issuance, transfer to an ineligible shareholder or material modification.

[c] Straight Debt Safe Harbor.

[i] General Definition.

Treas. Reg. Section 1.1361-1(l)(5)(i) defines straight debt as a written unconditional obligation (regardless of whether embodied in a formal note), to pay a sum certain on demand or on a specified due date, which:

(A) Interest Rate. 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) Convertibility. Is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and

(C) Permissible Shareholder or Person Regularly Engaged in Business of Lending. Is held by an individual (other than a nonresident alien), an estate or a trust described in Section 1361(c)(2), or a person which is actively and regularly engaged in the business of lending money.

[ii] Subordination.

Treas. Reg. Section 1.1361-1(l)(5)(ii) clarifies that if an obligation is subordinated to other debt of an S corporation this will not prevent the obligation from qualifying as straight debt.

[iii] Modification or Transfer of Straight Debt.

Treas. Reg. Section 1.1361-1(l)(5)(iii) provides that where an obligation originally qualifies as straight debt, such obligation will cease to qualify as straight debt in the following circumstances.

(A) Material Modification. An obligation will cease to qualify as straight debt if it is materially modified so that it no longer satisfies the definition of straight debt.

(B) Transfer to an Ineligible Shareholder. An obligation originally qualified as straight debt will no longer qualify as straight debt if it is transferred to a third party who is not an eligible S corporation shareholder, including an otherwise eligible person who would constitute the corporation's 101st shareholder.

[iv] Treatment of Straight Debt.

Treas. Reg. Section 1.1361-1(l)(5)(iv) provides that an obligation qualifying under the straight debt safe harbor will not be treated as a second class of stock even if it is considered equity under general principles of tax law. Rather, such an obligation will be treated as debt for all purposes, so that interest paid or accrued with respect to a straight debt obligation will generally be treated as interest by the corporation and the recipient and will not constitute a distribution under Section 1368. Where a straight debt obligation bears an unreasonably high rate of interest, however, an appropriate portion of such interest may be recharacterized and treated as a payment that is not interest. Nevertheless, such debt will not result in the corporation being treated as having more than one class of stock.

[v] Conversion of a C Corporation Into an S Corporation.

Under Treas. Reg. Section 1.1361-1(l)(5)(v), where a C corporation has an outstanding obligation satisfying the definition of straight debt that is considered equity under general principles of federal tax law, such obligation will not be treated as a second class of stock if the C corporation converts to S status and such conversion will not be treated as an exchange of debt for stock.

[vi] Inadvertent Termination Relief**.**

Treas. Reg. Section 1.1361-1(l)(6) now makes it clear that inadvertent termination relief under Section 1362(f) will be available where an S corporation's election is inadvertently terminated because of a breach of the one class of stock requirement.

Part 2 of this outline, which will appear in the Spring issue, will address the sale and purchase of S corporation stock, planning opportunities and pitfalls in connection with terminating elections, the Section 338(h)(10) election, tax-free organization, and special elections relating to QSUBs.